

BlueCrest testimony to House Finance Committee 4/4/2016



Slide 1

Good afternoon co-chairs Thompson and Neuman, and members of the Committee. Thank you for the opportunity to comment on this very important issue of proposed changes to Alaska's oil and gas tax laws.

For the record, my name is J. Benjamin Johnson, and I'm the president and CEO of BlueCrest Energy Inc. Although BlueCrest is based in Texas, we definitely have Alaskan roots. My family first moved to Anchor Point in the early 1950's. I grew up in Kenai and graduated from Kenai Central High. I worked my way through college on Cook Inlet platforms and at Prudhoe Bay. Then after college, I came back home to Alaska, doing some of the early engineering work for ARCO on Prudhoe Bay and Kuparuk. In total, BlueCrest senior management has over 40 years of collective experience working in Alaska's oil and gas industry.

Since BlueCrest only has operations in the Cook Inlet at this time, I will only speak to the issues particular to the Cook Inlet, with a specific focus on the following points:

First, I want to emphasize that, specifically with regard to what BlueCrest is doing in the Cook Inlet, the tax credit program is a very good investment for the State. And I want to strongly encourage you to consider that any changes made to the system (whatever they may be) need to be well-planned with regard to the long-term consequences and done in an orderly progression over time.

BlueCrest has not been involved in drilling "wildcat" exploratory wells. We have focused on low-risk development of previously-identified resources of oil and gas. In the process of delineating the field in 2013, we discovered several new oil and gas zones that added to the total reserves, but the underlying basis of the oil and gas accumulation was already known at that time. The bottom line is that the State's investment in development of known reserves has a much lower risk factor than support for higher-risk exploratory drilling.

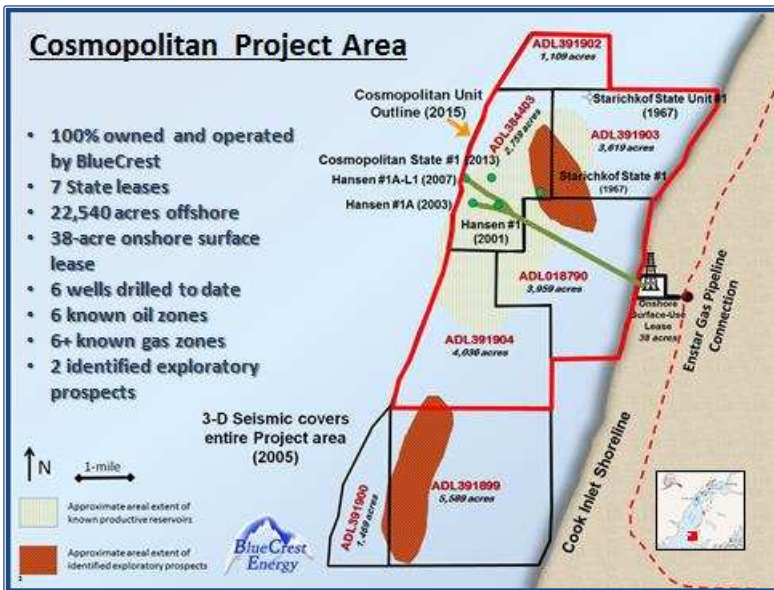
BlueCrest Energy was formed by a group of former major oil company executives, each of whom have extensive experience in developing and managing large oil and gas assets. Our original business plan was to find some oil and gas properties with already-identified reserves that could potentially be improved using our backgrounds and knowledge of

industry technology. We evaluated dozens of acquisition opportunities around the US (offshore California, Gulf of Mexico, Wyoming, Colorado, Texas, Louisiana and Alaska). Alaska's huge handicap was – and continues to be – that the exploration, development and operating costs in the State are at least three hundred percent of any other major hydrocarbon basin in the US. But we ultimately decided to invest in Alaska because, through the credit programs, the State was investing in itself, and that investment – the State's credits – somewhat offset the higher costs of drilling and development.

BlueCrest is in Alaska today directly as a result of the State's incentives programs. And it is the State's investment through the tax credits that has facilitated success in the Cosmopolitan Unit, which we are now moving into its first production. As I will demonstrate today, these credits will provide substantial future positive value to the State. I'm going to show you that the State's investments in the Cosmopolitan tax credits will provide high returns even at low oil prices. In fact, the tax credit investments under the current laws can actually provide higher rates of return to the State than the average investments in the Permanent Fund.

