

HOUSE FINANCE COMMITTEE

April 4, 2016

8:32 a.m.

8:32:58 AM

CALL TO ORDER

Co-Chair Thompson called the House Finance Committee meeting to order at 8:32 a.m.

MEMBERS PRESENT

Representative Mark Neuman, Co-Chair  
Representative Steve Thompson, Co-Chair  
Representative Dan Saddler, Vice-Chair  
Representative Bryce Edgmon  
Representative Les Gara  
Representative Lynn Gattis  
Representative David Guttenberg  
Representative Scott Kawasaki  
Representative Cathy Munoz  
Representative Lance Pruitt  
Representative Tammie Wilson

MEMBERS ABSENT

None

ALSO PRESENT

Bruce Webb, Vice President, Furie; David Elder, CFO, Furie; Pat Galvin, CCO, General Counsel, Great Bear; J. Benjamin Johnson, President and CEO, BlueCrest Energy; Matt Block, General Counsel, Ahtna; Chris Cook, Director of Finance, Ahtna.

SUMMARY

HB 247 TAX;CREDITS;INTEREST;REFUNDS;O & G

HB 247 was HEARD and HELD in committee for further consideration.

Co-Chair Thompson discussed the meeting agenda.

#hb247

HOUSE BILL NO. 247

"An Act relating to confidential information status and public record status of information in the possession of the Department of Revenue; relating to interest applicable to delinquent tax; relating to disclosure of oil and gas production tax credit information; relating to refunds for the gas storage facility tax credit, the liquefied natural gas storage facility tax credit, and the qualified in-state oil refinery infrastructure expenditures tax credit; relating to the minimum tax for certain oil and gas production; relating to the minimum tax calculation for monthly installment payments of estimated tax; relating to interest on monthly installment payments of estimated tax; relating to limitations for the application of tax credits; relating to oil and gas production tax credits for certain losses and expenditures; relating to limitations for nontransferable oil and gas production tax credits based on oil production and the alternative tax credit for oil and gas exploration; relating to purchase of tax credit certificates from the oil and gas tax credit fund; relating to a minimum for gross value at the point of production; relating to lease expenditures and tax credits for municipal entities; adding a definition for "qualified capital expenditure"; adding a definition for "outstanding liability to the state"; repealing oil and gas exploration incentive credits; repealing the limitation on the application of credits against tax liability for lease expenditures incurred before January 1, 2011; repealing provisions related to the monthly installment payments for estimated tax for oil and gas produced before January 1, 2014; repealing the oil and gas production tax credit for qualified capital expenditures and certain well expenditures; repealing the calculation for certain lease expenditures applicable before January 1, 2011; making conforming amendments; and providing for an effective date."

[8:33:36 AM](#)

^INDUSTRY TESTIMONY

[8:34:14 AM](#)

BRUCE WEBB, VICE PRESIDENT, FURIE, provided background information on the company that began producing natural gas in November 2015 in Alaska. He remarked that the most recent oil and gas tax restructuring had enabled the company to raise a significant amount of capital.

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DAVID ELDER, CFO, FURIE, relayed that the company viewed the tax credits as vital to the industry and the state. The company had invested over \$700 million; the company only had 11 employees. He believed the tax credits had done exactly what they had been designed to do. They helped lower the price of gas to the residents of Southeast Alaska. He spoke to the return provided to the state; the company had employed over 300 individuals on the project. Without continued support through the tax credit program the company would have to cut back significantly on its lease acreage.

Representative Gattis asked for clarification on the location.

Mr. Elder clarified that he meant Southcentral Alaska. He discussed the House Resources Committee Substitute. The tax credits were important to small companies' overall financing; to repay their lenders.

Mr. Elder stated that the project had been an investment in the state. The company had taken on a significant amount of risk and was ready to begin paying back the state. The company helped to bring back Nikiski and, the service companies relied on the project that had used over 100 local suppliers. He spoke about property taxes. They estimated the royalties they would pay to the state at \$300 million. They had brought prices down to // on the contracts.

