

**ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE**

February 29, 2016

6:00 p.m.

MEMBERS PRESENT

Representative Benjamin Nageak, Co-Chair
Representative David Talerico, Co-Chair
Representative Bob Herron
Representative Craig Johnson
Representative Kurt Olson
Representative Paul Seaton
Representative Andy Josephson
Representative Geran Tarr

MEMBERS ABSENT

Representative Mike Hawker, Vice Chair

COMMITTEE CALENDAR

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."

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 247

SHORT TITLE: TAX;CREDITS;INTEREST;REFUNDS;O & G

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

01/19/16	(H)	READ THE FIRST TIME - REFERRALS
01/19/16	(H)	RES, FIN
02/03/16	(H)	RES AT 1:00 PM BARNES 124
02/03/16	(H)	Heard & Held
02/03/16	(H)	MINUTE(RES)
02/05/16	(H)	RES AT 1:00 PM BARNES 124
02/05/16	(H)	-- MEETING CANCELED --
02/10/16	(H)	RES AT 1:00 PM BARNES 124
02/10/16	(H)	Heard & Held
02/10/16	(H)	MINUTE(RES)
02/12/16	(H)	RES AT 1:00 PM BARNES 124
02/12/16	(H)	Heard & Held
02/12/16	(H)	MINUTE(RES)
02/13/16	(H)	RES AT 1:00 PM BARNES 124
02/13/16	(H)	-- MEETING CANCELED --
02/22/16	(H)	RES AT 1:00 PM BARNES 124
02/22/16	(H)	Heard & Held
02/22/16	(H)	MINUTE(RES)
02/24/16	(H)	RES AT 1:00 PM BARNES 124
02/24/16	(H)	Heard & Held
02/24/16	(H)	MINUTE(RES)
02/25/16	(H)	RES AT 8:30 AM BARNES 124
02/25/16	(H)	Heard & Held
02/25/16	(H)	MINUTE(RES)
02/25/16	(H)	RES AT 1:00 PM BARNES 124
02/25/16	(H)	Heard & Held
02/25/16	(H)	MINUTE(RES)
02/26/16	(H)	RES AT 1:00 PM BARNES 124
02/26/16	(H)	Heard & Held

02/26/16 (H) MINUTE(RES)
02/27/16 (H) RES AT 10:00 AM BARNES 124
02/27/16 (H) Heard & Held
02/27/16 (H) MINUTE(RES)
02/29/16 (H) RES AT 1:00 PM BARNES 124
02/29/16 (H) RES AT 6:00 PM BARNES 124

WITNESS REGISTER

BILL ARMSTRONG, President/CEO
Armstrong Oil & Gas
Denver, Colorado

POSITION STATEMENT: Answered questions regarding how HB 247 would impact his company.

J. PATRICK FOLEY, Senior Vice President Alaska Operations
Caelus Energy Alaska, LLC
Anchorage, Alaska

POSITION STATEMENT: Provided a PowerPoint presentation about the impacts that HB 247 would have on his oil company.

SCOTT JEPSEN, Vice President External Affairs
ConocoPhillips Alaska, Inc.
Anchorage, Alaska

POSITION STATEMENT: Provided a PowerPoint presentation about his corporation's activities since tax reform was passed in 2013 [Senate Bill 21].

PAUL RUSCH, Vice President Finance
ConocoPhillips Alaska, Inc.
Anchorage, Alaska

POSITION STATEMENT: Provided a PowerPoint presentation about the impacts that HB 247 would have on his corporation.

PATRICK GALVIN, Chief Commercial Officer & General Counsel
Great Bear Petroleum
Anchorage, Alaska

POSITION STATEMENT: During the hearing on HB 247, testified about the importance of the State of Alaska's tax credit programs to exploration companies.

JOE REESE, Senior Managing Tax Counsel
BP Exploration (Alaska) Inc.
Anchorage, Alaska

POSITION STATEMENT: Testified about the impacts that HB 247 would have on his corporation.

ACTION NARRATIVE

6:00:00 PM

CO-CHAIR BENJAMIN NAGEAK called the House Resources Standing Committee meeting to order at 5:59 p.m. Representatives Herron, Seaton, Olson, Talerico, and Nageak were present at the call to order. Representatives Tarr, Josephson, and Johnson arrived as the meeting was in progress.

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

6:00:09 PM

CO-CHAIR NAGEAK announced that the only order of business is 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."

6:00:45 PM

BILL ARMSTRONG, President/CEO, stated he is available to answer questions, having provided testimony at an earlier hearing.

REPRESENTATIVE SEATON noted that for his decision making he is looking at the net present value (NPV) of the state's investment through the credits. He inquired whether Mr. Armstrong thinks that is the correct perspective to be using.

MR. ARMSTRONG replied that is a way to look at it and not necessarily a bad way to look at it, but there are other ways to look at it besides just NPV. He said it is really important for the State of Alaska to put out the image and reality that it is open for business. Getting other folks to come to Alaska to do what Armstrong Oil and Gas ("Armstrong") has done over the last 15 years is really important. He advised that many assumptions go into a straight NPV analysis, such as what price of oil to use and what kind of cost structure went into the development. It is a complicated formula and not something to just grind out should this or that credit not pencil, because there are lots of other ways to look at it. But, he allowed, NPV is a technique that the committee needs to look at and seriously analyze.

MR. ARMSTRONG stressed that the key to success for both the state and industry is to get wells drilled. If a straight NPV-only analysis doesn't fly, then some other way must be figured out to get people to drill wells in Alaska because good stuff will happen. Every single field on the North Slope was found by accident, he said. The key is putting the bit in the ground. It is a forgiving petroleum system. The state will not get oil down its pipeline unless wells are drilled.

6:05:40 PM

MR. ARMSTRONG emphasized that Alaska is tough, expensive, and difficult to drill in. He posed a scenario in which a wildcat well is drilled in winter that is 20 miles away from an existing road. A 20-mile-long ice road would need be built starting in December, he explained, at a cost of about \$1 million per mile. An ice pad would then be drilled and there would be a window of three months to drill and test the well. The rig would then need to be moved off the pad and then the ice road would melt. Nowhere else in the U.S. is there this \$20 million expense. It

is an uphill slog, cost-wise, in Alaska. So, whatever the state can do to help encourage the drilling of wells, whether credits or something else, is good. When contemplating any law, legislators should always ask whether this will hurt or benefit getting wells drilled - it is a very simple equation.

REPRESENTATIVE SEATON commented that [legislators] don't expect any company to undertake a project where the company doesn't expect to make money or expect its investment to pay off. So, if there are other methods of looking at that beside net present value, he would appreciate Mr. Armstrong sending those to the committee. He said net present value is the only thing he has come up with as an investor sitting on the board of directors for the state to say whether it makes sense to do an investment.

MR. ARMSTRONG agreed to do so.

[6:08:13 PM](#)

REPRESENTATIVE TARR recalled that when earlier asked about which of the credits were most helpful, Mr. Armstrong had said the Net Operating Loss Credit. She noted that under HB 247 the Net Operating Loss Credit for a company like Mr. Armstrong's would be limited to \$25 million per company per year and anything more than that would have to be carried forward. She requested Mr. Armstrong to comment further on how that would fit into his company's overall profile on an annual basis.

MR. ARMSTRONG responded that his company has come to Alaska and made a lot of investments, and the investments were made based on the rules and the laws set up by the legislature. To change those rules that dramatically and to limit the Net Operating Loss Credit at just \$25 million would be a crushing blow to anybody in a position like Armstrong or Caelus Energy Alaska, LLC ("Caelus"). It doesn't apply so much to the "big three" - ConocoPhillips, BP, and ExxonMobil. If the legislature's goal is to continue the oligopoly on the North Slope of the "big three," that would be a terrific way to do it because those companies have infrastructure that was built 30 years ago and has been paid for multiple times over. New players like his company are starting in a hole. The new players do not have that infrastructure to lean on and the Net Operating Loss Credit is a huge incentive for Armstrong to get going. Assuming success, this credit is a small price. He anticipated that his company's discovery this last year will provide a cash flow to the state just shy of \$1 billion a year through royalties, taxes, and ancillary things. So, the Net Operating Loss Credit

is a massive return on investment to the state in addition to the NPV for that expense; additionally, not many companies utilize it. He qualified that he is not saying it is Senate Bill 21 [passed in 2013, Twenty-Eighth Alaska State Legislature] or nothing, but that there is a lot of wiggle room between what is proposed by HB 247.

MR. ARMSTRONG added that he understands the state is running a fiscal deficit, but said the fact of life is that Alaska is a petro state. Every petro country - Saudi Arabia, Venezuela, Qatar, Iran, and Iraq - is losing hugely because of the price of commodity. That means there is no way that price of commodity is going to stay that low. Like Alaska, pretty much all of those countries have established some version of a rainy day fund. Alaska has \$65 billion in its rainy day fund, \$45 billion in its permanent fund and \$20 billion in its reserve fund, to weather through a few years of deficits. Every oil company is running deficits today, is laying off people, and trying to weather through this bad time. As a petro state Alaska will have times of deficit. Alaska has no income tax, no state-imposed sales tax, no state-imposed property tax, and everybody gets paid to live in the state, all of which is unbelievable to people in the Lower 48. There should be some shared pain.

[6:14:24 PM](#)

REPRESENTATIVE TARR requested Mr. Armstrong's view regarding the provision in HB 247 that would change confidentiality. She explained that [under current statute] members are unable to know where [the credits] are being used most effectively.

MR. ARMSTRONG answered he does not understand the bill enough to know exactly what that is. He said he will look into it and get back to the committee.

[6:15:04 PM](#)

REPRESENTATIVE JOSEPHSON remarked that the aforementioned \$1 billion per year in cash flow to the state really perks up his ears. He asked how that number was derived.

MR. ARMSTRONG replied it was based on the assumed flow rate that Armstrong expects off its developed field, a one-sixth royalty to the state, and, he thinks, an oil price of about \$70.

[6:16:22 PM](#)

The committee took a brief at-ease.

