

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

March 9, 2009

1:06 p.m.

MEMBERS PRESENT

Representative Craig Johnson, Co-Chair
Representative Mark Neuman, Co-Chair
Representative Bryce Edgmon
Representative Kurt Olson
Representative Paul Seaton
Representative David Guttenberg
Representative Scott Kawasaki
Representative Chris Tuck

MEMBERS ABSENT

Representative Peggy Wilson

COMMITTEE CALENDAR

PRESENTATION BY ARMSTRONG OIL & GAS: THE DIFFICULTIES OF DOING
BUSINESS IN ALASKA

PREVIOUS COMMITTEE ACTION

No previous action to report

WITNESS REGISTER

ED KERR, Vice President
Land & Business Development
Armstrong Oil & Gas, Inc.
Denver, Colorado

POSITION STATEMENT: Provided an overview of the difficulties of
doing business in Alaska, primarily in regard to gas exploration
and development in the Cook Inlet.

ACTION NARRATIVE

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CO-CHAIR CRAIG JOHNSON called the House Resources Standing
Committee meeting to order at 1:06 p.m. Representatives
Johnson, Neuman, Kawasaki, Olson, Seaton, and Edgmon were

present at the call to order. Representatives Tuck and Guttenberg arrived as the meeting was in progress.

PRESENTATION BY ARMSTRONG OIL & GAS: THE DIFFICULTIES OF DOING BUSINESS IN ALASKA

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CO-CHAIR JOHNSON announced that the only order of business would be a presentation by Armstrong Oil & Gas regarding the difficulties of doing business in Alaska.

ED KERR, Vice President, Land & Business Development, Armstrong Oil & Gas, Inc., began with a history of Armstrong Oil & Gas, Inc. (AOG), a 23-year-old company [headquartered in Denver, Colorado]. He said AOG is a true independent oil and gas company that carries no debt, so anything AOG does is out of its own hip pocket. The company became active in Alaska about 10 years ago and won its first lease on the North Slope in 2000 or 2001. To date, AOG has drilled 11 wildcats on the North Slope and has had various degrees of success. The Oooguruk project recently placed on line by Pioneer Oil Company was an Armstrong Project, as was the Nikaitchuq project that Eni is currently working on. The projects were sold to Pioneer and Eni because the capital expenditures associated with the two projects and the pace at which Armstrong's partners wanted to go were more than what Armstrong was ready to do, given that Armstrong carries no debt.

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MR. KERR said AOG is active in multiple states and the Gulf of Mexico and every state or location has its strength and weakness. The change in tax laws in the Cook Inlet was a catalyst for AOG to look into making capital investments there, he pointed out. Armstrong really scrutinizes an area prior to making capital investments because the company is in it to make a reasonable profit for its investment. Armstrong acquired the Northfork Unit in Cook Inlet three years ago after clearing up several pre-existing legal situations with it. The Northfork Unit was established in the 1960s and had only one well when it was acquired by AOG. In 2008 Armstrong successfully drilled a second well in the unit. However, he reported, the wells being found today are not as good as those found in the past.

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CO-CHAIR NEUMAN inquired whether the problems with the Northfork Unit were government or business related.

MR. KERR said Armstrong's overall experience dealing with the State of Alaska has been outstanding. On some narrow instances there are some challenges, he continued, but staff at the Division of Oil & Gas has been very amenable and has tried hard to work through any problems. The Northfork issues were created by the unit's previous owners, he explained. It was initially drilled by Union Oil Company of California (Unocal) and was owned by large oil companies for a long period of time. While these companies did not develop the unit, they did keep it in good legal standing. In the late 1990s the unit was purchased by a series of small individuals who parceled it out to even smaller individuals and that created the problems. The predominant problem was a lack of performance and another problem was the drafting of the granting documents.

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CO-CHAIR NEUMAN related his concern about state regulations that are imposed on industry and asked whether there are other regulations imposed by communities that make it difficult.

MR. KERR replied that at times AOG has had some challenges with communities, but for the most part the company has been able to work those out. However, he continued, some colleagues have had more significant issues than Armstrong. It is AOG's goal to move forward in getting a gas contract with any utility possible and to sell this gas to whatever communities is deemed best.