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Representative Wilson asked if the company understood that the credits were not necessarily paid in the present year.

Mr. Elder replied in the affirmative.

Representative Wilson remarked that the state was still meeting its obligations, but may pay four years out. If the state did not have the funding currently, the tax credits remained good.

Mr. Elder answered that the company relied on the existing program. The company did not anticipate that the tax program would begin in the current year. If the company knew with certainty what the future was they could plan around it. To make a change in the middle of their process would be difficult.

Representative Wilson stated that no changes had been made.

Mr. Elder replied that the company always understood that it was a risk, if the change was going to be made, it was hard in midstream to have the change. It would not be a problem if they knew what to expect.

[8:47:38 AM](#)

Representative Wilson spoke about SB 21. She asked if it was time for Cook Inlet to pay its share, as similar to the North Slope structure.

Mr. Elder answered that he was not as familiar with the North Slope tax structure. He there had been significant consolidation in Cook Inlet.

Representative Gara appreciated the importance of the work and what was provided to Cook Inlet. He thought the money that was provided to the companies went to paying very high interest rates.

Mr. Elder answered that the money was not going to pay the debts; it had enabled them to take the credits and make them liquid. He shared that the company had begun financing the project in 2014-2015.

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Representative Gara spoke to statutory terms related to the requirements the state would pay in tax credits. When the company applied for the financing he gathered the state was aware of the statute, and remarked that everyone would not get paid in the current year.

Mr. Elder replied that the company always understood that there was appropriation risk. The company was only asking for transition. The company relied upon the tax credits and had applied for the tax credits and received them in six months. The company understood the pressures and knew that things would get scaled back. He spoke to the high cost of investing in the state.

Representative Gara clarified that the state was not honoring its appropriations; it had a statute on the books that he wanted to ensure the company would inform its lenders about.

Mr. Elder replied that the company understood it was a risk; however, it had not anticipated that the change would occur so rapidly.

Representative Gara sympathized with the company, but the state did not anticipate the change would come so rapidly either. He asked what was wrong with the governor's proposal to switch to a financing structure of low interest loans in the marketplace. He spoke to the state's tight budget situation.

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Mr. Elder responded that the governor's proposal of \$25 million would not benefit the company that much; its capital program would slow. He asked the committee to keep in mind that the company had spent over \$300 million in the past two years.

Representative Gara felt that the company would not really be paying production taxes, but rather would be paying royalty of roughly 12.5 percent. He asked if the company believed it was fair to his company and to the state.

Mr. Webb answered that Cook Inlet was unique and not like the North Slope. He remarked that, in 2014, the Anchorage Chamber of Commerce drafted a report on the benefits of oil and gas to the Cook Inlet region. That report stated that the benefits were more than production tax. The industry in the Cook Inlet was approximately \$2.5 billion per year. He remarked that Anchorage was the economic hub in the state. He stated that all oil produced in the Cook Inlet was converted into diesel fuel and jet fuel, which supported the Port of Anchorage, airport, military base, and locally

used natural gas. He remarked that the benefits of the production would be much higher than the production tax to the state.

Representative Gara felt that not imposing a production tax in the Cook Inlet require the other residents who do not receive that revenue to pay for that difference.

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Representative Guttenberg remarked state received economic activity, but that happened anyway. He asked about the company's confidentiality plan.

Mr. Elder answered that he had concern about disclosing the company's confidential information. The financing as proposed did not help it to transition out. He reminded the committee that they were structuring plans two years out.

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Representative Guttenberg stated that the credits were like grants. He spoke to the value of providing the money to the companies. He noted that there were many people in the state who did not see an effect from the companies. He stated that his region did not see the impact. Determining the value of the credit program was a challenge. He asked how the company defined transition.

