

ALASKA STATE LEGISLATURE
SENATE RESOURCES STANDING COMMITTEE

April 9, 2016
9:00 a.m.

MEMBERS PRESENT

Senator Cathy Giessel, Chair
Senator Mia Costello, Vice Chair
Senator John Coghill
Senator Peter Micciche
Senator Bert Stedman
Senator Bill Stoltze
Senator Bill Wielechowski

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

HOUSE BILL NO. 247

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

certain well expenditures; repealing the calculation for certain lease gas production tax credits for certain losses and expenditures; relating to limitations for expenditures applicable before January 1, 2011; making conforming amendments; and nontransferable oil and gas production tax credits based on oil production and the providing for an effective date." alternative tax credit for oil and gas exploration; relating to purchase of tax credit

- <PENDING REFERRAL>

SENATE BILL NO. 130

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

- HEARD & HELD

PREVIOUS COMMITTEE ACTION

BILL: SB 130

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

SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

01/19/16	(S)	READ THE FIRST TIME - REFERRALS
01/19/16	(S)	RES, FIN
04/04/16	(S)	RES AT 3:30 PM BUTROVICH 205
04/04/16	(S)	Heard & Held
04/04/16	(S)	MINUTE(RES)
04/05/16	(S)	RES AT 3:30 PM BUTROVICH 205
04/05/16	(S)	Heard & Held
04/05/16	(S)	MINUTE(RES)
04/06/16	(S)	RES AT 3:30 PM BUTROVICH 205
04/06/16	(S)	Heard & Held
04/06/16	(S)	MINUTE(RES)
04/07/16	(S)	RES AT 3:30 PM BUTROVICH 205
04/07/16	(S)	Heard & Held
04/07/16	(S)	MINUTE(RES)
04/08/16	(S)	RES AT 3:30 PM BUTROVICH 205
04/08/16	(S)	Heard & Held
04/08/16	(S)	MINUTE(RES)
04/09/16	(S)	RES AT 9:00 AM BUTROVICH 205

WITNESS REGISTER

PATRICK FOLEY, Sr. Vice President

Alaska Operations

Caelus Energy Alaska

Dallas, Texas

POSITION STATEMENT: Commented on how SB 130 would impact Caelus' Alaska operations.

BRUCE WEBB, Sr. Vice President

Furie Operating Alaska LLC

Anchorage, Alaska

POSITION STATEMENT: Commented on how SB 130 would impact Furie's operations in Alaska.

CHRIS COOK, Director

Finance

Ahtna, Incorporated

Anchorage, Alaska

POSITION STATEMENT: Commented on how SB 130 would impact Ahtna operations in the Copper River Basin.

PAT GALVIN, Chief Commercial Officer and General Counsel
Great Bear Petroleum
Anchorage, Alaska

POSITION STATEMENT: Commented on how SB 130 would impact Great Bear's operations on the North Slope of Alaska.

MR. J. BENJAMIN JOHNSON, President and CEO
BlueCrest Energy
Fort Worth, Texas

POSITION STATEMENT: Commented on how SB 130 would impact BlueCrest's operations in Cook Inlet.

ACTION NARRATIVE

[9:00:16 AM](#)

CHAIR CATHY GIESSEL called the Senate Resources Standing Committee meeting to order at 9:00 a.m. Present at the call to order were Senators Costello, Micciche, and Chair Giessel. Senator Stoltze joined the committee right after the call to order.

SB 130-TAX;CREDITS;INTEREST;REFUNDS;O & G

[Contains discussion of companion bill HB 247.]

[9:00:49 AM](#)

CHAIR GIESSEL announced consideration of SB 130.

PATRICK FOLEY, Sr. Vice President, Alaska Operations, Caelus Energy Alaska, Dallas, Texas, said he is responsible for all of Caelus' Alaska operations. He was sorry to not be present physically this morning. He was at their world-wide headquarters in Dallas resolving some "very significant employment issues" in planning for their 2016 operations. He would be back in the Anchorage office on Monday to deliver a very unpleasant message to about 25 percent of his workforce.

He said the slide presentation is the same series of slides that he previously presented and testified to in other committees on this same bill. He would not go through that pack page by page, but he would focus on key issues. He would also emphasize some of the points raised in President and CEO of Caelus Energy, Jim Musselman's, letter to the Governor on Friday.

CHAIR GIESSEL noted that members had received that letter.

[9:03:15 AM](#)

MR. FOLEY said Caelus, combined with their Pioneer heritage, had spent an aggregate of \$2 billion in the State of Alaska, produced 23 million barrels of oil, and last year had a drilling capital budget of roughly \$300 million. That work activity has earned them about \$100 million in transferable tax credits.

Over the last several years, Caelus had employed about 300 hard-working Alaskans focused on four projects: Oooguruk (offshore the Colville Delta), a companion onshore project called Nuna, a 400,000 acre acquisition of leasehold and exploration activity on those leases, and they have shot two very substantial 3D programs. In this last week they drilled two very expensive exploration wells at Smith Bay on their Tulimaniq Project.

[9:04:45 AM](#)

"On the bright side," Mr. Foley said, Caelus produced about 18,000 barrels of oil at Oooguruk yesterday and over the next month they will complete stimulation activities on all the wells, so that production will grow to over 20,000 barrels/day. Then production will deplete normally over the next 30 years.

He said the results from the two wells at Smith Bay are very encouraging and they plan to be out there next winter to continue with an appraisal program. He hopes to be able to tell them about development plans at some point in the future.

"On a significantly less bright side," in response to the low oil price and tax uncertainty, Mr. Foley said, Caelus has been forced to make very immediate and drastic changes to business operations and last week announced suspension of drilling "grass roots" wells at Oooguruk. This means that their Nabors 19 AC drilling rig that has been drilling 365 days a year since 2008 will cease. That project employs nearly 300 contractors and those jobs will be temporarily, he hopes, put on the shelf. In addition, they will lay off nearly 25 percent of their workforce next week. The Nuna Project remains on hold.

Simply put, Mr. Foley said, Caelus is struggling to survive and this is probably the story of many other oil companies in the United States today. Survival uses a fairly common formula: eliminate waste and reduce all the costs wherever possible. Now, the only tools that remain available to them are a reduction in their capital program and administrative expenses. Simply put, they cut payroll. They will do these things and at the same time maintain their wells and facilities and continue with the same excellent AHFC program. They will just have to find a way to accomplish their objectives with fewer people.

[9:08:20 AM](#)

MR. FOLEY said their business has been funded for the last several years by combining all of their available cash with any free cash flow that is available and all of their earned tax credits. They take that money and drill wells. The reality is that the company has limited capital and no excess revenue over their costs at this time, and in the future if the tax credits are reduced they will have even less capital. That is why they decided to suspend drilling operations.

[9:08:58 AM](#)

SENATOR WIELECHOWSKI joined the committee.

MR. FOLEY said slide 6 demonstrated how the current legislation would impact Caelus. It used today's pricing, \$36 or \$37/barrel in 2016, and increased that to \$52 over the next five years. They tried to portray what their base business is and then applied the various elements of the bill.

[9:09:50 AM](#)

SENATOR STEDMAN joined the committee.

MR. FOLEY continued that the GVR "fix" would no longer allow the gross value reduction (GVR) to be included in the calculation of a net operating loss (NOL). That simple piece actually erodes the value of his business by about 13 percent and adding a 4 percent hard floor erodes the value of his business even more by a total of 31 percent. A \$25 million transferable credit limit would erode the value of his business by 77 percent and raising the hard floor to 5 percent would erode the value by 83 percent. Then his business would be worth "17 cents on the dollar."

He also calculated the impacts of the bill that just came out of the House. It used a 2 percent hard floor, a \$100 million cap on transferable tax credits, and limited the GVR applicability period to 5 years. Its provisions are more favorable, but still reduce the value of his business by nearly 50 percent.