Second, I'd like to give you a quick overview of the Cosmopolitan Unit, or "Cosmo" as we call it. And I will show you the calculations made by both BlueCrest and the DOR showing the very favorable investment returns to the State as a result of the tax credits.

And finally, I will address the direct impact to BlueCrest of critical specific factors in HB247 and the CS.



Slide 2

The Cosmopolitan Unit is located about three miles offshore in the Cook Inlet, a few miles north of Anchor Point. All of the productive area in the unit is on State leases. We also have an onshore surface lease that contains the production facilities and the drill sites for drilling wells to the offshore leases. For the interest of time, I won't repeat my prior testimony to House Resources concerning the lengthy Cosmo history. But suffice it to say that the field was originally discovered in 1967. BlueCrest acquired the leases in 2012, and we are about to finally start-up the initial production this month. We drilled a very critical well in 2013 and gained new information that has allowed us to finally develop the field employing technology currently available today.

Cosmopolitan Unit Development Concept

- Separate oil and gas reservoirs are located approximately three miles offshore in the Cook Inlet
- The oil reservoirs can be reached by drilling wells from onshore
- The gas reservoirs are not as deep and can only be reached with offshore wells and platforms
 - Gas development is now on hold due to:
 - Economic limitations
 - Market demand constraints

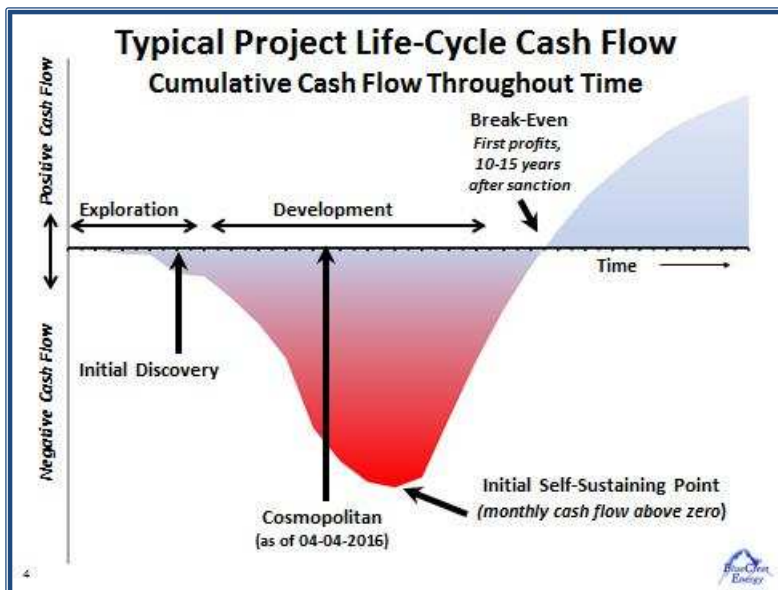
The diagram illustrates the geological structure of the Cosmopolitan Unit. It shows a cross-section of the earth with a brown landmass on the right and a blue ocean on the left. Two reservoirs are depicted: a red 'Gas Reservoir' closer to the surface and a green 'Oil Reservoir' deeper below. Onshore, a drilling rig is shown with wells extending to the oil reservoir. Offshore, a platform is shown with wells extending to both the gas and oil reservoirs. A text box on the right states: 'Onshore oil development began in 2014 and is now underway, relying on the existing tax credit structure'. A small logo for 'BlueCrest Energy' is in the bottom right corner of the slide.

Slide 3

The Cosmopolitan Unit actually consists of two separate development projects. The oil zones are deep enough that they can all be reached from an onshore drill site, using a very powerful land-based drilling rig.

We are now proceeding with development of the oil zones from onshore, but the offshore gas development is on hold due to economic limitations on costs and confirmation of sufficient market demand. The Cosmopolitan gas zones are simply too shallow to make drilling from onshore a possibility. So the gas zones will need to be developed by drilling gas wells offshore with a jack-up rig and setting small dry-gas production platforms over the wells. The gas will then be piped through sub-sea pipelines from the platforms to the onshore oil production facility. This is, of course, quite expensive. The Cook Inlet gas market is quite unique, in that the limited current demand for the gas (without some larger user such as Agrium) does not facilitate development of large new gas field like Cosmopolitan to spend all the money to get it on production and then shut it in. It is important to understand that, although we know there is a large quantity of gas, it will take several years to get it developed. And we are faced with another particular challenge, in that the one currently available offshore rig we could use cannot afford to sit idle in the Cook Inlet for years into the future without being put to work now. Once that rig leaves, it may be very difficult (and will certainly be very expensive) to bring in another rig in the future.