Mr. Elder asked that any changes not go into effect until January 1, 2016. He was not concerned about credits being paid out over one or two years; they had based their financing on a practice that had been in place.

Co-Chair Thompson stated that there had been a shortage of supply. The credits had worked to increase production. He remarked that the State of Alaska is a big business and needed to stop the bleeding.

[9:12:29 AM](#)

Vice-Chair Saddler asked for the company's royalty rate on its leases.

Mr. Elder answered that the royalty rate was 12.5 percent.

Vice-Chair Saddler queried the impact of the tax credit regime in the current version.

Mr. Elder replied that it would enable completion of development, and meet the obligations. He stated that there would be some reductions in development.

Vice-Chair Saddler queried the impact of the prospect of the tax holiday ending in 2022.

Mr. Elder responded that the tax holiday allowed for planning time. He pointed out that there was some technology that may be used to bring gas to other parts of Alaska. He shared that there was technology to deliver gas other than Liquid Natural Gas (LNG). He remarked that his company was not able to begin selling gas until the current year. The next contract that would be in the nineteenth time frame. He stressed that it was important that his company rely on the payments.

Vice-Chair Saddler asked how the tax credit regime would impact the in the industry overall.

Mr. Elder replied that he would tell industry that Alaska was a great place to do business.

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PAT GALVIN, CCO, GENERAL COUNSEL, GREAT BEAR, provided a PowerPoint presentation titled "Great Bear Petroleum: House Finance, HB 247" dated April 4, 2016 (copy on file). He turned to slide 3:

- Original Target -> North Slope Shale Play (aka "source rock play", aka "unconventional play")
- Soon Faced an "Alaska Shale Play Catch-22"
- Not economic without cost reductions
- Costs reduction requires a critical mass of drilling activity, such as that generated by a shale play
- Re-directed focus to extensive conventional prospectivity
- Still believe a North Slope unconventional play can be
- economic following a conventional play build-out

- New Management Team - focus on performance - expanding
- technical capabilities

Mr. Galvin addressed slide 4 titled "Great Bear - Leasehold Position and Activities (2012-Present)." He stated that the wells had been targeting the unconventional shale play, and there was a conventional exploration well that was located on an ice pad about three miles off the haul road. He remarked that Great Bear had only been able to finish one.

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Mr. Galvin turned to slide 5 and discussed Great Bear's immediate work plan.

1. Complete our seismic program
2. Complete our prospect inventory
3. Execute a multi-year, multi-well exploration program
4. Secure cost-effective services by using the multi-well commitment

Mr. Galvin moved to slide 6 and addressed four myths about North Slope exploration companies:

- Exploration companies are "financed" by Alaska tax credits.
- Exploration companies don't have "skin in the game".
- Alaska could get the same level of exploration activity with lower exploration tax credits.
- Tax credit payments can be delayed with little impact to exploration companies.

Mr. Galvin addressed the first of the "myths" related to financing.

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Mr. Galvin turned to slide 8 and addressed the second myth related to companies with skin in the game:

- Total Gross Spend of Approximately \$220 Million
- Approximately \$140M has been or will be reimbursed by State of

- Alaska
- Net Operating Loss Credits (25 percent -> 45 percent -> 35 percent)
- 40 percent Exploration Incentive Credit for Seismic
- 30 percent Exploration Incentive Credit for Wells
- Great Bear Petroleum and Partners have spent approximately \$80M that will not be recovered through tax credits
- As a result, Great Bear has been very prudent and deliberate in what activities we have conducted
- Tax Credits bought valuable exploration data - State now has extensive new data about its resources on the Great
- Bear leases

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Mr. Galvin spoke to slide 9 titled "How tax credits dictate exploration drilling volume." The slide stated that if the state offered a higher tax credit it would see much higher exploration. In order to understand the role of the tax credit in the exploration process it was necessary to know that exploration was risky. The program had been implemented because Alaska had not been seeing high exploration; the state wanted to lower the hurdle.