6:17:15 PM

J. PATRICK FOLEY, Senior Vice President Alaska Operations, Caelus Energy Alaska, LLC, began his PowerPoint presentation with slide 2, "Caelus Energy Alaska: Key Facts & Information." He said Caelus Energy Alaska, LLC ("Caelus") is a private equity company with all of its money coming from Apollo Global Management, LLC, a private equity firm out of New York. "We also have a lending side, we have a debt side, and it's a consortium of six different banks," he added. To date Caelus has invested over \$2 billion in Alaska. Caelus purchased the assets of Pioneer Natural Resources Alaska, Inc. ("Pioneer"), a company he was with since day one, so he actually reaches back to 2002 when Pioneer and Bill Armstrong made the first deal and drilled Oooguruk. He said he is here today as a result of that successful operation. Caelus will have a total budget in 2016 of about \$300 million that is split about 75 percent in developing Oooguruk and 25 percent in the ongoing exploration project in Smith Bay. Caelus has a full-time work force of 70 employees and today has 400 people in the North Slope working as contractors. That equates to about 600 full-time equivalent jobs annually on the North Slope. Some of Caelus's North Slope jobs are year-round and some are seasonal. Most of the North Slope jobs actually take two people to perform because there is a 24-hour shift. Operationally at Oooguruk, Caelus has produced 23 million barrels of oil [since 2008]. In 2015 Caelus made 4 million barrels and will make slightly more than that [in 2016].

6:20:12 PM

MR. FOLEY related that smaller companies are often asked whether they are responsible stewards of the state's assets and able to perform operationally with the same degree of care that the legacy majors do. He said this question offends him because Caelus is extraordinarily proud of its history environmentally. Caelus is not flawless, he allowed, as the company has had unreportable spills, meaning they did not get to the threshold of having to be reported because they were measured in cups and quarts, not in gallons and barrels. In 2015 Caelus had an extraordinary Occupational Safety and Health Administration (OSHA) recordable [injury] rate of 0.65, the rate the industry uses to portray its safety records.

MR. FOLEY pointed out that Caelus has paid to the state over \$65 million in royalties and \$60 million in property taxes. Caelus

currently sits on proven reserves at Oooguruk of about 85 million barrels yet to be produced, as well as about 100 million barrels at Nuna, a project that Caelus is commencing.

[6:21:41 PM](#)

MR. FOLEY showed slide 3, "North Slope Exploration & Development Program," and discussed Caelus's ongoing projects. Under its Tulimaniq Exploration Program located in Smith Bay, Caelus is in the process of drilling two very bold exploration wells this winter; one has already been drilled and the other is currently being drilled. The project is about 120 miles away from Prudhoe Bay and 60 miles away from Barrow. He said Caelus enjoys both Exploration Incentive Credits and Net Operating Loss Credits for this project. Absent those credits, he stressed, Caelus would not be drilling those wells. At the Oooguruk Field Caelus makes about 10,000 barrels a day, drills four or five development wells a year, and places heavy fracturing on them. So far, 40 of 48 wells have been drilled from the island and the hope is to have a drilling program that goes on for another two or three years and then that asset will be fully developed.

CO-CHAIR NAGEAK asked whether the eastern exploration acreage is active.

MR. FOLEY responded that the exploration acreage is state leases in offshore state waters in Smith Bay, and there is a drilling rig standing up on those leases today.

MR. FOLEY continued reviewing slide 3, noting the Nuna Project has commenced with the laying of gravel. However, he reported, the project is currently stalled as Caelus waits for some price recovery and some stability in the state's fiscal environment. He further pointed out that Caelus has purchased about 350,000 acres of leases [east of the Prudhoe Bay Unit]. High resolution three-dimensional [seismic surveys] were shot last winter. Caelus hopes to have a multi-well exploration program as soon as this coming winter but it may be delayed one more year.

[6:24:02 PM](#)

MR. FOLEY explained slide 4, "Alaska: An Attractive Investment Opportunity?" is essentially a scorecard on Alaska. Companies goes through a checklist like this when making an investment decision about whether to enter a new area where they aren't currently doing business. Alaska scores quite high in the first six elements on the list: it has a wonderful petroleum system;

there is access to leases; there is a reasonable amount of data although the drilling density is shockingly low; there is an expert contractor community; the regulatory community is hospitable and expert, although there is room for improvement, and permits are received timely so projects can proceed. However, Alaska scores less favorably as far as the logistic difficulty of doing business on the North Slope. It is dark, cold, a long way away, and there are seasonal limitations. That doesn't mean things cannot happen, it just means the costs are higher than what they would be elsewhere in the U.S. Regarding the item of favorable fiscal regime, he said there is a qualified yes under Senate Bill 21 in which the terms were fair and balanced. Those terms balanced the difficulties in Alaska and they balanced the wonderful petroleum system and opportunity had in the state. Senate Bill 21 was fair and reasonable and it was the tax credits that made it a balance. Another key element is the stability of the fiscal regime. Since Pioneer started its business in 2002, there have been five changes to the tax regime, so Alaska scores very poorly in that element. This affects the last element on the list, which is the confidence that lenders and equity providers have with the businesses in Alaska. This might not apply to companies that utilize their own money to develop projects, but for companies like Caelus that must go to private equity providers and banks, there needs to be the confidence that the tax regime is going to stay unchanged for a very long period of time.

[6:26:29 PM](#)

REPRESENTATIVE TARR observed on slide 4 that Bank of America was committed but spooked by change, and that ING backed out and Wells Fargo disengaged when changes began. She inquired as to the time period when changes began.

MR. FOLEY answered that these are actual experiences Caelus had. When Caelus was trying to finance its exploration program at Smith Bay and knew it would be getting these credits, it went out to the lending community seeking an advance of money. Caelus talked to all three lenders. Wells Fargo was on the edge and not really wanting to do business in the state of Alaska. Bank of America and ING were actively engaged, but a shock wave went through the lenders when the veto of \$200 million took place to fund the credits that could be earned.

[6:27:26 PM](#)

REPRESENTATIVE JOSEPHSON related his understanding that if the earnings from the permanent fund corpus are ignored, the state is predicted to raise \$1.8 billion in new revenue. In total, these credits are at about \$700 million. He asked whether those two facts would not also shock the investors, given the math itself has a stability problem.

MR. FOLEY replied he cannot speak specifically to those numbers, but when looking at the credit program he looks at the state as being a co-investor in his company's projects. This is not free money, he added, these are credits that are earned because Caelus makes investments and Caelus makes those investments with an expectation of a return. Those investments will lead to future royalty, future property tax, as well as payments from the net profit share leases at Ooguruk. The entire balance must therefore be looked at. He said his forthcoming slide about the Nuna Project might better answer the question.

REPRESENTATIVE JOSEPHSON commented he will be interested to hear about Nuna since it was earlier said that work on the project was suspended due to price sensitivities. Given [the state's] fiscal situation, he continued, [the state] needs to look at suspending some things as well, which is why members are here.

[6:29:15 PM](#)

REPRESENTATIVE HERRON asked whether industry would have gotten to the last \$200 million vetoed by the governor or whether it would have self-corrected before it got to the \$200 million.

MR. FOLEY answered he does not know whether the work was done such that the \$200 million would have ever actually accrued.

REPRESENTATIVE HERRON said the governor has proposed these changes and committee members are hearing that these changes are significant or spooky. He asked whether Mr. Foley understands the explanation for why the changes or whether Mr. Foley is still puzzled by the decisions to go forward with this proposal.

MR. FOLEY replied he understands the why. The state is in a fiscal crisis and he is not insensitive to that. Caelus met with the administration and was pleased to discuss the changes being contemplated and the impacts they would have on Caelus. The net result was HB 247 which is now before the committee.

REPRESENTATIVE HERRON inquired whether Mr. Foley understood the intent and whether these changes made sense after Mr. Foley heard the explanation.

MR. FOLEY responded no, they do not make sense. The goals seem to be a need to generate more revenue and for the state to have fewer obligations to pay out credits. He said he believes that is short-sighted because if the state does not continue to fund these investments they won't happen and everyone will see a sad day down the road when there are fewer companies doing business, fewer investments, and less oil going through the pipeline.

[6:32:25 PM](#)

REPRESENTATIVE TARR stated she was struck by the comment that Mr. Foley wasn't sure whether the \$200 million would have actually been used. She related that it was a delay in payment or delay until the next quarter, not that the state wasn't going to follow through on its commitment to pay the credits if they were due. She said she sees a delayed payment versus not going to be paid as slightly two different things. She asked whether that is perceived differently by the industry.

MR. FOLEY answered that Caelus was paid for all of the credits it earned. A delay in those credits wouldn't have been fatal, just less valuable than getting the value of the credits sooner rather than later. He said his forthcoming review of the Nuna Project will show the exact impact of the \$25 million cap per company and what that would do to a project like Nuna.

[6:33:51 PM](#)

REPRESENTATIVE SEATON noted some projects have profit sharing agreements, some a 16 percent royalty, and some a 12.5 percent royalty. However, the bill treats everything the same, not looking at the net present value to the state of those different factors. He inquired whether Mr. Foley thinks something more discriminating is needed in the bill of what is the net present value of the system that the state is funding the credits to, instead of an across-the-board everybody gets the same amount of credits regardless of whether the state will ever get return on its investment.

MR. FOLEY replied that Representative Seaton makes a wonderful point that not all projects are the same. Not all capital costs are the same, he continued, not all operating expenses are the same. Everybody is different. Values for a company like Caelus

are different from the average of the industry. For example, Caelus is currently in a phase of growing its business at Oooguruk - some production is made, but wells are being drilled and capital investment is very significant. When the amount of money Caelus has spent in Alaska this year is divided by the amount of barrels made this year, Caelus will have capital investment in excess of \$50 per barrel. So, Caelus is not represented by the average work that has been done to try to evaluate the bill. He said he believes the goal is to find a one-size-fits-all policy as opposed to having boutique rules for different companies, and that is the challenge.

REPRESENTATIVE SEATON clarified he is not meaning the structure of different companies, but the royalty structure or structure that the state will receive. [Legislators] must look at it from the state's perspective in what is offered to companies to make things happen, but also the amount of money given for credits up front and how and whether it ever gets repaid. He understood Mr. Foley to be saying it shouldn't make any difference whether the royalty to the state is 16 percent or on land from which the state receives no royalty, and that there should just be a common system across everything.

MR. FOLEY replied he would encourage the state to have a common system on the North Slope. He said the forthcoming slide on the Nuna Project will maybe help answer the question.