The Nuna Project (slide 7) is the kind of project that is "on the bubble," Mr. Foley said. It needs some price recovery in order to go forward and it would also require some kind of a tax credit system. But if it does go forward, it represents about 100 million barrels of oil and peak at production of 20-25,000 barrels/day. It would employ nearly 300 full-time employee contractors for two years of construction and for about four or five more years of a drilling program. That would result in

future royalty payments of nearly \$900 million to the state and future net profit share payments of \$500 million. There would be \$250 million in future production tax payments and about \$100 million in ad velorem tax payments.

MR. FOLEY said this project would be entitled to earn about \$150 million in future NOL cash payments from the state. At today's prices, this project won't go forward, but in the neighborhood of \$70/barrel it would. Then they would receive \$250 million in credits and that would be offset by future production tax payments to the state in a similar amount. But over and above that, the state would bring in nearly \$1.5 billion in other revenues.

[9:14:34 AM](#)

MR. FOLEY said he appreciates that the Alaska State Legislature is in a fiscal crisis, like his company. Because of the economic conditions his company faces, he will be reducing the payroll by 25 percent, but they would "find ways" to accomplish their objectives with a smaller workforce. On Monday, he will have the very unpleasant task of sitting across the table from very smart, hardworking, caring, dedicated, hopeful people, many who are his friends, and he will explain to them that in a matter of days their employment will end. "And I can assure you that no matter what side of that table you find yourself, it'll be simply horrible..."

He said the oil industry has borne the vast majority of the state's tax burden since the early development of Prudhoe Bay and that may have been appropriate in the prosperous days of the past, but those days are behind us now. The price has collapsed by 70 percent in just this last year alone and at today's oil price, his company loses money with every barrel it produces.

MR. FOLEY said there is a lot of talk about a need to diversify revenue sources to help balance the budget and he advised that it would be wise to seek a fair and balanced approach that takes all the necessary measures to adequately protect the wellbeing of the most vulnerable. Many of the tax credits contemplated in the original bill attack the most vulnerable in industry, even if they are oil companies.

[9:18:12 AM](#)

CHAIR GIESSEL noted that Senator Wielechowski and Senator Stedman had joined the committee. She also noted that Deputy Commissioner of DOR, Jerry Burnett, was in the audience.

SENATOR COSTELLO said she appreciated slide 6 that laid out how the different components of the bill will impact his company and asked him to comment on the logic that previous legislatures have used to try to incentivize his and other companies' activities, and now say they were successful and now it's prudent to pull back on some of that because the state is facing budget challenges.

MR. FOLEY responded that SB 21 found the right balance of tax and credits. It was a simple bargain that said we're going to help struggling new companies by offering tax credits upfront. In exchange, those projects will generate royalties, production tax, and in his case, net profit share payments, as well as other payments to the state. So, SB 21 did exactly what it was intended to do. It allowed Caelus to purchase the Pioneer assets. The biggest driver that brought them to the state was the tax credit system. Alaska has always been known for being a high cost environment, but with tremendous rocks and tremendous reservoir properties and the tax credit program helped balance those costs.

[9:21:21 AM](#)

SENATOR COSTELLO asked how the investment community has responded to this legislation.

MR. FOLEY answered that the investment community is "terrified." They need favorable fiscal terms, but more than that, they need stability and predictability. They need to know that the rules in place when investment decisions were made will stay in place for the life of a project. Pioneer came up in 2002 and Oooguruk commenced production in 2008. So, they were "sort of born during the ELF environment." There have been five or six significant tax regime changes since then. Nowhere else on the planet changes its fiscal policy so frequently. When the investment community looks at that it gives them grave concern in making future investments. You can't blame everything on the tax policy, but along with the depressed oil price, it makes attracting future investment "very, very difficult."

SENATOR COSTELLO asked the total government take at the Oooguruk field.

MR. FOLEY answered that simply put, government take is a share of the profits, as are the costs. The company take is what is left over and at today's prices, he has no profits. His take is zero. Government take could be described as 100 percent, meaning they take royalty payment despite profitability. Property tax

payments are made despite profitability, as well - although that is part of their contract. The issue today is that there are no profits and the bill before them tries to take a greater piece of the money that is available.

CHAIR GIESSEL said some folks assert that the rig being down and layoffs would have happened for Caelus anyway in today's price environment.

MR. FOLEY responded that there is an element of truth to that, but the facts are that the price is horrible, Caelus is not profitable and can't continue to make investments to drill wells. To finance drilling of wells they take the cash they have available and add future tax credits to that. As they lose confidence that they are going to continue to receive and earn those tax credits, their future forecasts for capital that would be required to continue drilling wells is higher than it otherwise would be with those tax credits.

[9:25:24 AM](#)

Their rig is idle, but hopefully, they will see price recovery and be able to start it back up again. He didn't know the exact price at which that would happen, but he did know that if changes are made to the tax credit system and other elements of the state's fiscal policy, the price required to restart goes higher than it would otherwise be if the tax policy remained as it is today.

CHAIR GIESSEL thanked him and asked if he had received a reply to the letter he sent to the Governor.

MR. FOLEY replied that the letter was sent by Jim Musselman and he was not aware of a reply.

SENATOR WIELECHOWSKI asked him if Alaska should be lowering its taxes or providing more tax credits to keep companies like his from leaving Alaska.

MR. FOLEY answered that he believes the balance found in SB 21 is appropriate. Caelus was able to drill two exploration wells out in Smith Bay under it, which also earned exploration incentive credits (EIC). It is also a program that will sunset. He appreciates that it costs the state money to fund the credits earned for exploration, but he also believes more wells were drilled because of those credits. If those go away, he suspected there would be less exploration activity in the future.

SENATOR WIELECHOWSKI asked if it's appropriate for the state to take more than 100 percent (that Mr. Foley had testified it was taking under the current tax structure).

MR. FOLEY answered no.

SENATOR WIELECHOWSKI asked if he was saying in order to change that, the tax needs to be lowered.

MR. FOLEY answered under today's price Caelus make no profits. Hopefully, the price will go up and they will again make profits. They made previous investment decisions under SB 21 rules and they would continue making those investment decisions.

SENATOR WIELECHOWSKI asked what percentage of the exploratory work was paid to Caelus with state tax credits.

MR. FOLEY answered that tax credits haven't been paid for anything yet. The work has been done and all of the bills have been paid by Caelus; that work enabled them earn tax credits which they have not received. Specifically, Caelus has earned two forms of tax credits: NOL and EIC credits, and the combination of those two equals nearly 75 percent of their costs.

SENATOR WIELECHOWSKI asked if any other oil jurisdictions in the world provide 75 percent in tax credits incentives.

MR. FOLEY answered no, but the bargain struck under SB 21 offered credits up front in exchange for a bigger piece of the profits down the road. If there is no project, there are no profits.

[9:29:57 AM](#)

SENATOR WIELECHOWSKI said the director of the Tax Division testified earlier that the state wouldn't receive more in production taxes than it is paying in tax credits until 2025 and asked if Caelus received any royalty relief in any of its projects.

MR. FOLEY answered yes; their Oooguruk project enjoyed royalty relief. It is one of the highest royalty and NPSL projects on the North Slope. He explained that royalty modification basically encourages a project to go forward by improving the economics. Pioneer was encouraged at the time to make its original investments with a flat 5 percent royalty until the project became profitable.

As to the second question about credits being greater than the state's revenues, and the point he tried to make with slide 7 is that there is coincidentally an absolute balance between the credits that are earned by the Nuna project and the future production tax payments. But production tax is not the only revenue that the state gets; it also gets nearly \$1 billion in royalty payments and about \$.5 billion in net profit share payments.

SENATOR WIELECHOWSKI asked if any of Caelus' projects are eligible for the GVR, which reduces the production tax down to zero.

MR. FOLEY replied that the Oooguruk field qualifies for a 20 percent GVR reduction that allows them to eliminate 20 percent of the revenue in the calculation of their tax bill and NOL. In this instance he is not yet profitable, so he does not pay a production tax. The GVR doesn't necessarily mean that each and every GVR field would not pay a production tax.

SENATOR WIELECHOWSKI said the State of Alaska paid 75 percent of their exploration costs and asked what percent of the development costs the state picked up through development credits and deductions.