Representative Guttenberg pointed to slide 9. He was an advocate for strong exploration activity. He wondered when an exploration well became a development well.

Mr. Galvin responded that there was a proxy for determining exploration. He explained that more than three miles from and preexisting well, then the well would be eligible for a 30 percent credit. He stated that a well that was both more than three miles from a preexisting well, and more than 25 miles from a unit, the well would be eligible for a 40 percent credit. Additionally, the Department of Natural Resources (DNR) needed to make a determination before a company drilled.

Representative Guttenberg wondered if a new well near an exploration well would keep that explorations well's status intact.

Mr. Galvin responded that it would no longer be considered an exploration well.

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Mr. Galvin addressed slide 10 related to the impact of tax credit payment uncertainty:

- Delay in tax credit payments will result in increasing financing costs for explorers
- Additional interest payments & higher interest rates
- Less money goes into the ground - more goes to the banks
- Uncertainty or surprises in tax credit payments by the state causes financing sources to leave the market or freeze existing credit agreements
- Makes tax credit financing far more expensive, or completely unavailable
- Dramatically reduces the exploration activity that is bought by the tax credits

Mr. Galvin discussed tax credits - keep what is working (slide 11):

- Alaska Has Emphasized North Slope Exploration in State Oil and Gas
- Policy for the Past 15 Years
  - Area wide Leasing Program
  - Exploration Incentive Credit (EIC) Program
  - Net Operating Loss Credits
  - Tax Credit Certificate Payments
  - Collateralization of Tax Credit Certificates
- It Took A While, But That Effort is Now Showing Success
  - Diversified Group of North Slope Explorers
  - Recent Discoveries
  - New Production Coming On-Line
- Elimination/Reduction of Credits Will Be Costly
  - Likely to Slow Down or Stop Exploration
  - Lower Likelihood of New Discoveries
- Getting Momentum Back Will Take A Long Time

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Mr. Galvin addressed a summary on slide 12:

- Great Bear is a highly active North Slope explorer
- Great Bear's investment to date has been substantial and well spent
- Great Bear's pace and volume of future exploration activity will be directly related to tax credit program
- Risk is reduced, and likelihood of success is increased by more exploration
- Reducing exploration risk of Alaska's North Slope resources is a good investment for the State of Alaska
- The Exploration Incentive Credit Program ("025 Credits") is a valuable catalyst for North Slope exploration activities

Representative Guttenberg wondered about a slowdown in the rest of the world on industry investments. He asked how the state would look at the state curtailing the credits. He believed the state was acting prudently.

Mr. Galvin distinguished the two decisions that Representative Guttenberg had combined. It was not the state's role to look at individual investment decisions. He noted the self-correcting aspect of the credit program; if an investment was not good, it would preserve the state from having to make a payment. If the exploration bar cost for an explorer was raised, the explorers would make the decision on whether or not to invest in exploration.

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Representative Guttenberg remarked that most companies did not do exploration because it was too risky, and asked if the state should be involved at that point. He surmised that at that point credits should become loans. He thought at that point the risk was downgraded to moderate.

Mr. Galvin replied that there were positive and negative conversations regarding a credit program and loan program. He felt that a loan program would put the state in a different position as it related to the companies, so it makes efforts complicated. He felt that the credit program allowed for the private industry to make decisions based on a certain level of criteria.

Representative Guttenberg noted that he had been combining former Commissioner Galvin's (former Department of Revenue commissioner) role with his current role.

Representative Gara wondered when Mr. Galvin served as commissioner for DOR.

Mr. Galvin replied that he had been commissioner of DOR for about a month after Great Bear had come in - 2010.

Representative Gara surmised that the Great Bear had one of the best shale plays in the country at one point. He wondered if that assertion had been overly optimistic, because of the many years of paid tax credits.