But with regard to the oil development that we could start right away and given the success of our 2013 drilling program, we were then faced with the challenge of how to pay for development of the new field. Right now, BlueCrest is a small private company with a singular focus of developing the Cosmopolitan Unit. The members of our management team all have extensive technical and business experience in developing projects like this, but the potential costs far exceeded our personal financial capabilities. So we teamed with a group of oil industry investors who have much greater financial capabilities, and we very carefully created our plan with them for financing the development of Cosmopolitan.



Slide 4

Now I'd like to digress for just a minute to explain something that's really important to understand about oil and gas developments. This next chart figuratively shows the cumulative cash flow over time for a typical life cycle of a successful oil or gas development. When the curve goes down, it means that the company is spending more cash in a month than it is bringing in. When the curve is rising, it means that the company is receiving more revenues than it is spending. But as long as the curve is below the horizontal axis, it means that the company has cumulatively spent more money than it has received on the project. When the curve (hopefully) eventually goes above the axis, that's when the company finally begins to receive a return on its investment. There can be no profits whatsoever until the curve is above the axis. And prudent oil or gas developers will never begin such a project unless they believe that it will eventually provide enough future revenues to justify the large initial expenditures.

What is important to note about this chart is that the successful development of a new oil or gas field is a very long process and requires a lot of money to be spent before any profits can be generated. You can see that the very first stage is spending money to explore. At this stage, there is no assurance that anything will be found. The only way to know that an area will be productive is to spend lots of money to drill expensive wells, and then test them if it looks like there may be some potential. The vast majority of exploration prospects are, in fact, dry holes – the money spent will never be recovered. Just because you might drill a lot of wells does not guarantee you're going to discover anything.

But in the minority situation where the exploration process is successful, then the really huge cost of developing the field comes into play. In many other basins around the world, producers can just simply set up a tank and start flowing a new oil well into it with the produced gas either being flared or venting into the atmosphere. In Alaska, however, we have higher standards. BlueCrest takes a very strong stance on safety and protecting the environment, and it costs a lot of money to do it right. Before we can sell the first barrel of oil from a new well, we have to have a way to collect all the associated gas and water to make sure that nothing makes its way into the atmosphere or the environment. That means construction of drilling sites and sophisticated production facilities with the ability to safely handle everything that comes out of the wells. So you can see that, after the discoveries have already been made, this curve starts to go very negative. Whenever this curve goes lower, it means that we have had to come out of pocket to put more investment into the project. In our case with developing the Cosmopolitan oil zones, we expect that we will have to spend about \$525 million dollars before we can – hopefully – get to the point that we are finally generating enough money from sales of the oil to cover the monthly costs. It will have taken decades to get from the first exploratory well to the point where we don't have to keep spending more money than we are receiving.

Now, what a lot of people get confused with is this point at the bottom of the curve where it begins to turn up for the first time. That simply means that the project is finally paying out more money on a monthly basis than we are putting into it. But that DOES NOT mean that any profits have been made or that the project has broken even. No profits can be generated until the curve comes all the way back up to the zero point. The zero line here is the break-even point. Or, in other words, all of the investments over time have been repaid at that point but no profits have yet been generated.

To further complicate the issue is that we have to consider the fact that this curve represents development of a **successful** exploratory prospect. In fact, the vast majority (anywhere from 2/3 to 90%) of exploration projects do not find economic oil or gas. So, for the industry to survive, we have to at least be able to generate enough profits on the successful developments to pay for the losses on the exploration failures.



Slide 5

So let's talk more specifically about Cosmopolitan. Right now, we are just days away from the very first commercial production of oil that will begin with minor production from one of the old wells. Next, we have to bring in our new specialized drilling rig and start spending over \$40 million per well to bring on the new production that can finally start paying off the loans. And that can't happen until we have finished the drill sites and the production facilities, which will occur mostly in the second half of this year and the first half of 2017.

These photos show the progress we have made so far with the onshore Cosmo production facility after about two years of construction. The total site is 38 acres, and contains the drill sites for up to 20 wells and the facilities to process up to approximately 10,000 barrels per day of new oil production. The site includes a 50-person camp for housing our operations and drilling workers, and we are already connected into the Enstar gas line for sales of our gas into the Southcentral gas supply. We are also designed to allow expansion of this facility as needed to handle additional production increases in the future. Of course that's going to depend on the performance and number of new wells that we can drill. We are now almost complete in our construction process, and we are now running the final operational tests of all the components. We are on schedule for starting the first oil production later this month.

