BlueCrest Testimony to Senate Finance Committee 4/13/2016

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Good afternoon Madam Chair and members of the Committee.

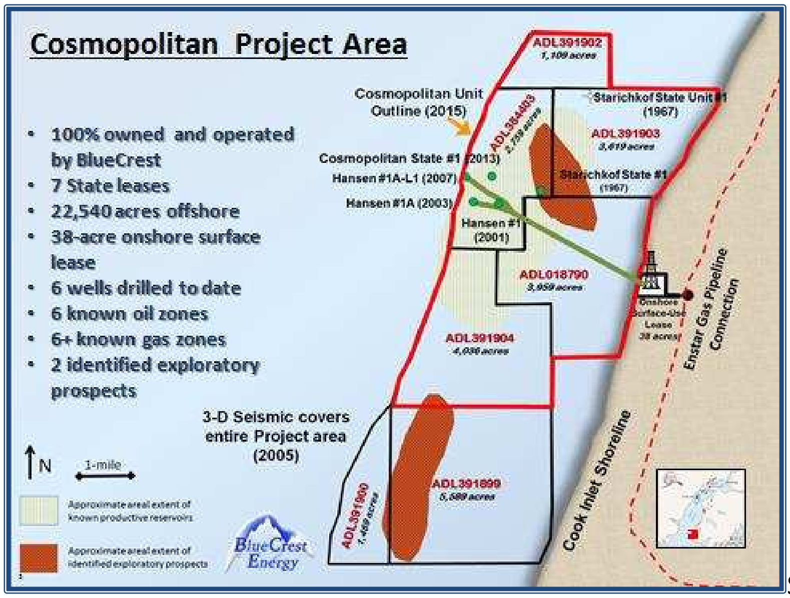
For the record, my name is J. Benjamin Johnson, and I'm the president / CEO of BlueCrest Energy Inc.

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 an extremely good investment for the State.

Second, the State's investment in Cosmopolitan through the credit program will provide significant future positive value to the State, even at low oil prices. And it is the State's investment through the tax credits that has facilitated success in the Cosmopolitan Unit. 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.

Third, I will speak to several specific issues we have identified in SB 130 and the CS from Resources.



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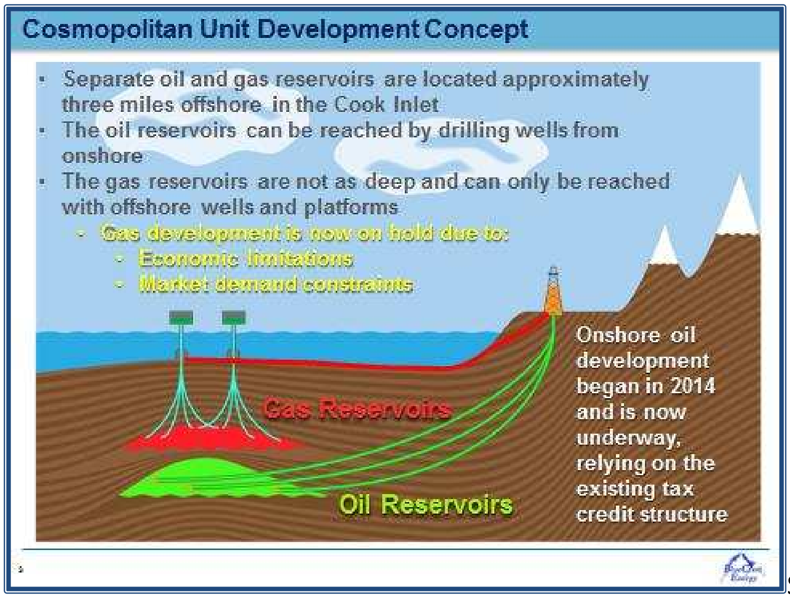
For your reference, the Cosmopolitan Unit is located about three miles offshore in the Cook Inlet, a few miles north of Anchor Point. All of the productive area in the unit is on State leases.