[6:37:03 PM](#)

MR. FOLEY turned to slide 5, "Tax Program Changes & Impacts to Caelus," to demonstrate the impacts of the various components of HB 247. He offered his agreement with the point-by-point technical analysis of the bill that was provided by the Alaska Oil and Gas Association (AOGA) at an earlier hearing, and said he will focus on four of those elements that are specifically detrimental to Caelus. He explained that the bar graph of net present value on the slide looks at the core business of Caelus: the ongoing investments at the Oooguruk Field ("ODS"), a 48-well program; and the Nuna Program, a 30-well program, \$1.2 billion investment for 100 million barrels. He noted the figures on the graph were done with a 10 percent discount rate and at a strip oil price, which is the forward curve of what the market believes oil is worth today and what it is going to be worth in the future. He qualified it doesn't mean the values used are right, he is just sharing how the evaluation was done. The strip right now would say that a 2016 oil price is going to be \$36, coincidentally about what Brent is today. It will increase

a little bit each year over five years, reaching about \$52 flat. He said he absolutely shares the sentiments of Mr. Armstrong that a low oil price environment will not be of long duration, but it might be several years. When Caelus looks at a project the next three years are absolutely critical to the company, so for its investments Caelus considers a strip price. The figures on the slide assume the basis of Caelus's business, so the net present value is what it is today at those strip prices.

[6:39:24 PM](#)

MR. FOLEY continued his discussion of slide 5, first looking at the bar on the graph representing the provision in HB 247 to fix the Gross Value Reduction (GVR), which some have characterized as a loophole in the current law. Currently, Caelus can use the GVR to increase its net operating loss. Some people say that was an unintended consequence, not the intention, and this should be corrected. However, he said, Caelus has reviewed the current law, has made business decisions based on the current law, and all modeling has assumed that the GVR can be used to take the company's net operating loss lower. Eliminating the GVR, he reported, would erode the value of his business by 13 percent. For example, if his company is worth \$1 today and that provision is passed, his company would be worth \$.87.

MR. FOLEY then looked at the bar on the graph representing the provision in HB 247 that would implement a hard 4 percent floor. Right now, the tax regime is not a hard minimum floor in a company like Caelus, he explained. All of Caelus's credits can carry the company below the floor, so Caelus currently does not pay a production tax. If HB 247 becomes law and the hard floor is left at 4 percent, Caelus would be subject to a minimum tax floor that would take the value of the business down 31 percent, making his company only worth \$.69 on the dollar.

MR. FOLEY next looked at the bar on the graph representing the provision in HB 247 that would limit the transferable/refundable credits to \$25 million per year per company. This provision, coupled with the GVR fix and a 4 percent hard floor, would erode the net present value of his business by 77 percent, now making his company worth \$.23 on the dollar.

MR. FOLEY lastly looked at the bar on the graph representing the provision in HB 247 that would raise the minimum hard floor from 4 percent to 5 percent. He said that provision would take Caelus to 83 percent of its current value, making his company only worth \$.17.

6:41:45 PM

REPRESENTATIVE SEATON inquired whether each succeeding bar on the graph includes the previous bars.

MR. FOLEY confirmed the bars are cumulative, they cannot be done separately because they interrelate with one another.

6:42:20 PM

REPRESENTATIVE JOSEPHSON asked whether Caelus receives other royalty reduction in addition to Nuna.

MR. FOLEY replied Caelus enjoys two forms of royalty reduction. The first is at the Ooguruk Field for the existing Kuparuk and Nuiqsut production; the second is a separate and distinct royalty modification agreement that addresses the Nuna Torok. He said Caelus has been doing business since 2002, its first production began in Ooguruk in 2008, and Caelus is yet to make a profit, meaning Caelus is spending more money reinvesting in the state than the sum of all of its revenues.

6:43:14 PM

REPRESENTATIVE TARR inquired whether changing the proposed limit from \$25 million to \$50 million, or some other number, would still be problematic in Mr. Foley's opinion.

MR. FOLEY responded he dislikes suggesting a number, but obviously bigger is better and if it was big enough to accommodate all of Caelus's needs that would be wonderful. In reality, he added, the state needs more companies. Policies should be created that encourage new players to enter the state, any kind of a limit will not accomplish that goal.

6:44:17 PM

MR. FOLEY displayed slide 6, "Nuna: A Project on the Bubble," and related that the original hope was to have Nuna come on line in late 2017. However, it is going to be very difficult to keep it on that schedule, he allowed. The hope now is for first oil in 2018, but two things must happen. First is price stabilization, which he said he thinks will be coming. While he doesn't know how high the price needs to be, he added, his hope is that prices will soon be \$50-\$70, and with prices like that

Caelus hopes to continue its investments in Alaska. Caelus also needs confidence that the fiscal regime isn't going to change.

MR. FOLEY reviewed the worth of the Nuna Project. He said it is about 100 million barrels of reserves and production would peak at 20,000-25,000 barrels per day in about 2021. About 300 full-time equivalent contractors would be working during the two-year-long construction phase, followed by four to five years of drilling that would provide about 300 full-time equivalent jobs on the North Slope. According to the McDowell Group, the multiplier effect would be 20:1, which is 6,000 jobs. These jobs would be placed in jeopardy if a project like Nuna does not go forward.

[6:46:22 PM](#)

REPRESENTATIVE SEATON understood Mr. Foley's statements about price and hopes to be speculation. He recalled that a few years ago the legislature's consultants at analytica stated the price of \$50-\$70. He asked whether that is a range where the 80 percent probability is for Caelus longer term.

MR. FOLEY answered he has several skills in life, but predicting oil price is not one of them. He said he hopes it will be a world of \$60-\$80, but he has no ability to make that prediction.

[6:47:32 PM](#)

MR. FOLEY continued his discussion of slide 6 and addressed the payments that could be made to the state from the Nuna Project in the balance between the credits given to a company and the future revenue. He noted that these numbers are real, are at a flat price forecast of \$70, and are undiscounted. The sum of all future payments to the State of Alaska would be about \$1.75 billion, broken down as follows: \$900 million from royalties, \$500 million from net profit share payments, \$250 million from production tax payments, and \$100 million from Ad Valorem taxes. Regarding the simple question of whether the state is paying more in credits than the value it receives, he said the answer is overwhelmingly no on the value for production taxes. The sum of all of the credits that Nuna would enjoy is coincidentally about \$250 million. Given these numbers are undiscounted, he allowed that the money Caelus gets today from the state is more valuable than the same \$250 million that Caelus pays back. But, he continued, when the value from the royalty, the net profits, the property tax, and the impact of the jobs is added into the equation, overwhelmingly the state is making a wise investment

in continuing to fund tax credits that directly support more oil through the pipeline.

[6:49:57 PM](#)

MR. FOLEY concluded his presentation with slide 7, "Closing thoughts," stating Alaska needs to make public policy that has more exploration and production companies, not fewer. He said HB 247 is absolutely a very significant increase in taxes on the oil industry. If the bill is passed, projects would be delayed or canceled and there would be a very negative effect on current production, jobs, and revenue. Most importantly, passage of HB 247 would discourage third party capital investments, he said. He offered his understanding that the committee's task is to find a way to come up with additional revenue to balance the state's budget, but strongly urged that the oil industry not be looked to for providing the answers to the budget problem. Specifically, the refundable Net Operating Loss/Loss Carry Forward Credits are absolutely critical to a company like Caelus and its ongoing investments. Senate Bill 21 is what attracted Caelus to the state; it was the balance of the petroleum system and the difficult environment and the difficult logistics, and the overwhelmingly favorable tax credits. Caelus probably would not have purchased Pioneer if HB 247 had been law when the purchase was being considered. Caelus would not be drilling its two exploration wells in Smith Bay without the Exploration Incentive Credit (EIC) and the Net Operating Loss Credit. Nuna is on the bubble and two things are needed: stable and favorable terms, and a smile from the oil price gods.

[6:52:13 PM](#)

REPRESENTATIVE OLSON inquired whether Caelus is drilling in other jurisdictions where the tax laws or structure are changed every two years.

MR. FOLEY replied he has worked in Alaska, in every jurisdiction in the Lower 48, in the Middle East, and in most Latin American countries. And, no, he has never seen a regime that changes its tax policies with this kind of pace.

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REPRESENTATIVE HERRON related there have been many conversations throughout the building about the definition of "new" oil. In doing some research he found that Oklahoma provides 36 months

before "new" oil becomes "regular" oil. He asked whether Mr. Foley has any thoughts on this subject.

MR. FOLEY responded all he can say is the tax policy created by the legislature has worked really well to stimulate activity.

[6:53:45 PM](#)

REPRESENTATIVE TARR, regarding the proven and potential reserves [outlined on slide 2], commented that today's situation is due to a glut of supply. She inquired as to how Caelus looks at the issue of overall global production relative to investments in Alaska. In some ways, she said, it would seem better for Caelus to not develop and to hold off for a better price. She further asked how having no control over what is done by the Organization of Petroleum Exporting Countries (OPEC) factors into Caelus's investment decisions in Alaska.

MR. FOLEY replied that Alaska is the only place Caelus does business, so it doesn't have the luxury of choosing to invest elsewhere. He said the pace is extraordinarily important for Caelus and most small independent companies, and maybe for the large companies, too. Caelus cannot have its business sit idle for two or three years and then pick up the helm and try to do projects years down the road. Caelus must make its investments now, it needs to make oil now. Caelus makes those investments with an expectation that prices will recover to a level that makes the company healthy.

[6:55:48 PM](#)

The committee took an at-ease from 6:55 p.m. to 6:59 p.m.

[6:59:13 PM](#)

SCOTT JEPSEN, Vice President External Affairs, ConocoPhillips Alaska, Inc., began his PowerPoint presentation by summarizing the activities that have been undertaken by ConocoPhillips Alaska, Inc. ("ConocoPhillips") since the 2013 passage of Senate Bill 21, the More Alaska Production Act (MAPA). Turning to slide 3, "Activities Since Tax reform (MAPA) Passed," he reported that ConocoPhillips has added two rigs to its Kuparuk River Unit rig fleet and placed an order for a new rotary rig and a new coiled tubing drilling rig. Expenditures were authorized to build Drill Site 2S ("DS 2S"), an extension of the Kuparuk River Unit on the southwest edge of the field. This extended the field itself and increased the reserves that will

be covered from Kuparuk. This project is being drilled right now and is expected to produce about 8,000 barrels a day at peak. The cost was about \$500 million and building it provided over 250 on-site construction jobs. ConocoPhillips also moved ahead with North East West Sac (1H NEWS), a viscous oil field that overlies the Kuparuk Field. The West Sac is a bit heavier crude than the light oils seen at Kuparuk, Alpine, or Prudhoe Bay. Because this crude is also a lot thicker it is hard to flow this oil and get it out of the ground. Modules that were built in Anchorage and trucked to the North Slope are set on site and electricity has been hooked up to them, but drilling the wells for 1H NEWS has been deferred until 2017, partly in response to the current low oil prices. All told, 1H NEWS will cost about \$450 million and several hundred people will have been on site during the construction. First oil is anticipated in late 2017.