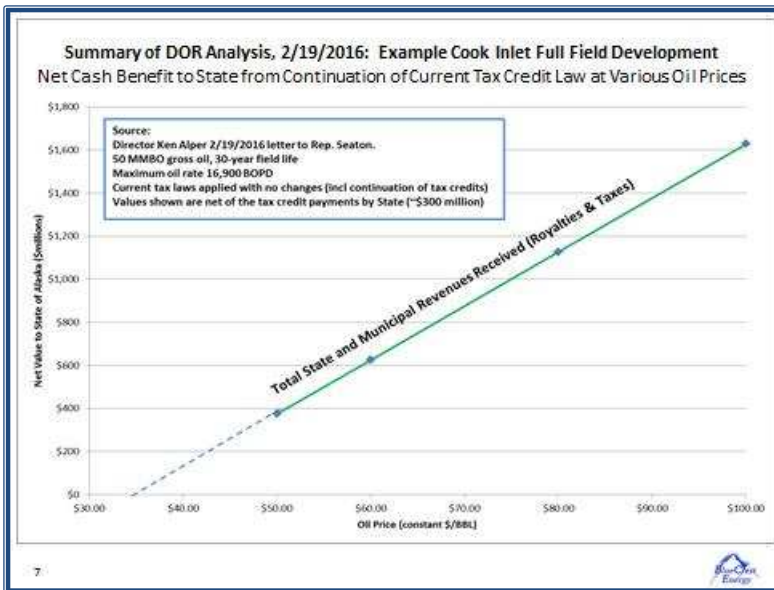
Tax credits for development of previously-discovered proven reserves are a solid, low-risk investment for Alaska.



Slide 6

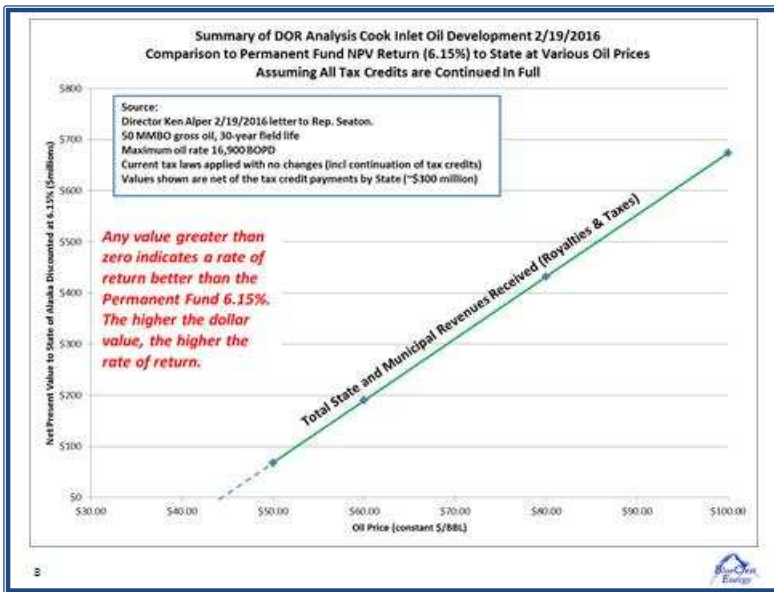
So let's look at what the tax credits from a successful development project like Cosmopolitan actually mean to Alaska. When the tax credits are used for development of new proven reserves in the State, they are – without question – a valuable low-risk **investment**. Speaking of the credits as a cost or a “give-away” completely ignores the substantial value that is received by the State. The tax credits make new projects work, and they bring new sources of long-term revenues to the State for decades into the future.

At Cosmo, we are sitting on a large proven resource of future oil and gas that now simply requires additional new investments to bring it to full production. On February 19, the DOR provided its analysis of the financial impact to the State on development of a new Cook Inlet oil field, assuming that no changes are ever made to the existing tax laws (including tax credits and production tax rates). DOR's analysis modeled an example Cook Inlet field that is somewhat more expensive and less productive than the actual Cosmopolitan oil development. So the DOR's calculations are, in fact, conservative. Their analysis assumed only 50 million barrels of ultimate oil recovery and a maximum oil producing rate of about 17,000 barrels per day, which would represent the low side of our future Cosmo expectations. The total capital costs it assumed were about \$600 million, and it assumed that the full tax credits, as currently written, would continue indefinitely into the future.