REPRESENTATIVE OLSON surmised that Armstrong is looking for gas on the Northfork Unit even though Unocal was originally looking for oil.

MR. KERR responded correct. The well drilled by Armstrong has confirmed gas in the Tyonek Formation. There is still some potential for oil in the Hemlock Formation and if AOG can work out the scenario for gas then it can pursue that oil as well.

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MR. KERR continued his presentation, stating that he will be talking with the Regulatory Commission of Alaska (RCA) in a couple of days. It is a good idea to keep people informed about Armstrong's activities and plans, he said. This prevents miscommunication and helps assure that AOG does not waste time

negotiating a gas contract that will not be agreeable to the RCA. If a project is not going to be agreeable to the RCA, then Armstrong is better off to pursue projects elsewhere.

CO-CHAIR JOHNSON requested that discussion be avoided about what may or may not be happening before a regulatory body. If the legislature wants to fix something it will pass a law, he said, but it is not the legislature's position to influence a regulatory agency.

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REPRESENTATIVE SEATON pointed out that this area is within his district. He said that in the past things have happened before the RCA that the community of Homer was not made aware of and the community fears that this gas will be exported from the local area, whether it be to Anchorage or overseas, without the building of infrastructure for local supply.

CO-CHAIR JOHNSON said this type of thing can be discussed, but he wants to avoid any specific docket that might be before the RCA. He added that he and Co-Chair Neuman have discussed having the RCA speak before the committee.

REPRESENTATIVE SEATON responded that he would like to know whether AOG can contract with communities or is prevented from doing so by the RCA.

CO-CHAIR JOHNSON said this type of question would be okay.

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MR. KERR remarked that the aforementioned discussion is duly noted. He reiterated that gas was found in the second well at the Northfork Unit and Armstrong's goal is to enter into a gas contract. He explained that the unique thing about oil and gas exploration and development is that until there is expansion and the drilling of additional wells, it is unknown how big or small an asset is. At this time Armstrong is comfortable saying that the Northfork asset is between 7.5 and 12.5 billion cubic feet (Bcf) of gas, he reported, and it may well be 20-60 Bcf or even larger. The issue associated with these numbers is that they are risk numbers and AOG will not know until additional wells are drilled. Armstrong has made a substantial investment to date in the Northfork Unit, he said. The next step is to get a gas contract and then AOG will move forward with developing the asset and drilling additional wells. Capital expenditures could

be anywhere from \$40 million to substantially more, depending on the well results.

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CO-CHAIR JOHNSON asked whether it is typical to get the contract prior to proving the reserve instead of the other way around.

MR. KERR replied that Armstrong is in between because the two wells have proven the reserves and now what needs to be done is proving the size of the reserves. This is the norm, he said. The unique situation in Cook Inlet compared to the Lower 48 is that there are a limited number of gas buyers. In addition, the Lower 48 has lots of gas pipelines already in place, which is not the case in the Cook Inlet. The challenge before Kenai Peninsula and Cook Inlet producers is that most of the currently producing fields were found in the 1960s. They used to be world class oil and gas fields, but now they are declining. He said this puts the Kenai Peninsula in a gas market that he has never seen before - a significant decline associated with 96 percent of the production and a limited number of new wells being drilled.

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MR. KERR compared the Cook Inlet to two other basins of similar size, the Bighorn Basin and the San Juan Basin, both about 100 miles long by 100 miles wide. To date, the Cook Inlet has produced a total of 7.6 trillion cubic feet (Tcf) of gas and 1.3 billion barrels of oil, he related. The Bighorn Basin has produced 2.4 Tcf of gas and 3.1 billion barrels of oil and the San Juan Basin has produced 41.5 Tcf of gas and 380 million barrels of oil. He said he researched this comparison to determine for himself whether the challenges of the Cook Inlet were real or imagined. In response to Co-Chair Johnson, Mr. Kerr said the Bighorn Basin is in northwest Wyoming and the San Juan Basin is in northwest New Mexico.

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CO-CHAIR NEUMAN voiced his concern that when the 24-inch gas line from Prudhoe Bay to Southcentral is turned on, exploration in Cook Inlet will come to a halt, causing job loss and impact to Southcentral's economy, as well as the loss of investments made by the Cook Inlet explorers.