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MR. JEPSEN continued reviewing the activities on slide 3, noting ConocoPhillips has sanctioned the Greater Mooses Tooth 1 (GMT1) Project in the National Petroleum Reserve-Alaska (NPR-A). The GMT1 investment decision was made in late 2015 and some of the key federal permits have been received, so construction is now moving ahead. When done, about \$1 billion will have been spent and the expected peak gross rate is about 30,000 barrels of oil per day. There will be about 600-700 jobs during construction and first oil is expected in 2018. Once GMT1 is finished, things will move ahead with GMT2, another discovery made in the Greater Mooses Tooth area about 9 miles southwest of GMT1. Not many details are yet had given it is still early, but the expected cost of development is over \$1 billion and will require 600-700 people to build it. It is currently anticipated that GMT2 is a larger accumulation than GMT1.

MR. JEPSEN said ConocoPhillips has been active in exploration. Two wells were drilled in 2014 that were part of the delineation program for GMT2. Seismic was shot over GMT1 in 2015. Three exploration wells will be drilled this year. Two explorations are being drilled in the Greater Mooses Tooth Unit west of GMT2. Thus, there is CD5, and about nine miles west of that is GMT1, and about nine miles west of that is GMT2, and two more exploration wells are being drilled in another nine miles. The first well has been finished and the rig is now being moved to the next well. After those wells are drilled, another exploration well will be drilled this spring off the CD5 pad. Mr. Jepsen noted he is not talking about the CD5 Project in the

context of tax reform because ConocoPhillips elected to pursue that project in 2012 before Senate Bill 21 was passed. That decision was made primarily because the company spent about 10 years getting it permitted, so there was a lot of momentum and desire to get it going.

MR. JEPSEN recalled sitting before the committee [during hearings on Senate Bill 21] and being asked what ConocoPhillips would do if the bill was passed. He said his response then was that he couldn't say exactly what his company would do, but that if a favorable investment climate was put in place he could say there would be more investment. That is exactly what has been seen over the last couple of years, he added.

[7:04:51 PM](#)

MR. JEPSEN addressed the four graphs depicted on slide 4, "Capital Spending Trends." He explained that the graphs show the capital trends of ConocoPhillips as a corporation, how these change with regard to oil price, and what the corporation's capital investment in Alaska has been over the past few years. He said he is focusing on capital investment because it is the closest proxy for adding new rate and new reserves. Not shown on the slide are expenditures for projects like well workovers, which also add rate to the company's production. Speaking to the upper left graph, he said it shows the corporation's capital spending since 2012, which peaked in 2014 at about \$17 billion. Turning to the bottom left graph, he pointed out that the Alaska North Slope (ANS) West Coast (WC) oil prices began going down significantly right after 2014. Like the State of Alaska, he said, a corporation cannot have significant negative cash flows for long periods of time, so ConocoPhillips acted rationally and started ratcheting down its capital program and cutting back on expenses in many places. Drawing attention to the top right graph, Mr. Jepsen explained it shows what has happened in Alaska. Despite high oil prices during the years of 2007-2012 under the tax regime of Alaska's Clear and Equitable Share (ACES) [passed in 2007, House Bill 2001, Twenty-Fifth Alaska State Legislature], ConocoPhillips only averaged about \$800 million annually of investment in Alaska. After passage of Senate Bill 21, ConocoPhillips ramped up its investments, and even for 2016 the corporation estimates it will spend about \$1 billion. Referring to the bottom right graph, he explained that it depicts the percentage of Alaska capital spend as a function of total corporate spend [6 percent in 2012, increasing over the years to an estimated 16 percent in 2016].

[7:06:41 PM](#)

MR. JEPSEN said his point with slide 4 is that Alaska has been differential to the corporation's other business units, with ConocoPhillips spending more in Alaska relative to its spending in other places. The corporation announced in late 2015 that it thought it would spend about \$1.3 billion in Alaska for 2016. But in the intervening months prices went lower and the corporation anticipates the lower prices are going to stay lower longer. So, capital spending has been ratcheted down about 20 percent [in Alaska], but as a corporation spending has come down about 40 percent. Referencing Representative Tarr's question of whether it would be better to stand back and leave the oil in the ground, Mr. Jepsen said ConocoPhillips is continuing to spend in Alaska because, as was explained by Mr. Foley, there is a lot of momentum and investment that must occur before a company can see production. Oftentimes it takes years to get permits, it takes years to build infrastructure, and rig contracts are signed that have duration of years. So, once all this is in place it can be very expensive and relatively hard to unwind and would be very difficult to restart once that was wanted. Also, ConocoPhillips got on to this growth in spending in part because Senate Bill 21 passed. It was a positive investment climate. Senate Bill 21 has been a factor in the investment decisions made by ConocoPhillips over the last few years. Obviously, it is not the sole investment criteria, but it has been part of the corporation's discussion and has been a very positive factor.

[7:08:25 PM](#)

MR. JEPSEN specified that the graph on slide 5, "Alaska Producers Negative at Current Pricing," captures what this whole conversation is really all about. He noted the data for the graph is from the fall 2015 Revenue Sources Book [published by the Department of Revenue]. The Y axis is the net cash flow in millions of dollars and the X axis is the ANS WC price in dollars per barrel. The orange bar represents the state's share, the state's cash flow as a function of oil price; the green bar is federal share; and the blue bar is what goes to the producers. Included in the state's share are royalties, severance tax, income tax, and property tax; the tax credit program is not included, but it does include the per-barrel production tax credits. Mr. Jepsen stated that at current prices on up to about \$50 a barrel, industry is losing money. The federal government is losing money because industry is in negative cash flow and producers basically get a loss carry

forward on their federal taxes. The state is still making over \$1 billion a year from the aforementioned components. The discussion right now, he continued, is about whether to increase the tax burden on an industry that is in a negative cash flow situation. The state is in a positive situation at this point in time, although maybe not as positive as it would like. From an industry point of view, increasing taxes drives industry to make equally rational decisions as it did when Senate Bill 21 was passed. If industry has a greater tax bite on its operations it will have to find ways to make up those costs somewhere else, such as reducing costs or reducing investments this year and looking at whether that is going to be encouraging for industry to make investments down the road.

[7:10:30 PM](#)

REPRESENTATIVE TARR requested Mr. Jepsen to again describe where the number of \$1.2 billion to the State of Alaska comes from.

MR. JEPSEN replied it was his corporation's modeling based upon the state's forecast of cost and capital expenses and looking at what would be the derived royalty, severance tax, and so forth.

MR. JEPSEN added that ConocoPhillips was negative cash flow last year. The average price for Alaska was about \$52 a barrel and prices are lower this year, so ConocoPhillips anticipates being negative cash flow this year as well.

[7:11:23 PM](#)

PAUL RUSCH, Vice President Finance, ConocoPhillips Alaska, Inc., brought attention to slide 6, "Key Concerns with HB 247." He said the proposal in HB 247 to increase the minimum tax from 4 percent to 5 percent is especially troubling given industry's negative cash flow position. ConocoPhillips is unique in that it discloses the results of its Alaska region externally, unlike most companies. On a net flow basis, ConocoPhillips had a loss in 2015 in excess of \$100 million. He surmised the other companies also had a similar sort of loss, and said an increase in the minimum tax in this environment clearly would further negatively impact industry's results in Alaska.

MR. RUSCH specified that the hardening of the minimum tax floor proposed in HB 247 also represents a tax increase for industry. Current tax law allows the use of some limited credits to reduce the tax below the minimum, he noted, in particular Net Operating Loss Credits and credits associated with new oil. Eliminating

this potential will effectively serve as a tax increase for those companies that are experiencing a loss and those that are investing in new oil. He said that HB 247 proposes a number of other changes which also represent increases in tax, such as higher interest rates, a loss of per-barrel credits, and excluding certain items from the net operating loss calculation.

[7:13:45 PM](#)

REPRESENTATIVE SEATON related that [ConocoPhillips's] fourth quarter [2015] detailed supplemental information shows \$67 million as loss from continuing operations for income taxes. He asked whether this is cash flow or is different than the [loss] in excess of \$100 million.

MR. RUSCH offered his belief that the adjusted net income on that same report was \$482 million.

REPRESENTATIVE SEATON understood, then, it is going off adjusted instead of cash flow.

MR. RUSCH responded yes and explained that there is a higher net income figure, a financial accounting figure that is then adjusted by non-cash items. Depreciation was in the amount of \$680 million, he believed, and then there is subtraction. That doesn't capture the real cash outflow of capital expenditures, he continued, which were in the neighborhood of \$1.4 billion. So, that's the full equation. The earnings figure does not have that capital number in it, so capital investment is an adjustment that is made.

REPRESENTATIVE SEATON explained he is just trying to figure out how all the numbers correspond.

MR. JEPSEN interjected that the financial accounting does not reflect the cash position.

[7:15:20 PM](#)

REPRESENTATIVE HERRON, regarding the proposed 25 percent tax increase [through raising the minimum tax floor from 4 percent to 5 percent], inquired what ConocoPhillips would think about a tax increase that was 5 or 10 percent as opposed to 25 percent.

MR. JEPSEN answered any time there is a tax increase, investors should be expected to react rationally. A tax increase would decrease the attractiveness of investing in Alaska and would be

compared to other existing investment opportunities to see how Alaska looks on an overall basis. An increase to 4.1 percent would be better than an increase to 5 percent, but it would still be moving in the wrong direction at this point in time.

7:16:36 PM

REPRESENTATIVE TARR, regarding the proposal in HB 247 to increase the interest rate for under/over paid taxes, stated that the interest rate under ACES seemed too high and under current law [Senate Bill 21] seems too low. The sweet spot is trying to be found, she said, so as not to incentivize behaviors that happen on either end of too high or too high. If the interest rate is too low it might be advantageous for companies to underpay. She requested Mr. Rusch to comment in this regard.