Slide 7

This chart is a summary of the calculations the DOR provided. It includes a summary of the total net benefit received by the State and municipalities, including taxes and royalties, as a function of various future oil prices. It shows that, if oil prices over the entire field life average only about \$35 per barrel, the State would break-even. In other words, the State would receive back 100% of its investments in the tax credits (unchanged from current law for many years into the future). At about \$47 per barrel average oil price, the State would receive back double the amount of its investment in the tax credits. And at about \$59 per barrel average oil price, the State would receive back triple its investment in the tax credits.



Slide 8

The DOR also provided their calculations showing the impact of the tax credits as a pure investment, with a head-to-head comparison to the investments by the Permanent Fund. According to the DOR, the Permanent Fund’s September 2015 earnings were 6.15%. So if an alternative investment earned less than 6.15%, it would have a worse performance than the average investments in the Permanent Fund. On the other hand, if an alternative investment earned more than 6.15%, it would be a better investment than what the Permanent Fund had in place in September 2015.

This chart shows that, even in the case where there are never any changes to the tax system in the Cook Inlet (that is, all tax credits stay in place and there are no oil production taxes until 2022), the State’s investment in those tax credits for the example field is still better than the average investment in the Permanent Fund as long as oil prices over the next 30 years average only \$44 per barrel.

Now I’d like to provide our additional comments on particular portions of the bill specific to BlueCrest and the Cosmopolitan Unit.

Continuation of 023(a) and 023(l) Credits

Continuation of the 023(a) and 023(l) credits is a good investment for the state.

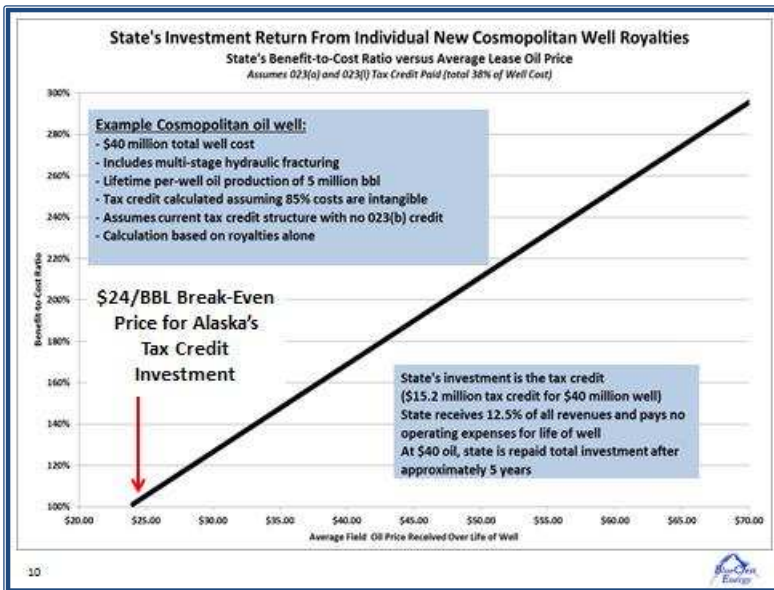
Termination of the 023(l) credits will result in a significant reduction of BlueCrest's ability to continue drilling at Cosmopolitan.

Continuation of the 023(l) credits facilitates Cosmopolitan continued drilling at ~\$10/BBL lower oil prices.



Slide 9

First of all, termination of the 023(a) and 023(l) credits would result in a significant reduction in our ability to continue making investments in the Cosmo oil wells, resulting in less future revenues to the State. The Governor's original bill completely eliminated the 023(l) (Well Lease Expenditure) credits, effective immediately. The House Resources CS temporarily retained the 023(l) credit but effectively scaled it down to 20% over two years from the current 40% and reduced the NOL credit from 25% to 10%.



Slide 10

We've done some interesting analyses of the value to the State in keeping both the 023(a) and 023(l) credits as they apply to Cosmopolitan. We looked at the effective return to the State using a simple and conservative calculation including only the incremental royalty for each single new Cosmopolitan oil well drilled. This calculation does not even include the production taxes that would be paid after 2022 nor does it include property taxes. The bottom line is that, in periods of low oil prices, the 023(a) and 023(l) credits allow us to continue drilling the Cosmopolitan oil wells at approximately \$10 lower oil prices than without the credits. This is likely to be an important factor in our 2017 capital program.