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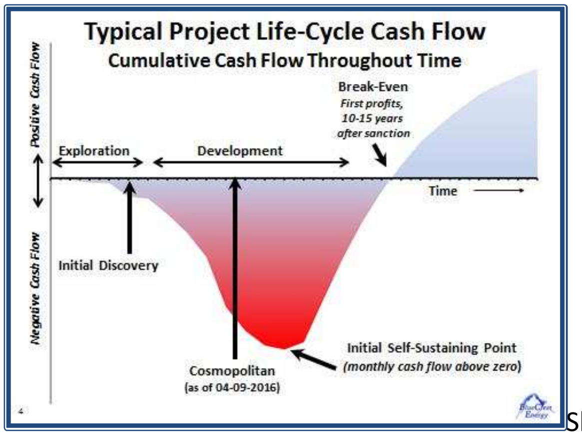
The Cosmopolitan Unit actually consists of two separate development projects. There are numerous productive gas zones directly above underlying oil zones, and the gas reservoirs are not connected to the oil reservoirs.

We haven't yet started developing the Cosmopolitan gas zones. The offshore Cosmopolitan gas development is now on hold, due to economic questions on tax credits, costs and confirmation of stable long-term market demand.

But development of the deeper oil reservoirs was more straightforward. And two years ago, based on the tax regime in the Cook Inlet under current laws, we committed to begin development of the oil reserves. BlueCrest is a small private company with a singular focus of developing the Cosmopolitan Unit, and we are very careful in development of our business plans. This is a large project for our company, and we were faced with the challenge of how to *pay* for development of the new field. We teamed up with a group of oil industry investors, and we very carefully created our plan with them for financing the development of Cosmopolitan.



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I have shown this conceptual slide in previous testimony, so I won't go into the details. However, the main point to see here is that any oil and gas development is a long process. It takes a lot of spending just to get to the point where we are bringing in enough cash to cover our monthly costs without additional investment or borrowing.

We estimate that it will have taken investments of over $500 million to reach that point for Cosmopolitan, and BlueCrest is within about 6-9 months of getting there.

As you can see, we still have considerable additional investments to make in drilling a few new wells later this year that should provide enough cash flow to at least make our debt service payments going forward. And we've already committed to that spending, based on the existing tax credit structure. So the timing of any changes over the next few months is very important to us.

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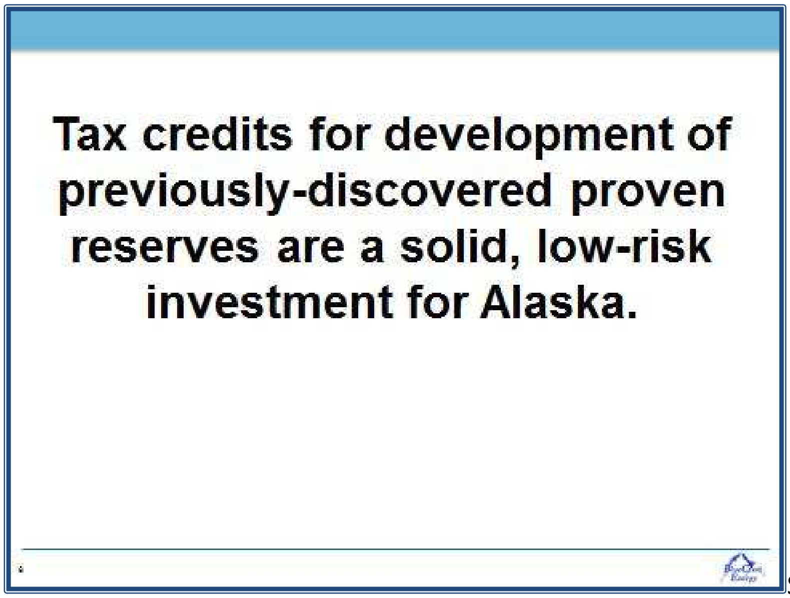
So let's talk specifically about Cosmopolitan. We've been working on the oil development for over two years, and right now, we are literally a few days away from the very first commercial production of oil. Next, we will bring in our new specialized drilling rig and start drilling new wells to bring on the production that can finally start paying off our loans. And that new drilling cannot begin until the second half of this year.