Mr. Galvin replied that Great Bear began looking at a shale play. Soon the company realized that the shale play would not be economic without conventional work. He stated that the company had invested about \$80 million to get \$220 million of exploration information. He shared that current seismic data could be used to identify the conventional plays that the company believed would be economically producible. He shared that there would be a significant amount of risk capital to explore and determine that possibility. He stressed that the tax credits were an overwhelming catalyst to the amount of activity Great Bear was able to achieve, and advance the state's interest in developing that acreage. He shared that there were only eleven exploration wells in 600,000 prior to Great Bear.

Representative Gara asked if Mr. Galvin had any realistic calculations of how much production would come out of the area.

Mr. Galvin replied that Great Bear had confidence that there was an overwhelming amount of hydrocarbons in the acreage. He stressed that there was a concern whether those hydrocarbons could be drawn from the type of rock that would facilitate economic development. He stressed that there were many unknown variables that would not be known until the wells were drilled. He shared that he was optimistic that a significant amount of oil would be development from the acreage, but more work was required to determine the absolute outcome.

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Representative Gara surmised that companies invested based on a positive net present value rather than a negative net present value. He queried any issue with a tax that might be better than no production tax up to \$73 dollars per barrel with the knowledge of application for royalty relief. He shared that royalty relief could be used with proof.

Mr. Galvin accepted the premise that the state needed a return on production. He suggested that the assertion that there would be no money back up to \$73 dollars was simplistic. He stressed that there were many variable, and the picture would have to include an evaluation of all variables.

Representative Gara understood that the \$73 estimate may be altered for different fields. He remarked that the DVR level was generous to companies. He queried any problem with a modest tax change, knowing that there may be an option for royalty relief.

Mr. Galvin replied that the companies did not negotiate a tax rate with the state. He stressed that the state would set the tax rate, and the companies would determine how much production could occur at what cost. He remarked that the tax policy set the framework to determine whether the company could meet the hurdle, and then decide to apply for royalty relief.

Vice-Chair Saddler asked Mr. Galvin to address the argument that if oil required a tax credit in order to be developed, it was uneconomic. Therefore, it should not be developed until a profit could be made.

Mr. Galvin replied that it was a valid position. He referred to conversation years back about turning off production from Trans-Alaska Pipeline System (TAPS) during low prices. He believed the program was an investment by the state and important for the economy in the state.

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Vice-Chair Saddler asked if Great Bear understood the risks that the credits were subject to appropriation.

Mr. Galvin replied in the affirmative, and he had a different memory of the statute when it had been formed and

its intent. The expectation was that tax for the fund would be a "placeholder" to keep funds flowing through the fund, so the annual appropriation process could be based on that placeholder. He felt that it was intended to begin the appropriations process.

Representative Guttenberg asked on what evidence he had related to the topic.

Mr. Galvin responded that he had been present when it had been written, as the commissioner of DOR at the time. He shared that he advised his staff to determine the fund level in order to keep the fund functional.

Vice-Chair Saddler asked about the proposal to have Alaska Industrial Development and Export Authority (AIDEA) // loan program.

Mr. Galvin stated that there could not be a loan program during the exploration phase because there was nothing to loan against.

Vice-Chair Saddler asked about the current Committee Substitute and how it would impact the company.

Mr. Galvin answered that it would not have significant impact on the company's activity, except that it did not include an extension of the exploration incentive program.

Representative Wilson wondered whether the company anticipated the state's current budget position.

Mr. Galvin replied that he did not believe anyone expected the current fiscal climate. He remarked that there was an expectation at the time of the creation of the structure, it was thought that the state would have enough in savings to provide the tax credits.

Representative Wilson stressed that "timely" may be seen differently between the legislature and industry.

[10:06:55 AM](#)

J. BENJAMIN JOHNSON, PRESIDENT AND CEO, BLUECREST ENERGY, spoke about the company and its presence in Alaska. He shared information about the company executives. He

provided a PowerPoint presentation dated April 4, 2016 (copy on file). He read from a prepared statement:

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 HB 247 and the CS.