This next chart shows the calculated return on investment to the State (including ONLY the royalties) from the 023(a) and (l) credits. A 100% return on investment means that 100% of the tax credit would be repaid out of increased royalties over the life of the well at an average oil price of only \$24 per barrel. At \$40 per barrel, the total return would be about 170%, and at \$60 per barrel, the return would be about 250%. So you can see that these credits, at least for Cosmo, are likely to be a very good investment for the State.

Per-company limitations for cash payments:

- **Arbitrary**
- **Particularly disadvantages small companies like BlueCrest who have invested but do not yet have production**
- **BlueCrest has invested in good faith, based on the tax policy in existence when the investments were committed**
- **BlueCrest has financed the Cosmopolitan development assuming the credits would be paid on time**
- **The state is backing out on its prior commitment if previously-filed credits are not paid**
- **A strong disincentive for future investments**



Slide 11

Another factor in the original bill was setting a limitation in the amount of the credits that can be paid annually. While the CS provided for a larger limit (that probably would not negatively affect BlueCrest), it still does not recognize the differences in qualified investments made by different parties. If this limit is too low, it would be particularly damaging to small companies like BlueCrest who have already invested in good faith, based on the tax policy in existence when we entered into the commitments for our investments. We came to Alaska based on the credits. We invested our cash, and we have borrowed a lot of money and committed to spending a lot more – all based on the tax credits. And the timing of the receipt of those payments for the credits is paramount in our ability to make the payments on the loan used for making those investments.

Effective Date for Changes (July 1, 2016 – July 1, 2017)

BlueCrest has already contracted for work that will take place over the next year. Funding of that work was based on current tax laws/credits.

BlueCrest's funding plan for initial Cosmopolitan oil development

Total cost: \$525 million

Funding sources

Cash investment by shareholders:	\$200 million
AIDEA loan on drilling rig:	\$30 million
Development loan:	\$150 million
Tax credits received to date:	\$24 million
Tax credits for 2015-2016 spending under current law:	\$121 million

Slide 12

Most important of any of these provisions to BlueCrest is the timing of implementation of any changes, whatever they may be. It is now April, and the proposed changes in the original HB247 are supposed to take place on July 1. The CS moved that date back, which certainly helped but does not completely solve the problem.

BlueCrest has been very careful in its financial planning process. Before we ever started the oil development project, we made sure that we would have enough funds to allow us to complete construction of the onshore drill site, production facilities, bring in the most powerful drilling rig in Alaska, and to drill at least the first two new oil wells. We calculated that we would need approximately \$525 million to reach the point of self-sufficiency (where we no longer have to keep borrowing additional money to put into the project). And we expect that should happen in the first half of 2017. In order to make that work, our shareholders invested approximately \$200 million in cash. We have borrowed \$30 million from AIDEA for a loan on the drilling rig. We secured a \$150 million high-interest development loan. We have received \$24 million to date in tax credits. And the remaining \$121 million was to come from credits earned for 2015 and 2016 spending under the current tax laws. We have spent a lot of money to get to the point where we can now start drilling these new wells, but an abrupt termination of the tax credits on which we have based our entire financial planning would be devastating.

We have finally reached the point – by completing all this work and spending all this money– to where we will finally have our drill site and rig ready to drill in the second half of 2016 and the first quarter of 2017. We need the production from the first new wells to pay for the costs we have spent so far. Those drilling costs – at least through early 2017 – are all based upon the assumption that we will be able to obtain the credits under existing law for those investments. We have done all this work and spent all this money to date, and it seems only reasonable for us to be able to claim the existing credits for the spending that is the result of our investments made in good faith based on the expectation that the State would honor its share of the investments. We need to be able to be able to get to the finish line. If the date for changes in the original bill (just three months from now) was reinstated, we would not have the full funding for finishing the initial part of the project, although we have basically already committed those investments. Not paying the credits that were the basis for the investments we've made is like saying "you can spend the money for a new house, but now you just can't ever move into it."

**When we are driving on
slippery icy roads, the most
dangerous thing we can do is
suddenly slam on the brakes!**



Slide 13

In conclusion, I'd like to reemphasize the importance of phasing-into any changes over a reasonable time period. Everyone in this room today understands that when we are driving on slippery icy roads (like the State of Alaska and Alaska's oil and gas industry is faced with today), the most dangerous thing we can do is suddenly slam on the brakes.

We appreciate your careful consideration of these important issues that will have far-reaching implications into Alaska's future.