These photos show the progress we have made so far with the onshore Cosmo production facility. The total site is 38 acres, and contains the drill sites for up to 20 wells and the facilities to process the oil. We are almost complete in our construction process, and we are now running the final operational tests today. We will have our new drilling rig in place to begin drilling the new wells by July 1 of this year.



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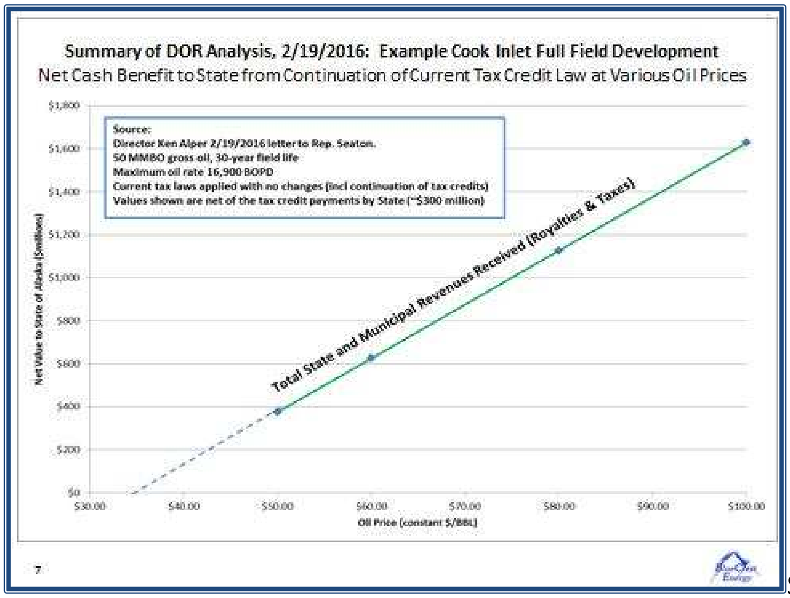
So let's look at what the tax credits from a successful development project like Cosmopolitan actually mean to Alaska. When the tax credits are used for development of new proven reserves in the State, they are – without question – a valuable low-risk **investment**. The tax credits make new projects 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. DOR's analysis modeled an "example" Cook Inlet field that happens to be somewhat similar to Cosmopolitan – but is more expensive and less productive than the actual Cosmopolitan oil development. So the DOR's calculations are, in fact, conservative with regard to Cosmo.



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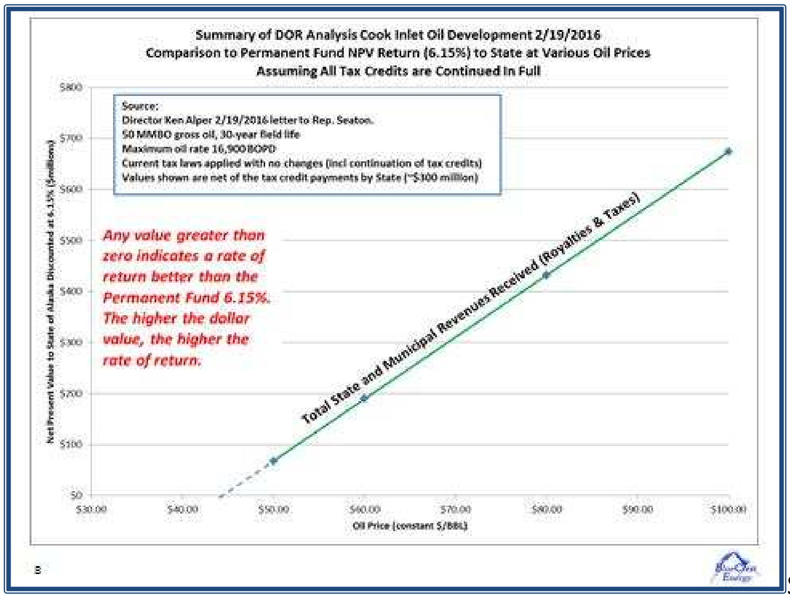
This chart is a summary of the calculations the DOR provided for their “example” field. It shows the total net future benefit received by the State and municipalities, as a function of various future oil prices. It shows that, even for this conservative example, the State would receive back 100% of its investments in the tax credits if oil prices over the entire field life average only about $35 per barrel (assuming no changes to the current law). At about $59 per barrel average oil price, the State would receive back triple its investment in the tax credits.