MR. RUSCH replied that the next slide will cover this point.

7:17:52 PM

MR. RUSCH turned to slide 7, "Key Concerns with HB 247," and addressed the proposed provision in HB 247 to increase the interest rate on taxes due. He said payments are made in good faith on time, and it seems inappropriate to apply a punitive interest rate. As far as what is a punitive rate, he noted that under the current rate and current system there is a period of 6-plus years in which the state completes its audits. So, if there is any follow-up discussion to resolve the tax, anything higher really does lead to excessive amounts of interest. For example, he pointed out, ConocoPhillips's 2006 audit was just now finally closed out - 10 years later. That is where the real objection comes from. The system currently in place drags out for a very long period of time; the corporation has no control over that. The corporation makes its best effort to pay its taxes in good faith and as accurately as it can. However, there is a lot of subjectivity in the system. Sometimes when ConocoPhillips appeals these rulings they go in its favor and sometimes they don't. No matter how hard a company tries to pay its taxes as accurately as it can, the company cannot do it because there is that much subjectivity.

7:19:12 PM

REPRESENTATIVE TARR related that tightening of the timeframe has been discussed and the Department of Revenue (DOR) has a plan for getting to where it is two to three years for the audits.

She asked whether this changes Mr. Rusch's opinion about this particular proposal.

MR. RUSCH responded, yes, the corporation would be open for considering that, but he would be hesitant to go there because it will take a number of years for DOR to get caught up. Second, there are some other things that ConocoPhillips has considered, such as whether the interest could begin being applied at some later point in a process, such as after the audit is completed and the company receives an assessment. Right now it goes back to the period in question, not to the time the assessment is issued. The big issue is the amount of time and that it is compounding interest over that time. There have been assessments where the interest component is close to or greater than the actual audit finding, which is not a goal that anyone has through the process. He said ConocoPhillips is open to anything that could be done to shorten the audit period.

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MR. RUSCH continued discussing slide 7, drawing attention to the proposed provision in HB 247 that would restrict the per-barrel credits earned and applying them on a monthly basis rather than the full-year basis that ConocoPhillips believes was the intention of the law. He said this appears to be an attempt by the state to game the system such that the state will always win in the event of a price movement or price volatility. In ConocoPhillips's view, that is in conflict with the concept of an annual tax. Monthly estimates are made, payments are made off those estimates, but the tax is intended to be a yearly tax.

[7:21:59 PM](#)

REPRESENTATIVE JOSEPHSON observed the statement on slide 7, "intent was full year basis." However, he said, testimony has been received that that was not the intent. Because that is definitely what the statutory language in Senate Bill 21 says, the presumption is strong that ConocoPhillips is in the driver's seat. But, he continued, the legislative history appears to be that that was not the intent; he inquired whether ConocoPhillips knows of any legislative history that counters that.

MR. JEPSEN answered he doesn't have any citations with him that he can provide today, but past practice tells this is what the intent was. Until this year it was never heard that this was supposed to be a monthly tax. That is how the corporation has

been paying its taxes and that is how they have been audited, it has been the basis on which the system works.

MR. RUSCH cited the language in AS 43.55.020(a)(5) [slide 10] that states, "less 1/12 of the tax credits that are allowed by law" and "for the calendar year," and said this language implies that it is a full calendar year tax assessment.

[7:23:45 PM](#)

MR. RUSCH continued discussing slide 7, addressing the proposed provision in HB 247 that would limit deductions for calculating net operating losses (NOLs), in particular capping transportation losses that result in a gross value at the point of production (GVPP) that falls below zero, and also excluding the Gross Value Reduction (GVR) from the net operating loss calculation. He said excluding the GVR is simply a question of whether the removal of this incentive will negatively impact future investment related to new oil, which was presumably put in place to incentivize new oil. ConocoPhillips views the elimination of transportation cost as a bit more problematic and arbitrary as the transportation cost is an actual cost that has been calculated and is a valid expense that has been accepted as a reasonable cost.

MR. RUSCH spoke to the proposed changes in confidentiality included in HB 247. He said these changes are concerning because it is unclear as to what the limitations would be on the data that would need to be provided. It was initially thought that this would only cover reimbursable credits, but it is ConocoPhillips's understanding that under the bill as currently drafted, it could potentially require the release of all taxpayer information. While it makes reference to the tax credits, the tax credits are based on a calculation of the taxpayer's full tax position. He said ConocoPhillips does not want to make it more difficult for the state to manage its budget, and he knows that obtaining some of this additional information would help, but his corporation is concerned about releasing potentially competitively sensitive information. Giving the information could result in a request for even more. The bottom line is that it opens up some very dangerous ground.

[7:26:17 PM](#)

REPRESENTATIVE SEATON pointed out it wouldn't be known what an individual company's tax liability is. Only the credits applied or refunded would be known, he said, and therefore he doesn't

see what the difference is. If the credits are secret, the state's investment by region is unknown except broadly across everything. He asked how that divulges something that shouldn't be known about the state's investment.

MR. RUSCH replied that as just explained by Representative Seaton he does not believe it would be an issue if this were restricted to releasing information on reimbursable tax credits. However, his understanding is that because the wording in the current law is referring to tax credits it has been suggested that net operating losses are also a tax credit, so that information would be available. Given the wording, if a company is required to release information on its net operating losses, is the company also required to release information on how those net operating losses were calculated? So, it is a concern if there is a requirement to provide some additional data. ConocoPhillips would ask that consideration be given to ensuring the language is very narrowly defined.

REPRESENTATIVE SEATON understood Mr. Rusch to be saying that ConocoPhillips Alaska, Inc. really doesn't have a large problem except for the net operating loss. He allowed he can see that if a Net Operating Loss Credit were to be applied then something would be known about the whole scheme. But, he surmised, as far as the other credits applied against tax liability that's not really so much a problem for ConocoPhillips because that is really like the reimbursable tax credit.

MR. RUSCH responded he would need to better understand what specifically other tax credits mean since the devil is in the detail. If it were to be very narrowly defined, he thinks ConocoPhillips would be okay with that. When it is more broadly defined in the legislation is when it gets more problematic.

REPRESENTATIVE SEATON requested that ConocoPhillips supply the committee with the definitions that would work without revealing the corporation's tax information.

[7:29:44 PM](#)

MR. JEPSEN moved to slide 8, "Observations," and expressed the concern that if HB 247 is passed the state will once again be entering a new significant tax framework. Tax stability and durability is important to investors, he said. It is a critical component in terms of how projects are evaluated in investment decisions. It has only been 18 months since Senate Bill 21 was

ratified by the voters and once again significant changes to the state's tax framework are being considered.

MR. JEPSEN further noted that ConocoPhillips Alaska, Inc. is in a negative cash flow position, which he believes much of the industry is. An increased tax burden will, with certainty, impact the corporation's long-term investment decisions as well as this year's operations, he said. Like the State of Alaska, ConocoPhillips is trying to find a way to get through this trough that looks like it is going to be deeper and potentially longer than was anticipated. If his corporation sees increased costs it will have to offset those somewhere. The only place where that can be done is by reducing investments and expenses. He offered his belief that it would have a very material impact on his corporation's long-term investments because, once again, it is being seen that when the state needs more money it comes back to the people who pay taxes. Last year his corporation incurred obligation to the State of Alaska of about \$665 million. So, ConocoPhillips is one of the players that provide revenue to the state. The corporation would like to stay in the position of continuing to invest for the future, but changes like this will impact the corporation's investment plans.

[7:31:34 PM](#)

REPRESENTATIVE TARR inquired whether an assessment has been done as to what the overall financial impact of HB 247 would be to ConocoPhillips Alaska, Inc.

MR. JEPSEN responded that when a company is in a negative cash flow position, and somebody wants more money from the company, that is a significant change. He explained that his corporation keeps its internal finances confidential; that is why he talks about the impacts using the Revenue Sources Book, which contains publically available data. Therefore, he is not in a position where he can tell the committee how much each change would mean to his corporation. But HB 247 potentially has a significant increase on his corporation's tax burden. Because of being in a negative cash flow position it is not something that the corporation can just absorb.

[7:33:09 PM](#)

REPRESENTATIVE JOHNSON understood ConocoPhillips Alaska, Inc. has five rigs working on the North Slope.

MR. JEPSEN answered that right now ConocoPhillips Alaska, Inc. has about five rigs running, which will increase to six for a short period of time between Alpine and Kuparuk when the new rigs are brought up. Some of the rigs are scheduled to leave the corporation's rig fleet because the scope of work for them has been completed. A couple of new rigs were brought in right after Senate Bill 21 was passed and those were designated as workover rigs and the corporation has basically worked through the backlog, there are no more broken wells to be fixed. Some of the other rigs will be phased out as the new rigs are brought in. The expectation for 2016 is four to five rigs working between Kuparuk and Alpine.

REPRESENTATIVE JOHNSON asked how many rigs ConocoPhillips has in the Lower 48.

MR. JEPSEN replied he thinks there were three rigs as of late last year, but he is unsure what the count is right now.

[7:34:21 PM](#)

REPRESENTATIVE OLSON inquired whether ConocoPhillips is working in any other jurisdictions in the world that have changed their tax structure as often as has the State of Alaska.

MR. JEPSEN responded not to his knowledge and deferred to Mr. Rusch to answer further.

MR. RUSCH answered no, he has not seen that. As was stated by a previous speaker, he recounted, a number of other countries are offering incentives; for example, deepwater incentives are being offered by Malaysia. If changes are being made, he surmised they are probably going in the other direction.

[7:35:16 PM](#)

The committee took a brief at-ease.

[7:36:18 PM](#)

PATRICK GALVIN, Chief Commercial Officer & General Counsel, Great Bear Petroleum, began his PowerPoint presentation by pointing out that Great Bear Petroleum ("Great Bear") is an exploration company. He displayed the slide, "PRESENTATION TOPICS RELATING TO PRODUCTION TAX CREDITS & HB 247," and said that as an exploration company Great Bear urges that the Exploration Incentive Credits be extended. This program is set

to expire June 30, 2016, he noted, and from Great Bear's perspective this program is an important investment for the state and is a program that should be extended as it relates to North Slope exploration activities.