CO-CHAIR JOHNSON inquired as to the timing for deliverability of Armstrong's gas.

MR. KERR said his opinion, based on 26 years in the business, is that Co-Chair Neuman's concern could be accurate if both projects were happening at the same time. He predicted that Armstrong's project will be on line well before the proposed "bullet line" from Prudhoe Bay is built and that a project of the size and scope of the bullet line will have a lot of challenges. Armstrong intends to sell gas as soon as a pipeline is built which would be late 2010. In response to Co-Chair Johnson, Mr. Kerr clarified that the 2010 pipeline is the one from his project. In response to Representative Olson, Mr. Kerr said his project's pipeline would be about 20 miles long. Armstrong has wells ready to produce today, subject to the permitting process, and more wells could be drilled during the permitting interim.

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MR. KERR, in further response to Co-Chair Johnson, explained that the gas is traditional Cook Inlet gas with no inert gases, [so no processing would be needed].

REPRESENTATIVE OLSON surmised that Armstrong has a ready market for the oil.

MR. KERR responded, "Yes".

REPRESENTATIVE OLSON further surmised that since "Tesoro" is only using 25 percent Cook Inlet oil, it would likely pay a premium to get more of that oil.

MR. KERR replied, "Exactly". Oil is not as formidable a problem as gas because it can be safely transported in trucks. Armstrong is advocating a pipeline as the best way to go for natural gas rather than trucking compressed natural gas by road.

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MR. KERR returned to his presentation, noting that in 2007 the San Juan Basin had 984 wells drilled, the Bighorn Basin had 100 wells drilled, and the Cook Inlet only had 8 or 14, depending on whether staked versus completed wells are counted. Thus, the Cook Inlet only had 10 percent the number of wells as drilled in the Bighorn Basin and 1 percent of the wells drilled in the San Juan Basin. The total number of wells completed in the San Juan

Basin is approximately 44,700, the Bighorn is approximately 12,800, and the Cook Inlet is 1,312. In response to Co-Chair Johnson, Mr. Kerr agreed to provide in writing the source of this information to committee members.

MR. KERR posited that while this is a signal that not a lot has been done in the Cook Inlet, it is also a signal that a lot could be done in the future. The bulk of Cook Inlet production has come from traditional structures that were drilled in the 1960s and early 1970s. However, in the Lower 48 today, exotic production such as shale has dropped the price of gas. The price dropped because a tremendous amount of gas was found in the shale and because competition was created between the service companies.

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MR. KERR pointed out that the cost of drilling a gas well in the Cook Inlet can be 400-600 percent more than in the Lower 48. Such an exorbitant cost necessitates selling the product at a given price in order to not lose money. The large easy reserves have been found in the Cook Inlet, but he said he believes there is still a lot more gas to be found even though it will be more challenging. The best way to promote finding that gas is to create an environment where independents can come to Alaska and feel like they will get a reasonable return on their investments. It can be seen by the number of wells drilled to date in the Bighorn and San Juan basins, that independents have felt it will be a challenge to get a return on investment in the Cook Inlet. For its size, an extraordinarily small number of wells have been drilled in the Cook Inlet.

MR. KERR said the Alaska State Legislature is doing a wonderful job in the Cook Inlet from a tax structure viewpoint. The legislature has recognized that something needs to be done to encourage drilling and not a lot more could be done in this regard. Armstrong is in the process of seeing whether it can get a return and if an arrangement can be made, Armstrong will drill more wells. If an arrangement cannot be made that will give AOG a return, then the project will be mothballed.

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CO-CHAIR NEUMAN asked whether AOG is talking to other companies about added-value that would create more jobs for Alaskans, although he acknowledged that the Cook Inlet's gas is dry and does not have a lot of natural gas liquids for added-value.

MR. KERR responded that AOG has offices in many locations throughout the U.S. and world, and therefore talks to other companies and takes on partners in many projects. The pervasive nature of the Cook Inlet is such that there is skepticism for an independent to go in there and be able to work a contractual arrangement to sell the gas at a price that allows a reasonable return. It is surprising how much it boils down to others looking and watching that first guy, he said. For example, when AOG first went to the North Slope the theory was that an independent could not do business there. But the Ooguruk project is now on line and the Nikaitchuq wells are being drilled. The capital expenditure committed for those two projects is a little over \$2 billion.