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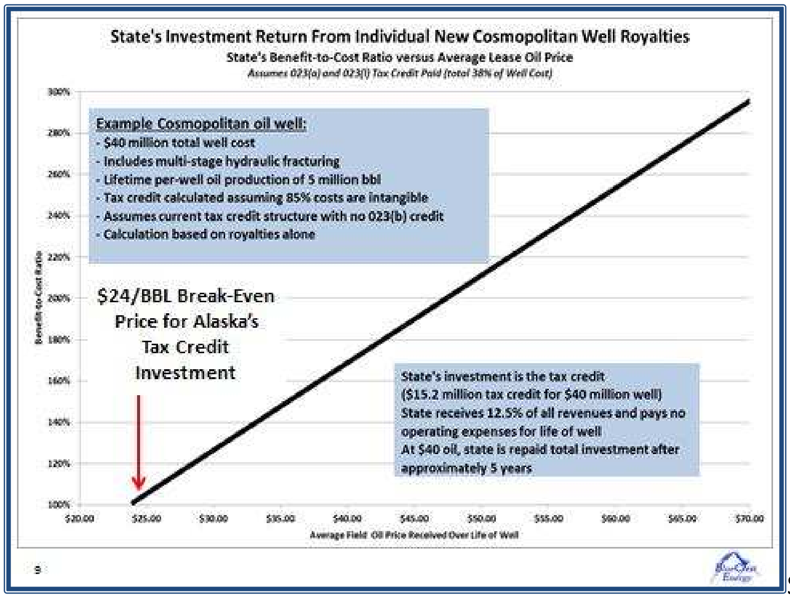
The DOR also provided discounted-cash-flow calculations for this example field, with a head-to-head comparison to the investments by the Permanent Fund. At any point on this chart greater than zero, the State would earn a better return through its investments in the tax credits than its investments in the Permanent Fund.

This chart shows that, even in the case where there are never any changes to the tax system in the Cook Inlet, 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.



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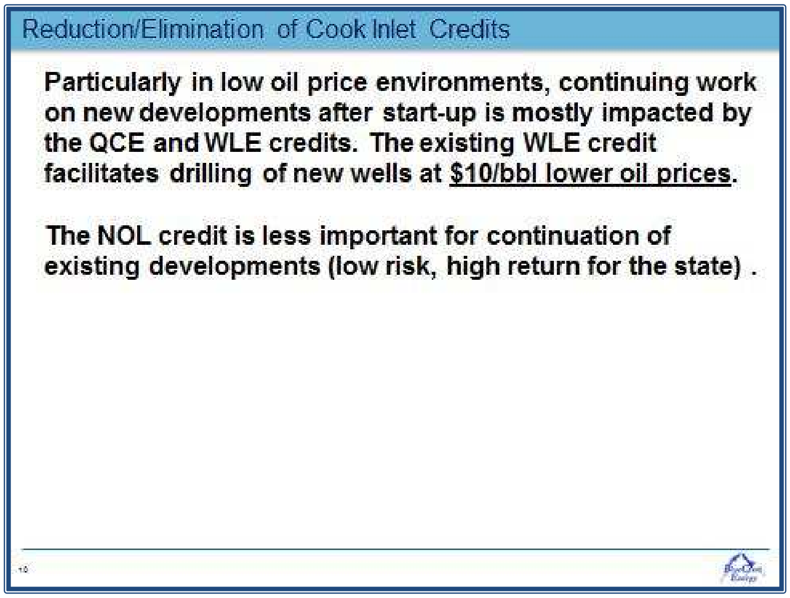
Now I'd like to show you BlueCrest's internal analysis of the value to the State in keeping the Qualified Capital and Well Lease Expenditure credits as they apply to new oil wells drilled at Cosmopolitan. We projected the net return to the State using a conservative calculation including only the incremental royalty for each single new Cosmopolitan oil well drilled.