MR. GALVIN addressed the slide, "GREAT BEAR PETROLEUM - A QUICK HISTORY, A NORTH SLOPE EXPLORATION COMPANY," and noted the company was founded in 2010, is focused exclusively on Alaska's North Slope, and has an office and all employees in Anchorage. Great Bear holds just under 500,000 acres, which is the limit for North Slope exploration acreage position, and Great Bear is the operator on about 590,000 acres of state oil and gas leases. Great Bear has acquired 500 square miles of three-dimensional (3-D) seismic over the past four seasons and is currently in the process of acquiring an additional 450 square miles of 3-D seismic. Great Bear has drilled three exploration wells.

MR. GALVIN moved the slide, "GREAT BEAR PETROLEUM - A QUICK HISTORY, FROM UNCONVENTIONAL TO CONVENTIONAL," and stated that Great Bear's original target was an unconventional, or shale, play on the North Slope. The company recognizes that with the cost environment in Alaska, shale plays face an "Alaska Unconventional Catch-22." This means that in order for a shale play to be economic it needs to have a cost environment that will provide for the return even at a higher oil price than is seen today. To achieve that cost reduction in Alaska will probably require a critical mass of additional drilling activity such as would be associated with an unconventional play. So, there is a bit of a chicken-and-egg aspect to the economics for unconventional plays in Alaska where the amount of cost savings associated with volume of drilling activity cannot be seen until actually doing it, but a company cannot anticipate that until it can get going on it. Great Bear is fortunate in having identified significant conventional oil and gas potential on its acreage. So, the company has been able to refocus its attention on the conventional plays within its leasehold and recognize that there is still an opportunity for an unconventional play, but it would likely come on the back of the buildout that would be borne by a conventional oil and gas discovery.

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MR. GALVIN showed the slide, "STRATEGIC EXPANSION OF CAPABILITIES, PARTICULAR FOCUS ON GEOSCIENCE & OPERATIONS," and said Great Bear is swimming against the tide by being in an expanding mode right now. As an exploration company Great Bear is not currently impacted by low oil prices other than costs are

going down, which creates opportunity for the company. Great Bear has had reorganization, has changed out its management team, and has significantly expanded in the areas of geosciences and operations.

MR. GALVIN presented Great Bear's new management team pictured on the slide, "STRATEGIC EXPANSION OF CAPABILITIES, NEW MANAGEMENT TEAM." He said the new president and chief executive officer (CEO) is Mike Mason, who has significant experience in the oil field as a petroleum engineer, spent many years with BP, and rose to the top petroleum engineer within BP. Clark Clement is the chief operating officer and is one of the leading experts in directional drilling as well as hydraulic fracturing. Larry Casarta is the new vice president for exploration and has a lot of experience both in Alaska and worldwide in finding oil in exploration plays.

[7:42:38 PM](#)

MR. GALVIN moved to the slide, "GREAT BEAR - PROJECT AREA," and pointed out that Great Bear's lease position is shown in blue. This position is located on the North Slope almost directly south of Prudhoe Bay and Kuparuk, he noted, but not in the foothills. Great Bear's acreage position is roughly the size of Prudhoe, Kuparuk, and Point Thomson combined.

MR. GALVIN showed the slide, "GREAT BEAR - LEASEHOLD POSITION," and said Great Bear's lease position has been acquired over five lease sales as those leases became available as they expired from previous holders. He displayed a second slide entitled, "GREAT BEAR - LEASEHOLD POSITION," and said Great Bear is very cognizant that the clock is ticking with regard to its leases. The expiration dates for Great Bear's leasehold are shown on this slide, he noted, and a large portion expires in mid-2018. This ticking is heard very loudly, particularly when dealing with seasonal opportunities for exploration activities. Great Bear has a number of partners, Mr. Galvin said, one being Halliburton. By farming in and doing work, Halliburton has earned a 25 percent working interest in a portion of Great Bear's acreage. In order to come under the acreage limitation, Great Bear last year sold a portion of its acreage to Borealis, which is owned by the Australian company Otto Energy. Borealis acquired an 8-10 percent interest in most of Great Bear's leases through that transaction.

[7:44:48 PM](#)

MR. GALVIN brought attention to the slide, "GEOLOGIC TARGETS," and reviewed the evolution of Great Bear's focus. When the company first came in it was focused almost exclusively on the shale source rock, he said. Great Bear was attracted to the North Slope by the three world class shale plays that are there. All three of these shale plays are stacked on top of each other within Great Bear's acreage, providing the opportunity to develop any of those three depending upon the location. Also, within that strata are a number of conventional or reservoir potential plays. These are mixed in to the shale plays, so within any particular lease location there may be any number of potential targets within these conventional and unconventional plays. Use of the terms conventional and unconventional is pretty loose within the industry, he noted. Due to technology advancements, things that were previously considered fairly unconventional are now becoming rather conventional. A model anticipated by Great Bear is to bring unconventional technology, horizontal drilling and hydraulic fracturing, to a conventional play in order to enhance the recovery from those fields.

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MR. GALVIN displayed the slide, "MODEL - MIGRATION OF SHUBLIK OIL," and noted Great Bear's location and proximity to Prudhoe Bay and Kuparuk. He explained that the current reservoirs have accumulated the oil through the migration from the original source rocks up into those reservoirs. This slide is a computer model that was generated from the input of all the North Slope wells and well data. A project of the U.S. Geological Survey (USGS) and PetroMod petroleum systems modeling software, it is a snapshot showing the migration route from the Shublik, the deepest and potentially most prolific of the source rock.

MR. GALVIN moved to the slide, "GREAT BEAR'S CONCEPT, FIND AND PRODUCE OIL FROM THE SOURCE OR FROM TRAPS ALONG THE MIGRATION ROUTE." He said Great Bear picked up the leases that cover those source rock areas because the company recognized that the tremendous amount of oil sitting in Prudhoe and Kuparuk was generated underneath this acreage. Great Bear is looking at an opportunity to produce from either the original source itself or from traps that collected oil along the way as the oil migrated up to the north.

MR. GALVIN outlined the activities done by Great Bear to date. Turning to the slide, "GREAT BEAR - 3D SEISMIC SURVEYS, 2012 - PRESENT," he said the most significant thing the company has done is to shoot modern 3-D seismic over a large portion of its

acreage. He explained that 3-D seismic provides a window into the potential conventional plays that may be with Great Bear's acreage and gives an opportunity to find those traps that may be holding the oil that is migrating through. This season Great Bear is acquiring about 450 square miles of additional seismic and once complete Great Bear will have nearly its entire contiguous position covered with 3-D seismic. This tremendous asset will provide an opportunity to identify drilling targets to pursue going forward.

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MR. GALVIN addressed the slide, "GREAT BEAR - EXPLORATION WELLS, 2012 - PRESENT," noting Great Bear has drilled three exploration wells. The first two were drilled the summer of 2012 along the haul road [Dalton Highway] on upland sites accessible year-round. Great Bear is one of the only exploration companies that is able to operate in the summer as long as the location is in one of the six sites shown on the map. All six sites are permitted for year-round access. The two well sites were selected primarily because of convenience and the first drilling program was primarily for drawing whole core samples out of the source rocks to tell what state they are in and their potential for producing oil and gas going forward. Using the seismic that was shot Great Bear identified three conventional oil and gas prospects. Great Bear was drilling last winter and was hoping to drill all three, but due to a number of factors, including the flooding of the Sagavanirktok (Sag) River over the Dalton Highway, the company was only able to get to the bottom of the first one, Alkaid #1. Great Bear remains encouraged by the prospectivity of all three of these areas, but now with the additional time the company has added those to the pot to compete with the rest of the prospects that are being generated through Great Bear's seismic analysis.

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MR. GALVIN turned to the slide, "GREAT BEAR PROJECT SPENDING (2010 - PRESENT), BUSTING THE MYTH THAT EXPLORATION COMPANIES DON'T HAVE 'SKIN IN THE GAME.'" He said Great Bear happened to come along at a time that saw the state provide probably the most generous credits that are going to be seen. Due to the change in the law and ability to stack the Exploration Incentive Credits on a temporarily increased Net Operating Loss Credit, there have been times when Great Bear's seismic program was receiving about an 85 percent tax credit. Overall, Great Bear has spent about \$220 million on its seismic, drilling, and other

activities, including holding the leases and general operating expenses. Great Bear has taken advantage of the Net Operating Loss Credits which have ranged from 25 percent to a temporary 45 percent to the current 35 percent. Great Bear has had 40 percent Exploration Incentive Credits for its seismic and generally 30 percent credits for its wells. Of that, the state has or will eventually reimburse Great Bear about \$140 million. This means Great Bear and its partners have spent \$80 million that will not be reimbursed by the state; it is real money that is being spent to acquire this information. Because Great Bear owns such a significant interest it has spent that money as wisely as possible in discovering oil on its acreage. The tax credit program requires Great Bear to convey to the state all of the data generated through the company's drilling and seismic programs. Therefore the state now has very valuable seismic data on its acreage as a result of these shared activities.

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MR. GALVIN spoke to slide, "TAX CREDIT FINANCING, BUSTING THE MYTH THAT EXPLORATION COMPANIES ARE 'FINANCED' BY TAX CREDITS." He said he wants to discuss the idea that companies that are enjoying tax credits are "financed" or "wholly financed" by the credit program. As far as the North Slope is concerned, Great Bear uses its investors' money to pay employee salaries, oil and gas rentals, office expenses, and other business expenses. Some of those expenditures associated with geologic work, permitting, and the actual contracting of the seismic and drilling qualify for tax credits, currently somewhere between 35 and 75 percent. Because of the ability to collateralize the tax credits Great Bear can borrow against the expected credit from the state. That means Great Bear can take the money it has available to it, can anticipate if X amount of dollars is spent then so much in credits will be generated, and the company goes to the bank and asks for a loan against that. As long as Great Bear has the money to pay its portion and the money to pay the bank's financing fee, the bank may be willing to lend the money. But, Great Bear must put real money up, a significant amount of capital, in order to do that. So, at no point are explorers making money off of the tax credit program. Explorers are investing that money to advance their exploration activities and doing it in conjunction with the state.

[7:56:03 PM](#)

MR. GALVIN showed the slide, "CHALLENGES UNIQUE TO NORTH SLOPE EXPLORERS, ADDING MORE RISK TO AN ALREADY RISKY INVESTMENT," and

outlined why the tax credit programs are so important from a North Slope explorer's perspective. Oil and gas exploration in definition is a risky venture, he said, there is no guarantee of a return on investment. Adding some of the particular items with regard to Alaska's North Slope and that just adds more risk to what is already a risky investment. There is a lack of geologic data on the North Slope, particularly anywhere outside of the existing fields. There is a short and unpredictable winter exploration season. Permitting is complex and there are often delays. And, Alaska is a very high cost environment.