MR. FOLEY answered that it is a matter of semantics, but no one has paid 75 percent of the costs. Caelus paid 100 percent of the cost and that work will earn them credits, but they don't have them now. Tulimaniq wasn't an exploration project and is not in development. Oooguruk is a field that does have a net operating loss and it does earn NOL credits. He reminded them that Pioneer came to Alaska in 2002 and spent \$2 billion and the project has yet to make a profit. So, they are in a net operating loss position. Some people may ask how they can have been here for so long and still not make a profit - they must not be very good. The reality is under the production tax system the net operating loss simply means that they spend more money in the state than they bring in. That is typical of any new growing business where all your money is plowed back into future capital projects, and down the road they will become profitable. And down the road Caelus would pay a production tax.

[9:35:16 AM](#)

SENATOR WIELECHOWSKI asked if the state were to make no changes to its oil tax structure or the tax credit system, would he

commit to reverse his decision to cut the workforce and cut back on some of their drilling.

MR. FOLEY answered that price of oil forced them to make that decision, but they hope for price recovery, and if the tax system becomes less favorable, it will take a higher price in the future for them to resume drilling activities.

SENATOR WIELECHOWSKI asked if they did nothing to the tax structure this year, would he stay in Alaska and keep current work levels as they are.

MR. FOLEY answered that Caelus has no plans to leave Alaska and will continue to produce the Ooguruk field, but they are not able to make continued capital investment. So, the real question is if the tax laws stayed the same, would they continue to make capital investments, and the answer is that they still need price recovery. But if the tax law changes the price has to recover to a higher level.

[9:37:26 AM](#)

SENATOR MICCICHE said the second page of Caelus' letter to the governor talks about the constant barrage of anti-industry rhetoric, but those that worked on the current tax regime are also under attack. "So, we get it." For some reason some folks just don't like the oil industry and that's just the reality. They like some larger companies that provide them products that perhaps are optional, but they strongly dislike energy companies that provide products that are necessary.

The letter says the state is struggling to evaluate its entire fiscal system right now, because it has a problem called the \$4.1 billion fiscal gap. He didn't like the "wiser heads in Juneau" comment. He found it offensive. He advised that as the legislature struggles through this problem, for people to provide helpful comments on some of the ways the state could better manage its way through a low price environment.

SENATOR MICCICHE noted the slide that says "Nuna, A Project on the Bubble" could have said "The Energy Industry, a Sector on the Bubble," because every member in that sector is feeling the pain right now and Mr. Foley had clarified that their decisions were based largely on the economics.

SENATOR MICCICHE said he had personally sat in on some very painful discussions over the last year and a half with industry and he has always counted the State of Alaska as a partner,

because it is "our economy." Unfortunately, the state is not diversified and is very dependent on the revenue that comes from oil and gas. He concluded that he would love to see a letter with some suggestions on how to manage through a low price environment and that he had asked the state's industry partners for the same. He would love to hear from them, but hasn't had a response.

What he gets from the Musselman letter is that the legislature and perhaps the administration has been largely irresponsible on some of their decisions, and he would like to see that turned around to: "If I were in your position, being an industry expert, what I would suggest is that you look at some of these suggestions."

[9:41:12 AM](#)

SENATOR MICCICHE said most of U.S. oil is just trying to manage its way through a very low price environment and hoping for an improvement in the future. He thought Mr. Foley would agree with that. He asked if Caelus has any production that looks different than slide 5 right now.

MR. FOLEY replied that Oooguruk is the only field that Caelus operates in Alaska and right now Alaska is the only place they operate. Senator Micciche is exactly correct, the whole industry is struggling whether they are in Alaska or the Lower 48. He uses his company as an example of all of the newer smaller companies, but in reality none of the companies are profitable at today's oil prices.

In response to Senator Micciche's comment about industry coming forward with suggestions, Mr. Foley said he was invited to testify as an expert in the oil industry, and his point is that the oil industry doesn't have any excess profits to give. They are struggling for survival just like the State of Alaska.

SENATOR MICCICHE said that was fair and he agrees. However, some suggestions might be ideas on how to manage through a low price environment together and ways that might soften the effect on the general fund when things are improved. Think about it that way, he advised; these are tough decisions.

CHAIR GIESSEL thanked Mr. Foley for his testimony.

SENATOR WIELECHOWSKI said Caelus alleged that there is a constant barrage of anti-industry rhetoric and asked if Mr.

Musselman or Mr. Foley could provide a list of the constant barrage of anti-industry rhetoric in writing.

CHAIR GIESSEL supported the request and asked Mr. Foley to submit that request in writing. She then invited Mr. Bruce Webb from Furie Alaska to testify.

[9:46:18 AM](#)

BRUCE WEBB, Sr. Vice President, Furie Operating Alaska LLC, Anchorage, Alaska, said Furie took over leases from Escopeta Oil Company in 2010, and with the State of Alaska as partner, they went down the road of putting in a new development in the Cook Inlet. For the last five years they have drilled five exploration wells; one was converted to a development well on their new platform. They have also put in about 16 miles of sub-sea pipeline and a new processing facility.

Prior to 2015, they had spent about a half billion dollars, and last year alone, they spent \$200 million to put the infrastructure in place. They employed about 300 Alaskans during that project. They are very proud of the two gas contracts that give them a brighter future. When they started this they had no gas contracts and no way to repay their debt. Furie is here for the long run, he said. Some companies have gone bankrupt and a couple large companies decided to leave Cook Inlet, but Furie decided to stay. They view the State of Alaska as a partner and hope they continue their partnership into the future.

[9:48:12 AM](#)

MR. WEBB said the tax credits are very important to the oil industry; they provide investments and jobs to Alaskans and supply revenue to the state. He explained that because Furie is in Cook Inlet it doesn't pay production tax, but they do pay lease rentals and royalties, property tax and other payments that directly benefit the state. They have already invested \$700 million and have employed 300 people in Alaska. Their utility contracts have begun to reduce energy costs in the Cook Inlet.

He pointed out that 100 percent of every tax credit reimbursement Furie gets is reinvested directly into their project. None of the tax credit money has left Alaska. Without the tax credits Furie will have to significantly reduce their exploration and development that will ultimately result in the reduction of jobs. He showed a couple pictures of their onshore facility at Nikiski and the offshore platform. He reiterated that they had lowered the price of energy in Cook Inlet and have increased revenues to the state of Alaska, as well as adding new

jobs. The tax credit lowers the risk of shortfalls of natural gas in the future and it may be short-sighted to end that 15-20 year supply of natural gas right now or they may be back to where they were in 2008/9.

[9:50:46 AM](#)

He had heard that Cook Inlet benefits only the people around Cook Inlet, but that is not correct. Everything that goes to all the communities in Alaska comes through Anchorage. Cook Inlet has what is called sweet light crude; it is taken to the local refinery and turned into gasoline, diesel fuel, jet fuel, heating oil and propane. This local energy reduces the cost of transportation of everything: food, building materials, automobiles, and everything that is shipped to the villages.

In March 2014, the Chamber of Commerce commissioned a study with Northern Economics that concluded that Cook Inlet oil and gas production directly benefits the rest of the state to the tune of \$2.4 billion. So, for people who say otherwise, it's just not correct. Without the lowered transportation costs, everything in all the other villages and communities would be more expensive.

MR. WEBB said the current tax credit program as it exists today is crucial to their business. They use the 20 percent qualified capital expenditure, the \$25 million carry forward loss, and the 40 percent lease operating costs. Without this tax credit structure, Furie would not have been able to make it in the Cook Inlet. The price of doing business there is about three times higher than anywhere else in the United States, and add the offshore environment to that where you can only drill six months out of the year and must pay for storage the other six months. The upside is that the resource is larger. So, there is the prospect of being profitable in the future and they hope to see a profit under the current tax structure until 2018 when the Enstar natural gas contract comes into effect.