[10:12:21 AM](#)

Mr. Johnson turned to 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.

Mr. Johnson addressed 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.

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Mr. Johnson turned to 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.

Mr. Johnson continued to address slide 4:

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 percent) 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.

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Mr. Johnson addressed 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.

Mr. Johnson turned to 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.

Mr. Johnson moved to 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 percent 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.

Mr. Johnson pointed to 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 percent. So if an alternative investment earned less than 6.15 percent, 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 percent, 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.

Mr. Johnson addressed 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 Committee Substitute temporarily retained the 023(l) credit but effectively scaled it down to 20 percent over two years from the current 40 percent and reduced the NOL credit from 25 percent to 10 percent.

[10:25:22 AM](#)

Mr. Johnson discussed 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 percent return on investment means that 100 percent 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 percent, and at \$60 per barrel, the return would be about 250 percent. So you can see that these credits, at least for Cosmo, are likely to be a very good investment for the State.

Mr. Johnson referred to 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.

Mr. Johnson discussed 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 Committee Substitute 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."

Mr. Johnson concluded with 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.

[10:32:21 AM](#)

Representative Wilson wondered if the presentation referred to the change in tax credits or the payment in cash.

Mr. Johnson replied he was referring to payments of the credits earned to date; and also what his company would earn through the end of the year and into early the following year. He stressed that the investments were made based upon the current law. He stated that the company would later decide to invest, based on the law at that point.

Representative Wilson stressed that the law had not been changed. She was tired of hearing that the state was not honoring its commitments because it was untrue. She asked

how a delay of payment for one to two years would impact the company's development.

Mr. Johnson replied that it would have a major impact on the company. He understood that the law did not require the payment, but it had been the state's practice.

Representative Wilson asked if \$121 million was what the company believed it was owed by the end of the current year.

Mr. Johnson answered in the affirmative.

Representative Gara spoke to the primary purpose of the Cook Inlet tax credits was to bring gas to the local region, but the credits were paid for oil. He queried the position of Mr. Johnson, should the state decide to put a fair production tax on the oil in Cook Inlet.

Mr. Johnson replied that if there was a tax on oil the company would pay it and would have to include the cost in its future plan.

Representative Gara stated that legislators found it hard to believe that no one was aware of the limit required to pay on tax credits, based on the amount of production tax in a given year. He noted a debate about limiting the payments to statutory amounts in 2015. He wondered if Mr. Johnson made the investments in 2016, with the knowledge of the payment limits.

Mr. Johnson replied that the company had committed to the work prior to the governor's veto. The company would adjust to the situation, but it was important to receive the funds over the next year or two.

[10:38:25 AM](#)

MATT BLOCK, GENERAL COUNSEL, AHTNA, introduced himself. He stressed that the tax credit program was critical to the company. He introduced a PowerPoint presentation titled "Frontier Basins Tax Credits" dated April 4, 2016 (copy on file). He explained that the company would not be moving forward without the tax credits.

CHRIS COOK, DIRECTOR OF FINANCE, AHTNA, shared that the company was using the credits for risk mitigation. He moved to slide 2 titled "Frontier Basins Experience"

- AS.43.55.025(a)(6) & (7) originally created in 2012 under HB 276 and merged with SB23
- Intent of Legislature -incentivize oil and gas exploration in under explored Basins
- Reduce the risk of development of local rural energy to Alaskans
- Create local energy source for rural residents
- Reduce or eliminate the Power Cost Equalization (PCE) subsidies

Mr. Cook addressed slide 3:

- AS 43.55.025(a)(6) -The first two exploration wells drilled inside each of the six Frontier Basins receives 80 percent credit or up to \$25M of qualified expenditures
- AS 43.55.025(a)(7) -The first seismic project performed inside each of the six Frontier Basins receives 75 percent credit up to \$7.5M of qualified expenditures
- Ahtna would not consider any exploration activities without tax credits