MR. GALVIN said the slide, "UNIQUE ANS CHALLENGES - LACK OF GEOLOGIC DATA, FEW WELLS IN GREAT BEAR ACREAGE," shows all of the well penetrations on the Alaska North Slope. Each dot is a well and the lines reflect deviated wells. A tremendous amount of activity has occurred in certain clusters. However, on Great Bear's acreage, only about 11 wells drilled were drilled before the company came along. From a density perspective and an oil and gas density perspective, this is basically unexplored area. Little to nothing is known about what is between those wells and each well has its own story about how much information was received from that well. From a risk perspective that adds tremendously in terms of whether an investment is going to pay off. Only two wells had penetrated the Shublik previous to the acreage being purchased by Great Bear. Great Bear has since drilled two wells through the Shublik, basically doubling the information relating to the Shublik within Great Bear's acreage.

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REPRESENTATIVE JOHNSON asked how much of the \$80 million spent by Great Bear Petroleum and its partners was leveraged.

MR. GALVIN clarified that the \$80 million was not leveraged, the \$80 million is entirely what Great Bear has spent.

REPRESENTATIVE JOHNSON recalled Mr. Galvin having stated that the tax credits allowed Great Bear to leverage money and to borrow money. He asked whether any of that \$80 million is leveraged or whether it is all straight ownership investment.

MR. GALVIN explained that when he says "leveraged" he that means Great Bear is putting its money up and is then able to borrow additional money against it.

REPRESENTATIVE JOHNSON said he understood Mr. Galvin to say that because of the tax credits Great Bear was also able to borrow money using that.

MR. GALVIN responded that a way to look at it is that of the \$140 million that will be reimbursed by the state, approximately half of it was borrowed ahead of time. So, \$150 million was put up and \$70 million was borrowed. It was over four years, so there are different cycles.

8:00:40 PM

REPRESENTATIVE JOHNSON recalled that in 2011 a Great Bear representative testified that there would be 200,000 barrels a day by 2020. The representative further testified that Great Bear planned to begin production in 2013. He inquired why there has yet to be production to date in 2016.

MR. GALVIN replied that the testimony was provided by former president and CEO, Ed Duncan, who is no longer with Great Bear. Pointing out he was not with Great Bear at the time, he offered his understanding that the slide being referred to by Representative Johnson was intended to provide a picture of what could be possible with an unconventional play if it were supported through both the state and Great Bear being able to advance it in an expeditious manner. The purpose of the slide was to basically give the state a reason to recognize that if this comes about, we are going to have to be ready to deal with a couple hundred wells a year on the permitting and other infrastructure aspects of it. He said he does not believe Mr. Duncan intended to say Great Bear was at this point guaranteeing it was going to be drilling this amount and producing that amount of oil because it hadn't yet done any exploration.

REPRESENTATIVE JOHNSON referred back to testimony provided before the Senate Finance Committee where a senator stated that Great Bear would be drilling 150 wells per year. However, there has been nothing close to that, only six have been drilled since 2011 when it had been said that there would be 100 a year. He asked whether this presentation is as speculative as that one.

MR. GALVIN responded he cannot speak to what the senator was referring to. He offered his belief that the senator was referring to the same slide that was intended to represent what was possible with an unconventional play and what would be necessary for an unconventional play. How it was used at the time is not anything to do with Great Bear. But, Mr. Galvin

said, what he is presenting to the committee today is not speculative whatsoever, he is showing the committee what Great Bear has done.

REPRESENTATIVE JOHNSON commented that he was not the only one confused by the statement, a senator also interpreted it the same way.

[8:03:33 PM](#)

REPRESENTATIVE TARR, regarding the state picking up 65 percent of the cost and Great Bear 35 percent, recalled previous speakers advising to think of tax credits as the state being a co-investor. Given [the state] is at much more than 50 percent, she asked when it is a subsidy versus a co-investment scenario from Great Bear's perspective. She said that when she thinks of co-investor she thinks more of equal investment or something that is more favorable for the state than is this scenario.

MR. GALVIN answered he would go back to something earlier described by Representative Seaton with regard to looking at this as an investment and whether it is worthwhile to the state. Mr. Galvin said he would argue that having the state provide a greater subsidy for exploration activity actually is a good investment from the state because of the return that the state could receive and the ability to basically multiply the amount of wells that the state is going to get for the amount of private dollars that are going to be available for taking that risk in Alaska. Because the state is the resource owner it has a significant interest in trying to get as many explorers to the state as possible, not just betting on one.

[8:05:14 PM](#)

REPRESENTATIVE TARR noted industry has said it wants some level of certainty, stability, and durability; therefore it doesn't seem unreasonable for the state to also want some similar level of certainty. She recalled that according to Mr. Ken Alper, director of DOR's Tax Division, there is a certain amount spent that can be directly linked to projects that are in production right now. She said she thinks about \$650 million was spent for things that are not in production. A significant amount of investment is being made on the part of the state without any level of certainty that production will come. Based on what Representative Johnson is saying, she thinks that previously [legislators] were given that expectation and factored that into

their decision making. She asked how [legislators] are to get the sense of certainty that industry likes.

MR. GALVIN replied that speaking as an exploration company, there is no certainty. There is nothing that an exploration company can give legislators with regard to certainty that there is going to be a particular outcome. If [the legislature] is going to encourage someone to drill two wells there will be a certain likelihood of success and someone drilling six wells will have a significantly greater likelihood of success. From the basis of an investment portfolio, the greater the diversity of investments the higher the level of confidence for the return being looking for. With regard to exploration, he suggested it is a similar dynamic - if additional exploration is encouraged there will be a higher likelihood of success because [the state] has diversified its risk more. On an individual company basis, he advised, if anybody tells the committee that it can guarantee exploration success, don't believe them.

8:07:35 PM

REPRESENTATIVE SEATON said the problem as he sees it is that net present value for the state's investment has to at least pay off some time. The scenarios being seen by the state are fields of 15,000 barrels a day with a 30-year life and the facilities and tax credits up front. The state has a net present value loss at \$80 when talking about production tax, and at \$60 when talking about corporate income tax, production tax, and royalty. At price ranges of \$60-\$80 the state never recovers its money and in fact has to generate other taxes to supplement that, which gives [members] pause for going forward in the current credit situation. He requested Mr. Galvin to tell him how that analysis is wrong or how the state should look at its investment as to whether it will ever be repaid in those situations.

MR. GALVIN responded that a fundamental question is whether members believe in the likelihood of finding additional oil on the North Slope. He related that pretty much every geologist he has talked to has said there is great certainty that there is a tremendous amount of yet undiscovered oil on the North Slope. If the likelihood of a 30 million barrel field is evaluated and what the economics of that would be compared to a 200 million barrel field it will be seen that they are significantly different. Doing that type of analysis accepts the probability that a range of fields is going to be found still sitting on the undrilled acreage on the North Slope. Because the state is the owner of the entire pool, the state investing along with

industry in exploring that area gives the state the greatest likelihood of getting a return on its investment than any of the individual investors because the state shares in the probability for all of those. Within the state land, and given the amount of oil that should be found up there and the expectation that prices are going to recover at least to a moderate level, Mr. Galvin said he would suggest that members will find that the net present value (NPV) analysis would show that it is positive to the state given the range of potential fields that would likely be found. He clarified he is talking about exploration acreage on the North Slope on state land.

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REPRESENTATIVE SEATON reiterated that what the state has gotten so far is fields of 15,000 barrels a day with 30-year lifespans. He surmised members need to look at larger fields to see what the net present value of those would be. However, he continued, with new oil having a 20 percent Gross Value Reduction (GVR) the net present values turn out to be negative at some pretty high levels "compared to ... if that P80 50-70 is right, then we're in negative territory much of the time."

MR. GALVIN answered that for any modeling exercise the assumptions must be set appropriately and with a wide enough window. Everyone has experienced the problems with having a narrow assumption field. A wide enough assumption area must be given and the probable outcomes set accordingly. [Models would need to be run] against a number of different field sizes, a number of different cost regimes, and a number of different price scenarios.

[8:12:47 PM](#)

MR. GALVIN resumed his presentation. He explained that the graph on the slide, "ANS CHALLENGES- SHORT & UNPREDICTABLE DRILLING SEASON," shows the number of days the tundra was open within Great Bear's acreage over the past 12 seasons. It is highly unpredictable and fairly limited, he pointed out. An explorer must identify the prospects a year in advance, begin getting permits in place six months in advance, commit to a rig, and put millions and millions of dollars at stake for an exploration season that might be less than a month or as long as four months. Such uncertainty adds significantly to the risk profile and how much of that investment will end up not generating the wanted results. For example, last year Great Bear was hoping to drill and complete two wells in the season,

but in the end spent virtually the same amount of money to get only one well drilled. That adds tremendously to the risk and is the reason why it is difficult to attract exploration dollars to Alaska.

MR. GALVIN referred to the slides, "UNIQUE ANS CHALLENGES - COMPLEX PERMITTING," and "UNIQUE ANS CHALLENGES - HIGH COSTS," and noted that permitting is difficult in Alaska. Great Bear's exploration program, which is fairly standard, had 19 different permits from 16 different agency contacts. The North Slope is a high cost environment. As price comes down, costs are coming down due to increased competition, increased equipment on the Slope, and more providers of the same type of service. But, one driver for Great Bear's costs is the number of wells it can plan to drill at any one time. When Great Bear drills one-off well programs the service provider is basically getting its rack price, but when Great Bear has a four to six well program it can negotiate and bring those costs down.

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MR. GALVIN showed the slide, "GREAT BEAR - IMMEDIATE WORK PLAN, HOW WE WILL REALIZE THE POTENTIAL," and reported that under its immediate work plan going forward Great Bear will: complete its seismic program for this winter; complete its prospect inventory to identify the wells to drill; execute a multi-year, multi-well exploration program over the next few years; and hopefully secure cost-effective services.