During the peak of construction last year, Mr. Webb stated, Furie employed 300 people. They paid \$2.9 million in property taxes to the state, cities, and borough in 2012-2015. Those same payments this year are going to be in the neighborhood of \$4.8 to \$5 million. So, local communities are already seeing an increase of income. The lease rentals paid to the state since 2011 are \$1.6 million; estimated royalties are about \$300 million for the life of the project under the current reserves if they don't develop any more. He provided a "short list" of 100 local businesses they supported during this project.

In terms of lowering energy costs, Homer Electric (supplying 30,000 customers in the Kenai Peninsula), stuck with them through the entire process. When they started the development, Hilcorp had absorbed the whole gas market. The attorney general instituted what was called "consent decree pricing." Their contract with Homer Electric started just a few days ago and now Furie supplies all the gas for the Kenai Peninsula. In 2018, those costs will decrease by about 16 percent over what they would have been had Furie not been in the Cook Inlet. Just recently, they signed the Enstar contract, which will decrease energy costs by 17 percent to Cook Inlet and the Railbelt communities. That isn't just Furie, though; the Chugach/Hilcorp contract in 2018 will decrease energy costs by 8 percent. That is because Hilcorp now has competition. Across the board, energy prices in Cook Inlet will go down as will the transportation costs to other communities in Alaska.

MR. WEBB said the tax credits were put in place for them to do what they have done. But they are not done yet. With the \$200 million Furie has invested, the State of Alaska is a partner that will be going down this road with them. The tax credits are like energy bars, and occasionally the state gives them an energy bar and says keep going. Taking those energy bars away will slow things down a lot. "We're still going to make it over the finish line, but we're just not going to be running as fast."

MR. WEBB had some general comments: Furie sympathizes with the situation the state is in with budget deficit and hopes to work out a good compromise. They think CSHB 245 is a good solution; it would be like the state not giving them as many energy bars. Saying, "Hey, we have to cut back; slow down your pace; conserve your energy. We'll help you get over the line." But, if you just take them away it will be devastating to the entire industry.

[9:56:36 AM](#)

MR. WEBB explained the process behind their low cost capital structure. He said they go to Wall Street and talk to banks like Bank of America and ING, and finance the tax credits. The certainty of the tax credits and their historic performance has brought their cost of capital down from 17 percent to 5 or 6 percent. Before the governor's veto of the \$200 million tax credit appropriation last year, companies were financing 90 to 95 percent of the tax credit's face value at an interest rate of 5-7 percent. Recently these same companies are willing to finance only 50 percent of the tax credit certificate at 17-20

percent. It's a huge difference. That money is received upfront and provides them the liquidity to invest in a project. Then they get the tax credit and pay it back. It's a constant, fluid motion of money coming in and going out of the company.

SENATOR STEDMAN asked if a finer distinction could be made on the credits' effect on their cost of debt, not their cost of capital.

MR. WEBB answered yes.

SENATOR STEDMAN said normally a 20 percent capital credit is offset with some tax collection mechanism. So, it looks like an imbalance in Cook Inlet where they have left the capital credit in place but there is no viable mechanism for the severance tax portion to do the offset.

MR. WEBB responded that Furie doesn't pay severance tax on oil or gas production under the current tax regime, and they are not opposed to paying their fair share. However, they do pay the royalties, which are much more significant than the property tax would be. Their cost of capital has gone down and with the sunseting of this project at the point of paying off all their debt, the prospect of paying tax in the future isn't exactly a negative.

SENATOR MICCICHE asked for a couple-sentence description of how the 2015 credit veto affected Furie.

MR. WEBB recalled that he was in Kenai for an economic forum when the governor vetoed the credit appropriation and a lot of cellphones started ringing, not just his. The reaction was immediate: Wall Street and European investors were calling the owners and CFOs to find out what was going on. That veto sent a ripple across the finance world that immediately started pulling back funds and looking at higher interest rates. Their comments were the worst thing they can deal with is instability.

SENATOR MICCICHE said, "We're proud to have you there, and I definitely believe a deal is a deal. We need to have clear-cut policy going forward and not provide a game changer in the middle of the season...Thanks for being there. We're excited about what you are doing."

[10:01:28 AM](#)

SENATOR STEDMAN said the legislature can make additional appropriations into that credit fund and asked Mr. Webb how he

thought the state could handle funding the credits to control their impact on the treasury. Should we have open-ended appropriations? Should we follow the appropriation cap language, which is currently at \$73 million?

MR. WEBB responded that the state is in a tough spot, but the industry needs stability. It makes raising additional debt or equity much easier. The \$25 million cap in the bill is not enough for Cook Inlet or his company. He would like to see a \$100-200 million range, something that they know will be there and will be enough to get through 2016 and into 2017. Once that happens, a reduction in the amount of the tax credits is something they can plan for. Time is needed for planning; abrupt change is hard to adapt to.

SENATOR STEDMAN said the cap is calculated off of the gross production tax revenue and they are in the minimum tax arena. Somebody has to pay it just to get the calculation to work. But tying the credits to the revenue side from a policy perspective also works together in a system. His concern was that some delinking is going on that is creating some instability. The state is in a very peculiar position.

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MR. WEBB said in the past there has always been a special appropriation, and it would be nice to continue that. He would ask his CFO to write a response with suggestions. "He's a pretty sharp guy."

SENATOR STEDMAN said he thought that would be a good policy discussion to have at the table, because in the minimum tax arena the whole concept of the tax formula gets turned upside down.

CHAIR GIESSEL said that formula is based on production taxes coming from another basin and asked his thoughts on a production tax for Cook Inlet noting that the House Finance Committee Substitute had a 35 percent production tax for Cook Inlet incorporated into it.

MR. WEBB answered that he thought Caelus could manage that if it becomes effective in 2017, so it could be planned for.

CHAIR GIESSEL thanked him for testifying today and invited Mr. Cook to testify.

[10:07:51 AM](#)

CHRIS COOK, Director, Finance, Ahtna, Incorporated, Anchorage, Alaska, said Ahtna is using AS 43.55.025(a) tax credits - the Frontier Basin tax credits and Middle Earth tax credits - currently to explore the Copper River Basin. Ahtna would not be doing that exploration if these incentives were not available due to the high risks of exploration and financial risks.

He said their current drill site is on state land. The upside for the state for this activity is royalty and production taxes, lower rural energy costs, and community and economic development in the Ahtna region. The purpose and need for gas in the Copper River Basin is to develop and produce energy for local residents and utilities by conducting exploration in the basin which includes drilling the Tolsona 1 in the next several months and potentially future targets in the area. He said Ahtna hopes to be able to reduce the cost of energy in the area and that would encourage business and therefore, reduce out-migration of the population. They also hope to build infrastructure in the region.

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Ahtna has drilled 11 exploration wells since the 1960s in the Copper River Basin. The most recent well was drilled by Rutter in 2005 and then they came back in 2008. So, there is a potential for energy exploration and production in that area.

[10:11:13 AM](#)

MR. COOK said Ahtna's originally acquired some Amoco seismic and over the last several years has been working their exploration program off of that. Ahtna has submitted its data to the DNR and obtained prequalification to utilize the 025 tax credits. Their seismic program has targeted drilling the Tolsona 1 in the next several months on state land. The site is about 10 miles outside of Glennallen heading toward Anchorage; the pad is being installed now. A road is being built that will be also be used for public access to the Crosswind Lakes Trail. He explained that the well is expected to be about 4500 vertical feet deep and targets the Nelchina sandstone. They have had natural gas shows in nearby wells, which indicates a great potential for a local fuel source.

[10:12:46 AM](#)

MR. COOK said the Tolsona 1 project team is 100 percent Ahtna. Although Ahtna prefers having good partners to work with, their partners with Copper River Basin experience are not able to participate in this well due to low energy prices (slide 8). The Tolsona Exploration Oil and Gas Company has a lot of Alaskan

companies working for it: Ahtna Construction is putting in the pad right now; Restoration Science and Engineering is working on permitting; HXR Drilling Services is doing the well engineering; Michael L. Foster Group companies are providing some of the services; and many state, local and federal agencies are supporting them in getting the well ready to go. As an example, the DNR Division of Oil and Gas director has visited the region and the project site.