This chart shows the calculated return on investment to the State from the WLE and QCE. A 100% return on investment means that 100% of the tax credit would be repaid to the State 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 low-risk investment for the State.



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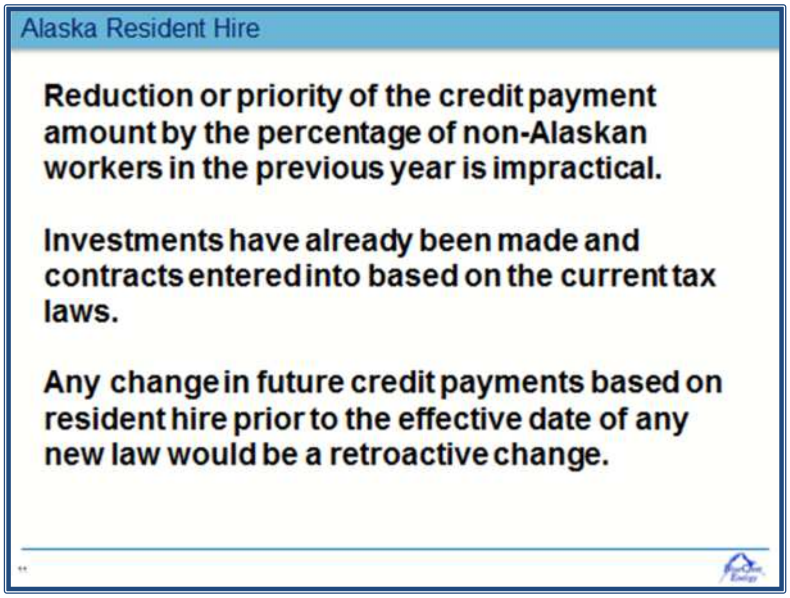
The bottom line here is that, in periods of low oil prices, the QCE and WLE credits allow us to continue drilling the Cosmopolitan oil wells at approximately $10 lower oil prices than without the credits. This is likely to be an important factor over the next few years and may allow us to continue drilling instead of shutting down the rig.

For us, the NOL credit is less important as we begin producing. So the most important credit for continuation of drilling in a development like Cosmo is the WLE.



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Under the CS, the tax credit repurchases would receive priority for payment based on the resident hire percentage in the prior year. While we certainly agree that we want to hire Alaskans for our operations, imposition of any reductions in credit payments for expenditures that were made prior to the effective date of a new law is truly a retroactive tax change.

For credits filed in 2016 (for 2015 expenditures) and those filed in 2017 (for 2016 expenditures prior to the new law taking effect), there would have been no way for us to even keep records. Retroactively changing the laws is grossly unreasonable. If this provision is adopted, a longer transition time should be considered.

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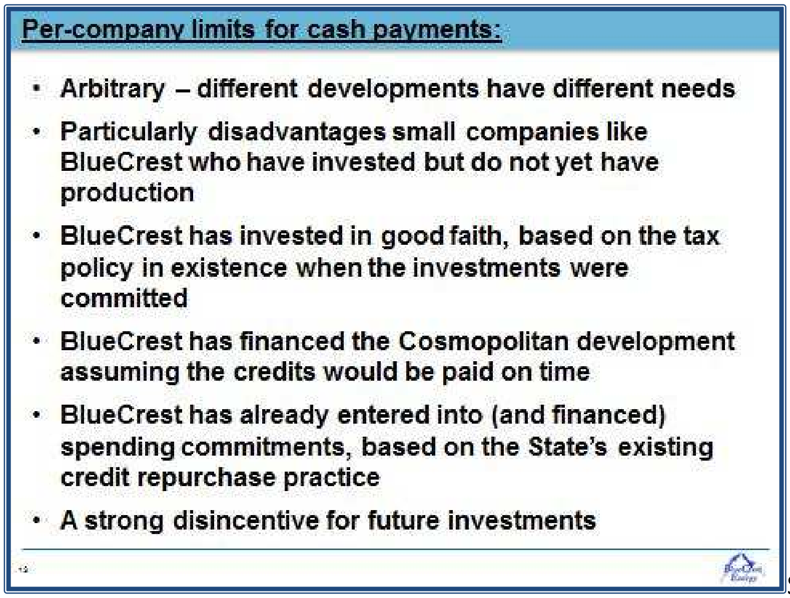
For the record, BlueCrest is strongly committed to hiring Alaskans. At this point, 100% of all our long-term operations employees are Alaskans. But making the future credit payments subject to hiring in the past is probably impossible to even measure. We can do it going forward, but I don't know how we go back in time.