MR. GALVIN moved to the slide, "GREAT BEAR - IMMEDIATE WORK PLAN, HOW PRODUCTION TAX CREDITS WILL DICTATE LIKELIHOOD OF SUCCESS," and said the number of wells that Great Bear drills will be directly related to the tax credit program that is in place. Thus far the state has supported exploration activities through the Exploration Incentive Credit and through allowing that credit to be stacked with the Net Operating Loss Credit. Collateralization of those tax credits has allowed Great Bear to borrow against them in advance. The secured repayment on those tax credits also allows Great Bear to secure the lowest cost financing. Unpredictability in the repayment of the credits is expensive because it adds to the cost of borrowing against them.

MR. GALVIN addressed the slide, "HOW TAX CREDITS DICTATE EXPLORATION DRILLING VOLUME, A CONCEPTUAL EXAMPLE." He pointed out that the tax credit programs work as a multiplier on an exploration company's capital. Great Bear has a certain amount of capital it has raised to execute an exploration program. The

amount of credit the state offers will leverage or multiply Great Bear's available capital and establish what the company's drilling program is going to be. He posed a scenario in which Great Bear has \$100 million available to spend, money it has and is putting in that is not going to be reimbursed. That money can then be leveraged up because of the tax credit program. Under a 35 percent credit program Great Bear can spend \$140 million and drill between 5 and 7 wells, and under a 65 percent credit program Great Bear can drill between 10 and 13 wells because it can spend about \$260 million. That is the difference between the state providing less than half versus more than half; it will provide that more wells can be drilled for the same amount of equity money put in by Great Bear.

[8:18:19 PM](#)

MR. GALVIN spoke to the slide, "EXPLORATION'S ROLE IN FUTURE STATE PRODUCTION," saying it is important from the state's perspective to get more wells drilled. The more wells drilled, the more discoveries there will be, the more projects that will come into production to replace the decline in the current fields. To feed the system so it is not on a perpetual decline requires more exploration at the front end in order to replace the fields that are decline.

MR. GALVIN turned to the slide, "WHY THE STATE SHOULD EXTEND EXPLORATION INCENTIVE CREDITS," to advocate that successful exploration will result in cash flow to the state. He argued that it will be significantly net present value positive to the state if the exploration companies on the North Slope are successful. The chance of success is increased by drilling more wells. There are multiple play types on the North Slope and one entity's success is going to inform the opportunities in other parts of the Slope. It has a virtuous circle aspect to increasing activity levels on the Slope. Costs will come down because of increased activity levels. As the resource owner the state has a greater chance of success than any individual company. The state is able to increase its confidence in a return by having more activity. At a minimum, the state will gain valuable information about its resources that will begin to chip away at that lack of data that is a barrier to entry for new companies that are looking at Alaska.

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MR. GALVIN elaborated on the slide, "TAX CREDITS - KEEP WHAT IS WORKING," asserting that the state's reason for putting these

policies in place is still valid - trying to encourage and accelerate the transition of the state's field from being dominated by a couple multi-nationals to one that is attractive and creates a vibrant and diversified group of independents exploring in the area. The state has taken a number of steps to try to do that and has generated a significant amount of momentum. There are more operators on the North Slope than ever before. A lot of recent successes have been announced. There is tremendous potential for oil discovery on the North Slope and the state needs to recognize that and join the industry in trying to make it a success. The one thing that must be understood is that the momentum that is currently going can also end up working in reverse if the state ends up stopping it. Inertia is a significant force in the industry. If the state stops the activity level, if the state discourages the companies that have invested thus far, trying to get new companies back to follow behind the ones that came to Alaska and failed is going to be extremely difficult and the state will lose the years of time it has invested in trying to get this momentum going.

MR. GALVIN concluded by turning to the slide, "SUMMARY." He said Great Bear is a highly active North Slope explorer that has invested significant amounts to date; those investments have been well spent. He said the pace and volume of Great Bear's future activity will be dependent upon the tax credits, the Exploration Incentive Credits, that are available to it. The state's interest is in reducing risk of exploration and increasing the likelihood of success for the state and the Exploration Incentive Credits under Alaska Statute (AS) 43.55.025 are very valuable in that regard and should be extended for North Slope exploration activities.

[8:23:18 PM](#)

REPRESENTATIVE JOSEPHSON asked what Great Bear spent for its leases.

MR. GALVIN offered his belief that all told on all of its leases Great Bear is approaching \$30 million. He said he will provide the committee with a more accurate figure.

[8:24:04 PM](#)

The committee took a brief at-ease.

[8:25:26 PM](#)

JOE REESE, Senior Managing Tax Counsel, BP Exploration (Alaska) Inc. ("BP"), stated that BP is a member of the Alaska Oil and Gas Association (AOGA) and supports the testimony that was provided by AOGA earlier in the day. He said BP is very interested in Alaska's oil and gas tax policy and the success of it, as well as ensuring that BP, the State of Alaska, and Alaskans benefit from that policy. The policy is crucial to BP's business and to its successes. BP is looking forward to continuing to maintain a safe and compliant business in Alaska that is sustainable. Oil prices have dropped about 70 percent over the past two years and this has created a very difficult situation for BP. The corporation is currently cash flow negative, which is not a sustainable way to operate a business. As a result, BP is instituting an approximate 13 percent reduction in force and is also collaborating with its working interest owners at Prudhoe Bay to right size the business for the current economic environment.

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MR. REESE said BP is committed to complying with tax laws in a responsible way and is committed to developing relationships that are constructed and open with the tax policy makers. One of the major costs for BP is production tax and it is important to note that production taxes are not a tax on profits. Rather, they are more closely aligned with a tax on cash flow, but is not precisely that either. It is its own defined term and is a tax on production. Given the conflating of verbiage as this discussion has progressed, BP wants to ensure that the differences are understood. Those differences are basically based off of how capital expenditures are treated. In a cash flow analysis, all of a company's capital expenditures are deducted just the same as is done with operating expenditure. It is simply what cash is brought in and what cash is flowing out. From a profit standpoint, the capital expenditure is amortized and deducted over some period of time. So, it is really in the way that the capital expenditures are reflected. While BP is currently cash flow negative, it still pays production taxes because of the way those costs are treated. There are several investments that BP makes that are not deductible for production tax purposes - for example, the Alaska Liquefied Natural Gas (AK LNG) Project and certain other specifically excluded costs under the production tax law.

MR. REESE pointed out that at current prices, BP does not receive any production tax credits from the State of Alaska. Nor does Prudhoe Bay production attract oil production tax

credits under the minimum tax. While BP does not currently receive any oil production tax credits, BP believes that it is important to both the industry and Alaska that many participants are able to have a viable business here. Therefore BP does not support any change to the production taxes under Senate Bill 21.

MR. REESE said BP acknowledges that the State of Alaska is in a fiscal crisis and is struggling along with the industry to make ends meet. While reasonable people may disagree about how to improve the current oil and gas tax policy, BP does not believe that now is the right time to make any changes that would increase taxes and further inhibit BP's ability to maintain the activity level at Prudhoe Bay along with its working interest owners. Near-term changes to the state's oil and gas tax policies will have long-term consequences for everyone.

8:30:37 PM

MR. REESE provided specific comments about HB 247, saying that in particular the bill would increase the minimum production tax from 4 percent to 5 percent. He said this would be a 25 percent tax increase on the industry and for some folks it would be more. It would be a 25 percent increase to BP because BP does not have any credits that would lower the minimum tax.

MR. REESE stated HB 247 proposes to implement an artificial limitation on the use of credits within the tax year. The production tax is calculated on an annual basis with monthly installment payments, he explained. Those monthly installment payments are based off of forecasted prices and estimated costs, so BP makes a payment using those tentative numbers. The bill would suggest that any credits that are calculated on that monthly basis create a limitation to the total amount of credits that a company can take so that a company could not take more than that. If, upon true-up on March 31, a company determines that its forecasted prices and estimated costs were not actuals, the company would be capped out on the amount of tax credits that it could take. However, if it came lower, that advantage would swing the other way and go to the state.

MR. REESE specified that BP views the interest increase proposed by HB 247 as being a material change. Current law provides an interest rate that is 3 percent above the federal funds interest rate and is calculated on a simple basis. Under HB 247, the interest rate would be 7 percentage points above the federal fund rate and the interest would be compounded on a quarterly basis. This is significant for multiple reasons. First, at the

current federal funds rate, that would represent an increase to the principle amount of the tax due of about \$.55 per dollar during the period which the audit is outstanding. The current statute of limitations is six years, so in year one a company pays its tax, in year two there is a true-up on March 31, and then six years from that true-up event is the end of the statute of limitations and that is when the state is required to provide the company with its production tax assessment. During that intervening period, to the extent that the state has determined that an assessment is due, that assessment would attract interest. Because of the significant period of time that has elapsed, it becomes a material sum of money and BP views it as an incentive for the state to delay those audits and not provide them to a company until the end of that statute of limitations.

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MR. REESE said the Net Operating Loss Credit is important to the industry. While BP does not currently use this credit for oil taxes, BP believes that it is a matter of good tax policy to allow the recovery of those losses. Even if a company is not able to take that credit in the current year, it should still have the benefit of that credit.

MR. REESE lastly pointed out that BP views the confidentiality provision in HB 247 as a slippery slope. The bill proposes that confidentiality is expanded beyond simply an aggregate number of tax credits to disclosing an individual taxpayer's amount of tax credits. He expressed BP's concern about where that disclosure would begin and end. He further stated that there may be a constitutional issue with respect to both the Alaska and the U.S. constitutions regarding the privileges and immunities clause. It is BP's view that taxpayer confidentiality cannot be partially waived, BP's view is that it is an all-or-nothing proposition. Therefore, BP does not support the expansion in any way of the confidentiality provisions.

MR. REESE concluded by reiterating that BP is committed to maintaining a safe and compliant business in Alaska that is sustainable; BP is committed to complying with the tax laws in a responsible manner and to having open and constructive relationships with tax policy makers; and BP supports durable, predictable, and administrable oil and gas tax policy and that is why BP does not support HB 247.

[8:36:44 PM](#)

REPRESENTATIVE SEATON surmised that when Mr. Reese stated BP does not get any tax credits he was meaning that BP does not get any reimbursable tax credits, and that BP applies all of its tax credits against its production tax.

MR. REESE replied that he said BP does not yet currently receive any oil production tax credits and under the minimum tax Prudhoe Bay does not attract any oil production tax credits.

[8:37:19 PM](#)

CO-CHAIR NAGEAK thanked the witnesses for their testimony.

[HB 247 was held over.]

[8:38:02 PM](#)

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 8:38 p.m.