[10:14:02 AM](#)

MR. COOK concluded with their request: to extend 025(6)(a) and (7) tax credits from July 2, 2016 to July 1, 2022, similar to other tax credit expiration dates. Ahtna also supports keeping the 023 and 025 (a)(1-4) Middle Earth tax credits in place as incentive to explore and develop energy in that region. He thanked the committee, the Alaska Legislature, the Governor and his staff, and the citizens of Alaska for their support.

[10:15:04 AM](#)

SENATOR WIELECHOWSKI asked if their exploration is targeting oil or gas.

MR. COOK answered that it is targeting gas.

CHAIR GIESSEL finding no further questions, thanked Mr. Cook and invited Mr. Galvin to testify.

[10:15:23 AM](#)

PAT GALVIN, Chief Commercial Officer and General Counsel, Great Bear Petroleum, Anchorage, Alaska, related a quick history of the company (slides 2-3) and then talked about their project and how the state tax credit program affects it. He said Great Bear was founded in 2010 when it picked up almost 500,000 acres of oil and gas leases just below Prudhoe Bay and Kuparuk. They are exclusively focused on Alaska's North Slope and have offices in Anchorage; all of their employees work and live in Anchorage. They currently hold the original acres, but have brought in additional partners that has raised the total area to 590,000 acres. They have acquired 500 square miles of 3D seismic over the last four winters and are currently acquiring another 450 square miles of seismic. They have drilled three exploration wells.

He said the Great Bear story really starts with the shale play and the idea that the North Slope has tremendous opportunity, because of prolific shale intervals that are stacked on top of each other. The expectation is that those can serve as a source

for the kind of shale play that has been successfully developed in basins in the Lower 48.

Great Bear drilled its first two wells with the intent of pursuing that type of a play, but discovered that the 2010-2014 cost structure on the North Slope would prohibit that type of development. Then the question became how to get the initial investment in infrastructure in place in order to make such a project economic. Fortunately, during that time they were able to acquire the 3D seismic which allowed them to identify conventional plays for a development project that would support the infrastructure capital costs thus laying the infrastructure for the future shale play. They still believe that a shale play is a potential in the long term on the North Slope, but it will have to be built upon the foundation of a series of conventional plays.

MR. GALVIN said with that transition, the Great Bear organization significantly changed its management team and expanded its geoscience and technical capabilities. They analyzed the seismic data and developed a prospect inventory that increased their confidence where even in the current low price environment they saw opportunity.

[10:20:47 AM](#)

He said the management team was expanded to include operations expertise that it previously did not have; their new CEO and president, Mike Mason, is a petroleum engineer and has a long history and career of drilling throughout the world. At one point he was the top petroleum engineer at BP. He ran Apache's Egypt operations immediately before coming to Great Bear.

The Chief Operating Officer is Clark Clement who is one of the leaders in hydraulic fracturing. He has drilled all over the world and has significant experience in developing new technologies and unlocking the potential in different fields.

MR. GALVIN said their acreage sits due south of Prudhoe Bay and Kuparuk; Dead Horse sits just above them. The TransAlaska Pipeline (TAPS) and the Dalton Highway cut right through it providing a significant advantage as an established transportation corridor. Earlier, Great Bear formed a strategic partnership with Halliburton that became a 25 percent working interest owner of the leases and paid for the first two wells and some seismic. Recently, they struck a deal with Borealis that was subsequently purchased by Otto Energy, an Australian publically traded company that purchased an 8-10 percent working

interest in most of their leasehold in order to bring them below the acreage limit.

MR. GALVIN explained that there are three primary shale or source rock intervals on the North Slope and they are all present within Great Bear's leasehold. Most recently there has been a lot of talk about the QHRZ, because of the Icewine well that has been drilled just to the south of their acreage. That is one of the potential source rock intervals Great Bear is looking at.

The Shublik is considered to be potentially the most prolific of the source rock intervals. With the 3D seismic and the wells they have drilled, they have also identified reservoir rock that has been produced elsewhere on the North Slope present on their acreage as well. Those sit nested between the source rock intervals, which is an ideal situation. Their objective is to look somewhere between a conventional and an unconventional play within these various nested rock intervals and find out where the oil may be trapped and where it may be producible given particular rock properties.

The bright line terms for conventional versus unconventional have really been blurred over the last decade or so, he said, with new technologies being used on a more conventional basis. The particular reservoir properties they are looking for have shifted significantly over that time and have created opportunities to develop fields that previously would have been considered uneconomic.

[10:25:05 AM](#)

MR. GALVIN said that Great Bear sees the opportunity to use unconventional technology (horizontal drilling and hydraulic fracturing) to develop a range of fields that would be considered somewhere between conventional and unconventional.

[10:25:31 AM](#)

SENATOR COGHILL joined the committee.

[10:25:48 AM](#)

MR. GALVIN said slides 8 and 9 were a representation of the modeling that had been done previously on the North Slope as the oil is produced towards the south in the source intervals and then migrates north into the fields that are currently being produced. It recognizes that most of the oil being produced out of Prudhoe Bay and Kuparuk actually originated south of their acreage and has migrated over the millennia into their current

fields. The Great Bear concept recognizes that this oil has moved through their area or was produced under it and goes back to the source and to see if it can be produced there. Because most of the time, oil remains trapped within the reservoir or the first rocks that created it. Also, there are likely traps along the way where the oil has pooled, another opportunity to produce.

[10:26:54 AM](#)

He said Great Bear has spent four winters shooting seismic and has acquired 500 square miles across the center portion of their acreage position. This winter they have completed the western block and are currently shooting the eastern block with hopes of completion before the season ends. Once this is in hand, they will have a complete inventory across their primary contiguous acreage, a significant tool for identifying conventional prospects.

In 2012, Mr. Galvin said, they drilled two wells along the Haul Road and permitted six sites that are all adjacent to gravel access roads to TAPS, which means the sites can be accessed year-round (slide 10). The Alcor and Merak wells were drilled in the summer of 2012 primarily to test the shale intervals and to pull whole core samples from them to provide significant information about the shale play opportunities. Subsequently, using 3D seismic they were able to identify conventional targets and drilled the Alkaid well about 3.5 miles west of the Haul Road on an ice pad in the winter of 2015. They were hoping to drill two other sites that winter, but the short season as well as operational issues precluded that and they were only able to complete the one well.

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Going forward (slide 11), he said that Great Bear plans to complete their seismic program this year and develop a priority list of prospects that will be drillable and ready to pursue. They will execute a multi-year, multi-well exploration program to pursue those conventional prospects. And through that they hope to achieve more cost-effective services in the exploration side.

[10:29:06 AM](#)

He said there are four myths about how the North Slope exploration works in that environment and the tax credit issue. 1. That exploration companies are "financed" by Alaska tax credits.

2. That exploration companies don't have skin in the game on these exploration plays.
3. That Alaska could get the same level of exploration activity with lower exploration tax credits.
4. That tax credit payments can be delayed with little impact to exploration companies.

[10:30:22 AM](#)

MR. GALVIN said the truth is that companies have to actually spend the money up front to be eligible for the tax credits. They will pay for their employees, their offices, all their rentals, and all of their contractors, and then some of those expenditures will be eligible for tax credits in different amounts. Great Bear's seismic activities between the EIC and NOL programs are potentially eligible for up to 75 percent credit this year. It will drop to 35 percent in June 2016.

He explained that an explorer can currently borrow on the expectation of getting those tax credit payments back from the state. That's really the only borrowing that an exploration company can do, because it's the one certain cash flow coming back from the operation. Exploration companies have a better than 50/50 chance of not seeing any cash flow from their exploration expenditures and no one will lend money on that. Money is borrowed only through having equity.

[10:31:51 AM](#)

At no time does an exploration company make money off of exploration activities in Alaska, at least as it relates to tax credit reimbursement from the state, Mr. Galvin said.