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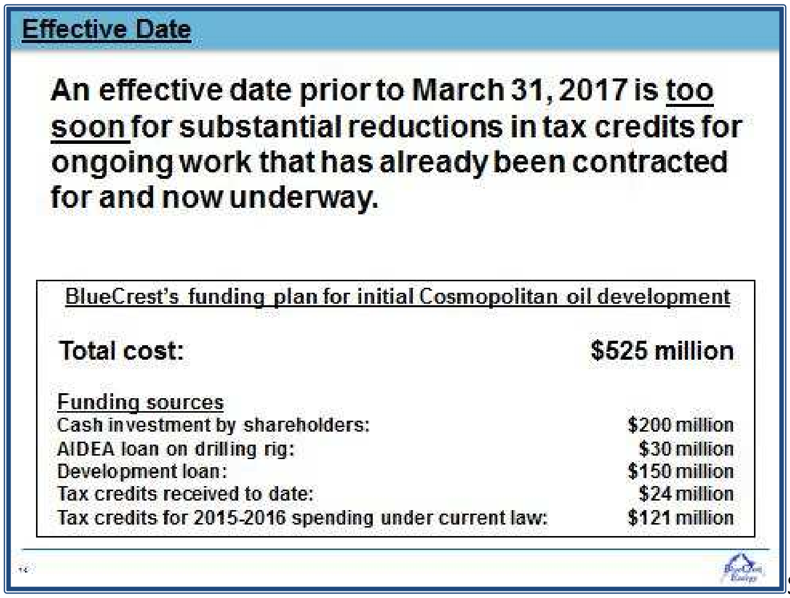
Another factor in SB 130 was setting a limitation in the credits that can be paid annually. If this limit is too low, it would be particularly damaging to small companies like BlueCrest who have already invested in good faith, based on the tax policy in existence when we entered into the commitments 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 obtained for those investments.



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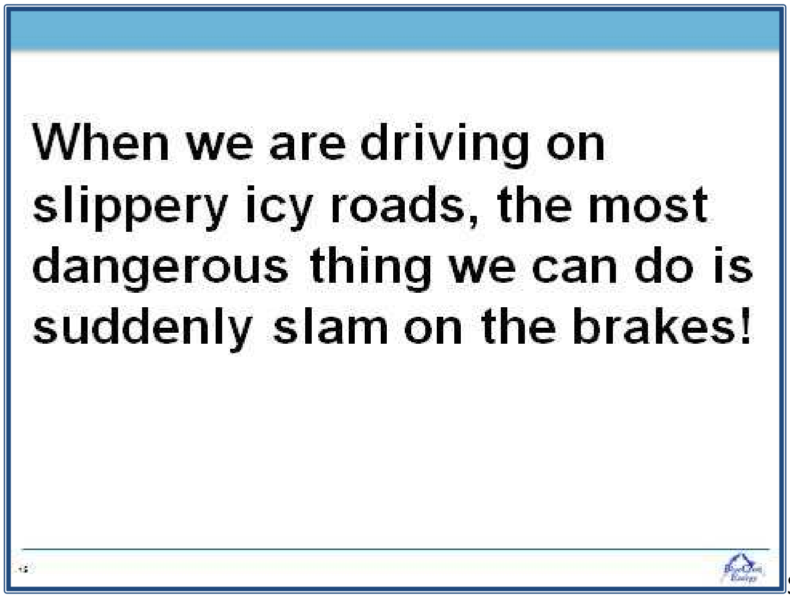
Most important of any of these provisions to BlueCrest is the timing of implementation of any changes, whatever they may be. It is now April, and the proposed changes in the original SB130 were supposed to take place on July 1. The CS has somewhat moved that date back, which would certainly help but may not completely solve the problem.