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CO-CHAIR NEUMAN inquired what AOG thinks it will be able to sell its gas for.

MR. KERR estimated that AOG will need to receive a price in the range of \$7-\$10 [per million British Thermal Units (BTU)]. The challenge is that AOG knows the gas is there, but will potentially have to spend \$40-\$80 million in costs; so the prices must allow a reasonable return. If Armstrong says it is going to do something and does not do it, then it does not do anything for the State of Alaska.

CO-CHAIR NEUMAN commented that \$7-\$10 is good information as he had anticipated \$15-\$17.

MR. KERR added that AOG knows it has gas, but the challenge is that it does not yet have absolutes as far as how significant the reserves are and what the cost structure will be. Issues inevitably arise in the exploration and development business, such as problems with drilling, the pipe gets stuck in the hole, or things get lost in the hole, and all of these things create cost overruns. He said AOG must have a price that allows it to stay in business in order to do good for itself as well as for the state.

CO-CHAIR NEUMAN remarked that he wants Armstrong and other companies that come to Alaska to make a profit, otherwise they will go somewhere else.

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REPRESENTATIVE SEATON asked what the current sales price is for Cook Inlet gas under current contracts.

MR. KERR said he thinks some are over \$8 and some are under. In further response to Representative Seaton, Mr. Kerr said the Kenai Kachemak Gas Pipeline is a 12-inch pipeline.

REPRESENTATIVE SEATON understood that existing gas suppliers have contracted through 2014 for 95 percent of the capacity of the Kenai Kachemak Gas Pipeline, leaving 5 percent available to additional suppliers. He asked Mr. Kerr to discuss the issue of an intra-state pipeline that is by contract versus a common carrier pipeline.

MR. KERR agreed that there is plenty of space for additional gas, but that he does not know who owns that capacity. When there is spare capacity available, folks are generally anxious for that capacity to be utilized. He said he would like to think that Armstrong could work through that issue, but he cannot answer the question specifically at this point.

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REPRESENTATIVE SEATON noted that there is legislation that would change the Pipeline Act in Alaska. Currently, pipelines are supposed to be common carriers, but instead contracts and settlements are being allowed which basically makes them closed carriers. He asked what size line and how many cubic feet per day Armstrong would need if it were to contract the gas that it has today.

MR. KERR first explained that the only thing preventing AOG from providing more gas than it has today is that it has not spent the money to drill additional wells. Since Armstrong carries no debt and is not a public company, it is not saddled with having to do an engineering report on reserves like what a public company must do. In that context, Armstrong is comfortable enough with its current reserves. It has spent a lot of money to date and is willing to spend more to find more gas. As far as what AOG could ship today, he said it would take at least a year to build the pipeline and AOG could drill more wells while the pipeline was being built. Providing six to seven million cubic feet per day consistently is very obtainable and if AOG drilled additional wells it could be substantially more than that. In further response to Representative Seaton, he said he thinks that six to seven million cubic feet could be shipped on

a six-inch pipeline, but the pipeline could be larger if desired.

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REPRESENTATIVE SEATON recalled that eight to ten years ago the Homer Electric Association and ENSTAR Natural Gas Company ("ENSTAR") competed before the RCA for the right to service the Homer and Anchor Point areas. ENSTAR won. The contract required "Northstar", owner of the unit at that time, to build an eight-mile-long pipeline to Anchor Point and ENSTAR to build a distribution line from there to Homer. He said he has always been concerned about someone in the drilling business building a pipeline. Is AOG prepared to build a pipeline, he asked.

MR. KERR replied that if everyone was agreeable, AOG could accommodate building a pipeline to Anchor Point.

CO-CHAIR JOHNSON added that regulations may or may not allow Armstrong to build that pipeline.

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REPRESENTATIVE TUCK inquired whether Armstrong is considering using directional wells in addition to the two wells that have been drilled at the Northfork Unit.