SENATOR STEDMAN said Mr. Galvin was in kind of a unique position being an ex-commissioner of the Department of Revenue (DOR), understanding the politics of the building, and having his current background. So he has a pretty good feel for what they are struggling with on both sides of the table in trying to meet payrolls and financing the credits with open-ended appropriations versus the appropriation cap mechanism that impacts industry and exposes the treasury, and he was wondering if he had any comments on that particular issue.

MR. GALVIN responded that he disagreed with the characterization of the statutory language as a "cap." It was never intended to be a cap in any way. It was intended to basically be a flow of automatic money that would go into the fund in order for it to be legally recognized as a source of funds from the state. The expectation throughout the development of the tax credit fund

was that there would be annual appropriations based upon what the expected cash flow obligations of the state to that fund would be. Almost immediately it was set up as an open-ended appropriation in order to forestall the risk that the state would not be able to meet the obligations of a credit certificate being submitted to it for reimbursement.

10:34:41 AM

He explained that the reimbursable tax credit program was always seen as a cash flow obligation of the state and it was expected to be part of the cash flow structure in terms of the plan the state would develop in order to meet its obligation. Right now with the low oil price, the state is in a significant cash flow challenge, but "it is just that: a cash flow challenge," he said.

MR. GALVIN said he had testified a number of times with regard to the oil production tax, that the expectation was at high oil prices the state would sock away the surplus in order to be able to meet its obligations during the times of low oil prices. The state is dependent upon a cyclically priced commodity and it has to plan accordingly. This happens to be one of the most extreme periods of having to meet that obligation.

SENATOR WIELECHOWSKI said the original ACES legislation had a lower progressivity than the ultimate ACES: a 25 percent tax rate and .2 percent progressivity after \$30, but it also had a 10 percent floor for legacy fields. As the bill negotiated its way through the process, the producers said they had to get rid of the 10 percent floor, which they did. But they increased the progressivity at the high end, too, to .4 percent. Now, they've taken away the progressivity at the high end and have decreased the floor to 4 percent, which can go below zero. He asked Mr. Galvin if he thinks it was appropriate at the time and is it appropriate now to have a 10 percent floor on legacy fields.

10:38:00 AM

MR. GALVIN replied he had testified a number of times on behalf of the Palin administration that the state accepted the elimination of the floor solely because of the addition of the progressivity; it was a trade-off. Elimination of the 10 percent floor resulted in basically falling back to the previous floor that existed; it wasn't putting a new floor in. That was seen at the time as the appropriate deal for that legislative session.

SENATOR WIELECHOWSKI asked now that we no longer have the progressivity levels that we had, would he agree that it's appropriate to reconsider a higher floor. He recapped:

The way the deal works, we no longer have the progressivity we had under ACES. The original deal was we get a 10 percent floor, lower progressivity. Oil companies said no we don't want that. We got the higher progressivity; got rid of the floor for the most part. Now that we've got rid of progressivity at the high end like we had, it would seem appropriate that we go back to a 10 percent floor on the legacy fields.

MR. GALVIN responded that he understands the logic, and he had accepted that trade-off in the early ACES structure as legitimate, but now there are a number of different considerations with regard to the tax system besides just those two moving parts.

He said Great Bear and its partners had spent a total of \$220 million on exploration activities and are eligible for and expect to recover \$140 million from the state in tax credit payments. Great Bear investors had contributed \$80 million that will not be reimbursed. As an exploration company, none of the tax credits go back to their investors; they are all put back into the ground to do more exploration.

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This exploration is valuable to not only Great Bear but to the state, because it is developing state resources. Their seismic is immediately available to the state and will eventually be available to the public after their lease term. The well data goes straight to the state of Alaska and becomes public after two years, as well. This is a tremendous resource for the state in its ability to identify future oil to be produced. This is important because there is a vast amount of oil that has not been discovered on the North Slope and the only way the state can get to it is to invest the money to acquire the information to determine where it may be and where it may be economically developed. So, the tax credits, particularly the exploration tax credits, were a very conscious decision on the part of the state's resource managers to try to incentivize the investment in this exploration activity that is otherwise very risky.

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As to the question of whether or not lower tax credits will still result in the same amount of activity, the truth is that the decision making process for an exploration company just doesn't work that way. As an example, he used a scenario where a company like Great Bear has \$100 million from investors willing to put that into exploration activity. So, with the ability to borrow on the tax credits they anticipate getting back from the state (35 percent tax credits), they can plan for a \$140 million exploration program. Their equity money will pay for Great Bear's portion of the well. The rest will be borrowed and be paid back at the end of the day with the tax credit reimbursement. A finance charge is associated with that and so a bit of money goes out of the system to the financiers, but the rest of it goes into the ground.

If the state offers a 65 percent tax credit, then Great Bear's exploration program is going to be \$260 million, because of their equity investment and borrowing against the tax credits they earn through that expenditure. So, the tax credits on the exploration side simply create a multiplier effect for how much exploration activity is going to be generated by the investment dollars that come from companies like Great Bear. Simply put, by offering a higher tax credit, the state will generate more exploration activity.

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To Senator Stedman's question, what happens when the state changes the flow of cash back to the exploration company, he said that if there is a delay in reimbursement but its anticipated and spread out, it will just take on more of a finance cost. More money in their budget will go to interest payments on the borrowing against those tax credits and it will likely be at a higher interest rate. If there is uncertainty or surprises in the state's reimbursement, such as the governor's veto, it increases the perspective of risk and basically scares away potential lenders.

MR. GALVIN explained that the state has successfully attracted much lower cost of debt capital on these tax credit financing deals over the past three years - going from the high teens to the single digits. That has resulted in a much greater amount of the tax credit money going back into the exploration activity itself, as opposed to going to finance costs.

If a pattern of uncertainty is created or a sense of vulnerability of that cash flow coming from the state to pay for the certificates, that will basically chase away the

conventional banks. Then companies will at best be able to retain the private equity groups that were lending at high interest rates. However, there is a good chance that even those will be lost as well. If exploration companies are no longer able to borrow against the tax credit reimbursement, the model he described earlier completely changes. They end up with that \$100 million and have a \$100 million exploration program, because that's all the money they have. Eventually they would get reimbursed from the state and would have to decide to pocket that money or try to have another exploration program, and somehow cobble together additional equity investment. The uncertainty would both slow down and result in significantly less exploration activity going forward than having steady predictable payments that the companies can borrow against and basically spend the tax credit before it comes back. From an exploration side, that is what creates the multiplier.

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SENATOR STEDMAN asked him to elaborate on short funding or lack of appropriations to pay full credits and how a company would plan on getting them in 2016 or 17, or could they even plan on getting them if they hypothetically still have 2015 credits on the books.

MR. GALVIN replied going back to his earlier characterization that the statutory language is truly perceived as a cap and the amount of annual funding for the tax credit reimbursement was set at that formulaic rate, then he could predict fairly confidently that Great Bear would no longer be able to borrow against the tax credits. The reason being that as an individual borrower, they could not predict to their lender when they would be reimbursed, because it would depend on multiple things outside of their control: the oil price, the amount of production tax the state is going to get, and the level of credit applications the state receives from other potential companies. "That level of uncertainty would pretty much dry up any ability to borrow against the credits," he said.

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If the state institutes a cap at an individual company level, similar to what is being proposed now, that would be manageable, because it would be a "predictable delay." The question is at what level it gets set: the lower the level, the more expensive the debt will be. More money will go to lenders and less will go into the actual exploration activity.

SENATOR WIELECHOWSKI said he appreciates Great Bear's work, but he was on this committee five years ago when Great Bear talked about how they would see 1 million barrels a day within 10 years. The state has now invested \$140 million and is hoping they see some production, but it seems that Great Bear has abandoned unconventional production and is now focusing on conventional, which won't get them anywhere near what they had initially said years ago. He asked from the big picture perspective, which is what they have to manage, how he can, as the former Revenue commissioner, have supported a system that had the state paying out more in oil tax credits than it gets in production taxes for a decade. The state won't be revenue positive from a production tax perspective until the end of 2024.