It's important to understand that, 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 use that rig to drill at least the first two new oil wells. We calculated that we would need approximately $525 million to reach that point of self-sufficiency (where we no longer have to keep borrowing additional money to put into the project). The timing here is very important, because we expect that should happen in the first half of 2017.

As I mentioned a few minutes ago, based on existing law, we very carefully planned how we could pay for development of the Cosmo project before we ever started. Our shareholders invested approximately $200 million in cash. We borrowed $30 million from AIDEA for a loan on the drilling rig (kind of like a car loan but for a drilling rig). We have already received a total of $24 million to date in tax credits. Under current laws, $121 million would come from future payment of credits earned for 2015 and 2016 spending (that's the total for two years). We then made up the difference by securing a $150 million high-interest development loan. 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. Any reduction in the credits for our spending through at least early 2017 would mean that we have to come up with that money from some other source. That's not easy in this oil price environment, and it may just simply be unworkable.

We have finally reached the point – by completing all this work and spending all this money– to where we will finally have our rig ready to drill in the second half of this year. 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 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 is too soon, we won't have the full funding for finishing the project, although we have already committed those investments. We've signed contracts, bought a drilling rig, built facilities – all based on the current laws in effect.



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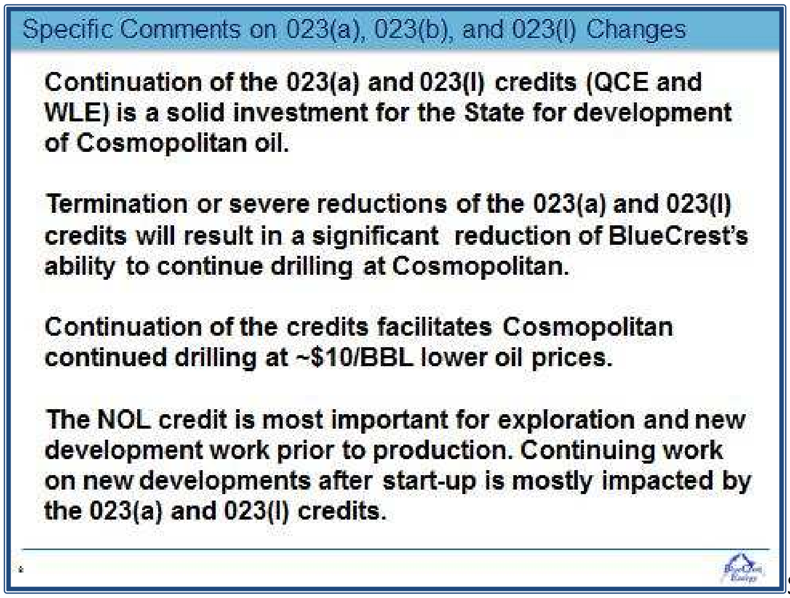
In conclusion, I’d like to reemphasize the importance of phasing-into any changes over a reasonable time period. Everyone in Alaska understands that when we are driving on slippery icy roads, the most dangerous thing we can do is suddenly slam on the brakes.

Thank you.



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First of all, termination or severe reduction of the Qualified Capital and Well Lease Expenditure 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 SB 130 completely eliminated the Well Lease Expenditure credits, effective immediately. Although we haven't yet seen the latest version, the House Resources and Finance committees have suggested reducing the credits by various amounts and phased-in over a longer time frame.

The NOL credit is valuable to a company in the exploration or early development phase prior to reaching the point of positive cash flow. But, as a company (like BlueCrest) continues expanding a known resource, the NOL credit becomes far less important and the Well Lease Expenditure credit becomes vital to continually increasing production through drilling new wells. In fact, the WLE credit (at its current level) effectively makes the oil price threshold for investing in drilling wells about $10 lower than without it.