MR. KERR explained that the gas is in the Tyonek Formation and this formation is composed of lenticular sands. There is an abundance of these lenticular sands, but they come and go rather than being one big continuous sand. The drilling of additional wells will define what the best way to drill is. Armstrong will therefore start out with conventional vertical wells. Deeper under the Tyonek Formation is the Hemlock Formation which has produced most of the Cook Inlet oil; this is the formation that was originally drilled in 1965 by Unocal. With new technology such as horizontal drilling, it could be that the Hemlock Formation is commercial. Because it is extremely expensive to drill a well to find this out, it must be underpinned with gas production. He said he thinks there are two things that could dramatically change production in the Cook Inlet: horizontal drilling and fracturing ("fracing"). So few wells have been drilled in the Cook Inlet that the service companies have not put their manpower toward either of these technologies as is being done in the Lower 48. Right now the economic threshold has not been reached in the Cook Inlet for applying this technology.

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CO-CHAIR JOHNSON interjected that the Northfork Unit would be characterized as a traditional gas play.

MR. KERR agreed. He said the unique aspect of the Cook Inlet is that there have not been enough wells drilled to rule out unconventional gas plays.

CO-CHAIR NEUMAN requested that the Department of Natural Resources be asked to talk to the committee about the different gas formations in Cook Inlet and who is working where.

CO-CHAIR JOHNSON agreed.

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CO-CHAIR NEUMAN inquired as to how many companies are working in Cook Inlet and how many people are employed.

MR. KERR answered that there are the large companies of "Marathon-ConocoPhillips, Chevron, and Texaco" but he does not want to guess the number of people they employ. "Pelican Hill" was there for a period of time but has left the Cook Inlet. He said he is unsure to what extent "Aurora Gas" is actively exploring. The big three have been in Cook Inlet for a long time and that has been a challenge for the Cook Inlet as indicated by the number of wells that have been drilled. In the Lower 48, it is the independents that drill the wells, the independents drive the engine. He offered his opinion that Cook Inlet suffers from not having independents. A lot of people will be watching to see what happens in Cook Inlet with Armstrong. In further response to Co-Chair Neuman, Mr. Kerr estimated that 100-200 people were employed when Armstrong drilled its Cook Inlet well, including people working as mudmen, mud engineers, drilling engineers, drilling contractors, hands on the rigs, surveyors, and road and fence builders.

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REPRESENTATIVE SEATON reviewed the history of the Northfork Unit in regard to the previous owners not coming through. He said independents are vitally important, but cautioned that not all independents should be classified as somebody who will complete the job. He added that he is pleased with Armstrong because they have followed through with every commitment.

CO-CHAIR JOHNSON agreed and said he looks at independents as well as the major producers as partners with the state. He said his goal is for the state to be a good partner and help mate, rather than an obstacle.

REPRESENTATIVE SEATON further added that what is needed are independents that follow through with work commitments so the state's resources are not tied up.

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REPRESENTATIVE OLSON pointed out that up until about 10 years ago virtually all of Cook Inlet's gas had been found by geologists looking for oil. This is why gas in Cook Inlet has not had the priority that oil has had, he continued. Now companies like Armstrong and "Marathon" are looking for gas.

MR. KERR addressed Representative Seaton's point. Armstrong scrutinizes potential partners, both business and government, to make sure that they can be worked with, he said. Armstrong takes pride in doing what it says it will do, however it cannot drill more wells in Cook Inlet without a workable arrangement.

MR. KERR concluded his presentation, stating that while there are real challenges to doing business in Alaska, Armstrong has successfully worked with Alaska's government agencies and finds them responsive. Armstrong tries not to get ahead of itself by promising something that it cannot deliver, he said. In this context Armstrong can say that it can find gas but it cannot guarantee the quantity until more wells have been drilled. If a workable arrangement can be found, then Armstrong will spend its money to drill those wells. He said AOG would like to do business in Alaska and the Cook Inlet.

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CO-CHAIR NEUMAN asked what the state can do to set the stage for a good working environment and ensuring that companies will want to invest in Alaska.

MR. KERR replied that a good working environment is one where permits can be obtained and where there is the ability to drill wells in a safe and efficient manner. With respect to the Cook Inlet, he continued, it is getting the product to market and selling it at a price that allows a reasonable rate of return on investment. A good working environment also allows access to

supplies and services in a fashion that is not so exorbitant that it precludes a reasonable return on investment. All of this is much the same with respect to the North Slope.