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MR. GALVIN answered that it's important to separate the different tax credits from each other. There is a difference between the North Slope cash flow and the Cook Inlet cash flow. On the North Slope different cash flows are associated with exploration, development projects, and with production. Exploration is probably the lowest of the cash outflow from the state in terms of that system, because development is what sucks up a lot of investment and creates a significant amount of tax credit eligibility. Their analysis needs to split those up and not just paint it all with one broad brush.

Great Bear truly believes tax credits still remain a very valuable investment for Alaska. Continuing the EIC credit would be a good investment, as well, because those are providing tangible benefits back to the state in the form of exploration data that the state needs in order to develop its resources in the future.

MR. GALVIN said while it's true that Great Bear was here five years ago talking about the shale play, they have not abandoned the concept of the shale play; the prize is still there. They just believe they have to take a different route to get there by doing a conventional play first in order to establish the economic framework that a shale play can work from.

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To Senator Wielechowski's overarching point that the state is not going to see any positive cash flow from production tax, he had not spent a lot of time looking at the modeling that results in that conclusion, but it is something he questions in the sense that there are multiple variables and there is a big

question with regard to behavior. If the low price environment continues on for that decade and results in low production tax, the state will simultaneously see significant reductions in expenditures from the companies, which paying out significantly less credits. So, there is a certain aspect of self-correction to the system.

MR. GALVIN said they had dropped into this exceptionally low price environment at such a rapid rate that a lot are hoping to come out of it and just continue to move forward. But as companies, like Caelus, begin to deal with that and begin to lower their capital expenditures, then the state's credit responsibilities are going to shrink, as well. Having been through a big drop and rise in oil prices, he still expects oil prices to come back up again, and whatever modeling Senator Wielechowski is looking at is going to prove to be as full of errors as Great Bear's was when he was commissioner.

He advised that a clear balance has to be struck, but it's not something one could broadly brush; you have to look at the component parts.

10:59:05 AM

He added that the state had invested significant policy and money in and attempted to help the natural evolution of the North Slope from being dominated by just a few players to having a diverse group of independents who will not only create new production, but also create a new economy that will bring down costs and create a more cost effective way of producing fields that currently may not look economic. That effort has worked. The landscape has changed significantly on the North Slope in terms of the players and the economy.

He noted that momentum is an extremely strong force in the industry. It took a long time to get folks to recognize that they had moved to a net profits based system and to move past some of their beliefs about the State of Alaska. The biggest risk continues to be the sense that the oil fiscal system is a ping pong ball that will continue to bounce back and forth as the political winds swing. A way has to be found through some form of a compromise to reach a sense of stability. Without it, there will be continued reluctance to come full force into Alaska.

SENATOR WIELECHOWSKI asked if Great Bear were to produce new oil would it be considered new oil and be eligible for the new oil provisions of SB 21.

MR. GALVIN answered yes; everything they have would be considered new oil.

SENATOR WIELECHOWSKI pointed out this fundamental problem: that the state has invested \$140 million in Great Bear that "took advantage of all the incredibly generous tax credits." And while he did not criticize them for doing that, they will also be able to take advantage of all the incredible tax benefits (GVR exclusion and a tremendous cut in production taxes) provided under SB 21, because their production will be considered new oil. His expectation is, since it probably has high expenses, if they ultimately go on line that the state will see virtually nothing in production taxes from any oil that Great Bear produces.

MR. GALVIN responded that a lot of modeling will have to go into the assumption of how much the state will get from Great Bear production. He would describe it in a slightly different way: that as an exploration company, they are hoping to make a discovery. If they do, they will have to evaluate whether or not it is economic enough to invest with development costs. Depending upon the tax system the state has in place and that they expect to be in place as they move into production, Great Bear will make that decision. It will establish the hurdle that they have to overcome in order "greenlight" that project.

If the state chooses to change that economic system between now and their discovery, then it will simply change that hurdle, and may preclude Great Bear from developing something that they otherwise would develop. That is the risk the state is taking; that is the choice the body is making in terms of setting this oil fiscal system. The state needs to know where that line should be drawn in order to properly balance the state's desire for a share of that revenue with the desire for more lights to turn green on these development projects. From Great Bear's perspective, the legislature gets to make that call.

MR. GALVIN explained that Great Bear is in a favorable position today, because they haven't already made a decision and aren't already half-way through a development project. His concern and request was that "you find that equilibrium point soon and provide a stable environment for a generation of oil and gas activity that I believe is still available on the North Slope."

[11:04:29 AM](#)

SENATOR STEDMAN asked what he thought about the \$5/barrel credit for the GVR that goes below the floor - \$75 million going against a floor of \$182 million. The new oil would eventually grow with the decay of the other fields and take out the entire minimum tax if they don't take out the minimum floor.

MR. GALVIN responded that from his perspective he hoped when Great Bear is in production they don't have to deal with the minimum floor. It's only during times of "crisis" that that aspect of the cash flow is faced.

CHAIR GIESSEL thanked Mr. Galvin for his presentation and invited Mr. Johnson to testify.

11:06:42 AM

MR. J. BENJAMIN JOHNSON, President and CEO, BlueCrest Energy, Fort Worth, Texas, said BlueCrest is operating only in Cook Inlet right now and he would only speak to issues particular to the Inlet. First, he emphasized that the tax credit program is a very good investment for the state, with a good return which he would illustrate. He said BlueCrest has not been involved in any wildcat exploratory drilling. Instead, they have focused on the low-risk development of previously identified resources of oil and gas in the Cosmopolitan Unit.

In the process of delineating the field in 2013, they discovered several new oil and gas zones that added to the total reserves. But the underlying basis of that project was the previously known oil reservoirs. He said, "There really can be no question that the state's investment in development of known reserves, like we're doing at Cosmo, has a much lower risk factor than support for higher risk exploratory drilling." It's important to understand that the exploration work has to have been done in order to get to this low risk development phase. So both are important.

MR. JOHNSON said that BlueCrest's original development plan was to find some oil and gas properties where reserves had already been identified and where their particular expertise could be used to make it more valuable. They looked all over the U.S. and Alaska. They found that the cost for doing this work in Alaska was roughly 300 percent more than in Lower 48 basins. What made the difference in BlueCrest's decision to come to Alaska was the state's incentive program: the tax credits and a zero oil production tax rate in Cook Inlet until 2022. They chose to come to Alaska and bought into the Cosmopolitan Unit.

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MR. JOHNSON emphasized that the state's investment in Cosmopolitan will provide significant, future, positive value to the state even at low prices. The state's tax credits have facilitated the success they are bound to see on the Cosmopolitan Unit. These credits will provide future positive value. In fact, the tax credits under current laws can actually provide higher rates of return to the state than the average investments in the Permanent Fund.

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He explained that the Cosmopolitan's project is located three miles offshore of Anchor Point in Cook Inlet; it is all on state leases and subject to state royalty. They also have an onshore lease that contains the production facilities and the drill sites for drilling to the offshore leases.

MR. JOHNSON said in the interests of time he wouldn't go into the lengthy Cosmopolitan history, but the field was originally discovered in 1967. BlueCrest acquired its first leases in 2012. In 2013 they drilled a critical well and gained new information that has allowed them to finally begin developing the field using current state-of-the-art technology.

The Cosmopolitan Unit consists of two separate development projects. There are numerous gas wells directly above underlying oil zones; these gas reservoirs are not connected to the oil reservoirs. They haven't started developing the Cosmopolitan gas zones yet; that development is on hold due to economic questions concerning tax credits, the cost of drilling and confirmation of a stable, long-term market demand. Two years ago, based on the tax regime in the Cook Inlet, they committed to begin development of the oil reserves and it is now under way.

MR. JOHNSON explained that BlueCrest is a small private company with a singular focus on developing Cosmopolitan and they are very careful in developing their business plans. This is a large project for their company and they were also faced with the challenge of paying for its development. Although the members of the management team have a lot of experience, the cost was far beyond their capabilities. So, they teamed up with a group of oil industry investors who have much greater financial capabilities and carefully developed their plan based on all of the laws in place at the time.