Mr. Cook addressed specific Frontier Basin regulations on slide 4:

- ADNR-DOG pre-qualification approval for seismic and well
- Various well depth and set back from previous wells
- Submission of all data to ADNR prior to credit award
- Public data disclosure of all data after 2 years
- Must provide energy source for rural energy needs!
- The AS.43.55.025(a)(6) & (7) tax credits are not eligible for stacking

Mr. Cook addressed Ahtna's exploration program history on slide 5:

- April 2012 Ahtna applies for SOA Exploration License
- May 2012 Legislature approves SB 23

- December 2013 Ahtna receives Tolsona Exploration License
- June 2014 receive ADNR Commissioner pre-qualification approval for seismic
- December 2014 completes 40-miles of 2D seismic over exploration area
- April 2015 completed reprocessing of seismic data identifying 12-sq. mile potential oil and gas trap
- May 2015 submit seismic data to ADNR-DOG
- September 2015 receive ADNR Commissioner pre-qualification approval of new well
- February 2016 -majority of permits approved
- March 2016 final stages of new well engineering and design

[10:44:19 AM](#)

Mr. Cook looked at a map of the Copper River Basin on slide 6:

- Proposed Tolsona well depth of 4,500' Vertical hole.
- Targeted structure is the Nelchina sandstone.
- 11 wells drilled in the basin since 1960's.
- Most recent well -drilled by Rutter in 2005-2008.
- Natural gas shows (approximately 94 percent methane).
- Tolsona number 1 potential for a great local fuel source.

Mr. Cook addressed the purpose and need for gas in the Copper River Basin on slide 7:

...To conduct exploration within the license area on a single natural gas well, Tolsona #1, with the potential to develop natural gas production for distribution to local residents and electric utilities...

Community and Economic Development Benefits:

- Potential Opportunities for Local Employment
- Economic Benefits, Expanding Local Business
- Lowering High Energy Cost for Our Rural Economy
- Reducing Out-migration
- Building Infrastructure in the Region

Mr. Cook turned to slide 10 related to the project schedule. He concluded with slide 11:

- Our Request: It is critical to our project that the Frontier Basin AS 43.55.025(a)(6) & (7) credits are extended from June 30th2016 to a future date, we recommend 2022 to coincide with other credit expiration dates.
  - o This will greatly help the Tolsona Project that is under way with a committed investment and a very tight schedule.
- Ahtna also supports the AS 43.55.023 and 025(a)(1-4) Middle Earth tax credits to be kept in place, as an incentive to the Frontier Basin exploration and development efforts by explorers who have taken the risk and committed investment based on these incentives.

Representative Wilson pointed to the timetable on slide 10. She queried the extension to 2020. She wondered if there were other targets not included in the chart.

Mr. Cook replied in the affirmative and relayed that there were additional targets.

Representative Wilson queried the type of resource provided by his company.

Mr. Cook answered that it would be commercial gas.

Representative Gara stated that most of the companies were paying no production taxes to the state. He asked if the company paid a production tax.

Mr. Cook was unclear and believed the company paid production taxes. He would follow up.

Co-Chair Thompson relayed that there was a provision for production tax.

Vice-Chair Saddler asked if there was any formal or informal understanding of who would be the ultimate purchaser of the gas.

Mr. Cook answered that the company did not have commercial commitments in place. The plan was to provide the resource, and to evaluate whether there was enough resource to provide for the local community. He stated that the intent of the well was to provide energy for the local community.

HB 247 was HEARD and HELD in committee for further consideration.

Co-Chair Thompson discussed the schedule for the following meeting.

#  
ADJOURNMENT

[10:51:26 AM](#)

The meeting was adjourned at 10:51 a.m.