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MR. KERR, in further response to Co-Chair Neuman, said the people at the Department of Natural Resources and the Division of Oil & Gas are part of what is good about working in Alaska. They sit down and try to work with the companies. When a company honors its side of the equation, these people will work hard to ensure success in finding hydrocarbons in Alaska. He said a downside about working in Alaska is the historical precedent in the Cook Inlet. Armstrong needs to make sure that it can obtain a gas contract and get access to a pipeline that allows for a reasonable rate of return; without that, AOG cannot move forward in the Cook Inlet. In addition, accessing and permitting for pipelines and wells has been challenging historically, he continued, although Armstrong has been able to work through them. By and large, AOG is a big advocate of Alaska.

Mr. Kerr, in response to Co-Chair Johnson, said Armstrong Oil & Gas does not deal with the Federal Energy Regulatory Commission (FERC) very often.

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REPRESENTATIVE SEATON asked whether Armstrong would consider multiple contracts with various communities or would it consider only one contract with one sole source of exit for its gas.

MR. KERR responded that there are challenges with a split stream, but as long as a reasonable rate of return can be received then it can be worked out. The issues for AOG would be: how much capital must be put in, how difficult it is to do operationally, how much can be received for the commodity, and the cost of producing the commodity. He said this might be a better question for the transporter rather than AOG since it is an issue that would be more in the transporter's lap than AOG's. Also of importance is having an environment where one can continue to do business and where the rules are not changed, thus providing consistency.

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REPRESENTATIVE SEATON inquired whether Armstrong, as an independent, would be making its gas sales to the shipper or to the purchaser. For example, would AOG deal with ENSTAR as the shipper or the purchaser, or with the "Marathon-Conoco" plant.

MR. KERR replied that there is not an absolute answer, but AOG's preference would be to sell to a utility at the wellhead or at Anchor Point. There would need to be some certainty as to what would be received for the product. He explained that when the price of commodities goes up so do the costs because the service companies are always there in that regard. Armstrong would need to set a floor for the price of its commodity, and then if the price goes up AOG will take the business risk that any uptick in service costs is mitigated by the uptick in commodity price.

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CO-CHAIR NEUMAN asked how Armstrong coordinates efforts with its peers in Cook Inlet to negotiate firm transportation commitments (FTs) with the utility companies and other buyers of its gas.

MR. KERR said Cook Inlet is a unique business environment because it is a captured market in terms of the amount of production and not being tied to any other pipelines. To date, AOG is a new player in the Cook Inlet and does not have any coordination for jointly pursuing a gas contract. He said AOG has not asked "Marathon" or "Chevron" about piggybacking a gas contract because of Armstrong's belief that those two companies would want to work their arrangements on their own.

CO-CHAIR NEUMAN commented that competition is a good thing. He surmised that Armstrong is basically on its own.

MR. KERR answered correct, AOG has not partnered with anyone. He qualified that Armstrong has three partners within the Northfork Unit that are independent oil and gas companies AOG has done business with in the past. So, they are pursuing it independently as a group.

CO-CHAIR NEUMAN presumed that Armstrong would go to the purchasers of its gas to come up with a contract.

MR. KERR said correct. For example, as the operator of the Northfork Unit, AOG would go to entities like Chugach Electric Association or ENSTAR to work out a gas contract. Armstrong has never contacted "ConocoPhillips" about doing a tandem gas contract.

REPRESENTATIVE SEATON inquired whether ENSTAR, a purchaser of gas with the Kenai Kachemak Gas Pipeline, would act independently as a shipper for gas from AOG that was contracted by another entity.

MR. KERR presumed ENSTAR would, but he said he cannot speak definitively to that.

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CO-CHAIR JOHNSON, in response to Co-Chair Neuman, said he anticipates having ENSTAR speak to the committee in the future because Cook Inlet gas is important.

REPRESENTATIVE SEATON remarked that it was good to have today's presentation in relation to what effect a bullet line and cheap gas could have on companies that are actively drilling in [Southcentral]. No companies have come to say there would be negative impacts from a bullet line such as was brought up as a possibility by Co-Chair Neuman.

CO-CHAIR JOHNSON said that what he is taking away from today's presentation is that there could be gas in two years from Cook Inlet. He discouraged the use of the term "cheap" gas because the issue is what the cost would be if there is not any gas.

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ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 2:27 p.m.