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The point of slide 4 was to illustrate the cash flow of a typical oil and gas project over time. It's important to see that as the curve goes down, more money is being spent than is coming in. However, when more money starts coming in, it's not automatically profit. It simply goes to repaying the money that was already invested. When that is done is when profit starts being accounted for.

He noted that slide 4 was a representation of a successful project where a company explores and actually finds something; then it has to come up with the money to develop that exploration success. One doesn't have exploration successes all the time. In fact, the vast majority of exploration wells are dry holes (two-thirds to 90 percent in the U.S.). However, that work has to be done in order to get to the point of having a success. And the profit from that success needs to pay for all the unsuccessful exploration wells.

MR. JOHNSON said the good news about Cosmopolitan is that it is literally a few days away from the very first commercial production of oil after two years of hard work. In a couple of months they will bring in a brand new drilling rig and begin drilling new wells at a cost of about over \$40-\$45 million per well and hopefully bring on the new production that will finally allow BlueCrest to start paying off its loans. That new drilling cannot start until the last half of this year.

Slide 5 showed BlueCrest facilities that are large enough to process the oil from 20 new wells. They are also designed to allow for future expansion. Final operation tests are being conducted before starting production.

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He explained what the tax credits from a successful development like Cosmopolitan actually mean to Alaska:

When the tax credits are used for development of new proven reserves in the state, they are without question, a good, valuable, low-risk investment. Speaking of these credits as a give-away - as we hear sometimes - just completely ignores the substantial value that is received by the state. These tax credits make new projects work, and they bring new sources of long-term revenues to the state for decades into the future. Now, Cosmo, we're sitting on a large, proven, resource of future oil and gas that now simply

requires additional new investments to bring it to full production.

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MR. JOHNSON stated that on February 19 the DOR provided its analysis of the financial impact to the state on development of a new typical Cook Inlet oil field very similar to Cosmopolitan, assuming that no changes are ever made to the existing tax laws (slide 7). Their example was actually more expensive and less productive than what they think Cosmo will be. So, bottom line, their calculations were conservative.

It shows the total benefit received by the state and municipalities including taxes and royalties as a function of future various oil prices. It shows that even for this conservative example, the state would receive back 100 percent of its investment in the tax credits if oil prices over the entire field life average only about \$35/barrel. At about \$47/barrel, the state would receive back double its investment on the tax credits, and at about \$59/barrel it would receive back triple its investments made on those tax credits.

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The DOR also provided a discounted cash flow analysis for this example that compared the impact of the tax credits as a pure investment to the investments in the Permanent Fund (Permanent Fund September 2015 earnings were 6.15 percent). The analysis shows that if there are no any changes to the Cook Inlet tax system the state's investment in those gets a better return than the average investment in the Permanent Fund, as long as oil prices over the next 30 years average only \$44 barrel.

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MR. JOHNSON provided BlueCrest's specific comments with regard to SB 130. First, termination or severe reduction of qualified capital and well expenditure credits (slide 9) would result in a significant reduction in their ability to continue making investments in Cosmopolitan, resulting in less future revenues to the state. The governor's original SB 130 bill completely eliminated the well lease expenditure credits effective July 1, but the House Resources and Finance Committees have suggested reducing the credits by various amounts and phasing the reduction in over a longer time period.

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The net operation loss (NOL) credit is valuable to a company in the exploration or early development phase prior to reaching the

point of positive cash flow. But as a company like BlueCrest and some others in the state continue expanding known resources, the NOL credit becomes far less important; in fact it goes away. BlueCrest does not expect to receive NOL credits in 2017.

What is important to allowing BlueCrest to continue drilling is the well lease expenditure credit. Keeping the well lease expenditure credit at 40 percent in Cook Inlet (as it is currently) will result in a positive return to the state. But, most importantly, it allows BlueCrest to drill at about \$10 lower oil price than without the credit. That is likely to be really important in 2017. If oil prices go to \$100 a barrel, they don't need the credits, but at \$40 they probably would not be drilling. The credits allow their operations to continue.

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BlueCrest's analysis of the value to the state of keeping both the qualified capital credits and the well lease expenditure credits is that it gives them the ability to function at a \$10/barrel lower price and return 100 percent to the state in both royalties and future taxes. The state would be fully repaid at \$24/barrel on each new well drilled. At \$40/barrel the return is 200 percent, and at \$60/barrel the return is about 250 percent. So, these credits, at least for Cosmopolitan, are expected to provide a very good return and be a very low risk investment for the state.

Another factor in SB 130 limits the amount of credits that can be paid annually. But Mr. Johnson said, the governor's \$25 million minimum does not take into account the differences in qualified investments made by different parties in the state. If the limit is too low, it's really particularly damaging to small companies like BlueCrest that has invested its money in good faith based on tax policies in effect at the time. So, the timing of the payments is critical.

MR. JOHNSON said the most important factor is the timing of implementation of the changes. Here it is April and the proposed changes in SB 130 are supposed to take place on July 1, 2016. The House helped solved that issued by moving the date back. He explained that before BlueCrest started its development program two years ago, they made sure they would have enough funds to allow them to complete the construction of everything they are developing: the drill site, production facilities, and bringing in the most powerful drilling rig in Alaska to drill at least the first two wells whose production will pay the debt service on their loan. The changes have to start post July 1, 2016.

He explained that for BlueCrest, it cost \$525 million to get to the point of not having to borrow any more money (slide 12). They put in \$200 million of their own money and borrowed \$30 million from the Alaska Industrial Development and Export Authority (AIDEA) on a rig loan. The total they have received to date in tax credits is \$24 million. Based upon their budgeting going forward they will receive \$121 million additional tax credits. So, that leaves them short by about \$150 million; so, they went out and negotiated a high rate development loan for \$150 million. That is how they have funded Cosmopolitan. The bottom line is if the credits change, they are not paid, or if they are not paid on time, there will be problems in making their debt service and reaching the point of self-sufficiency.

Lastly, he reemphasized the importance of phasing changes in over time. The most dangerous thing one can do on icy roads is suddenly slam on the brakes; they don't want to see that happen here.

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SENATOR STEDMAN said he personally doesn't figure property taxes, royalties, and income tax in looking at the state's credits. The production tax had been historically "siloed" to benefit both the industry and the state through credit programs. They should just have the zero severance and be done with it and only look at credits against royalties. If they decide to go down that road, the state should talk about taking an equity interest instead of providing credits.

He didn't think the comparison with the Permanent Fund was at all relevant. The Permanent Fund and the way its assets are allocated, its purpose, and why it has its charter return ranges is a whole different animal than the oil industry. The discussion should concentrate on the benefits of the credits to the state and the industry, and if they have to be modified because of cash flow issues, how that is done without "turning the apple cart upside down" either through lower funding on appropriations, interest carried costs, or timing of when changes are made.

He thought it was more on point for BlueCrest to look at how any changes to the credits might impact them within the corporate structure and how the state and industry can get out of this pickle, because they can't stay on the course they are on.

SENATOR STEDMAN asked how much flexibility there is before the apple cart gets turned upside down if they change the timing of paying the credits.

MR. JOHNSON answered that BlueCrest has not borrowed any money based upon the tax credits, yet. They have been negotiating with banks on that for some time. In their basic assumption they borrowed the money at a high interest rate for the full development. If they can borrow money at a lower interest rate, after they have spent it but before the tax credits come in, that saves them some time. All the loan does is save them the time value of money in terms of the interest being saved. All of their plans were based on borrowing money.

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SENATOR STEDMAN asked him to clarify if he was saying that if there was a delay in payment of the credit because the legislature didn't appropriate the funds that it might take two years for BlueCrest to get its credit. He wanted a finer point on a company-specific, risk level to that policy change of fully funding the credits versus some funding mechanism below that that starts the whole carry forward process, and first in/first out payout.

MR. JOHNSON responded that in their case the timing of the credits is absolutely "imperative," - probably more so than for somebody who is borrowing money from a bank for just the tax credits themselves. If the state takes two or three years to pay these credits the delay is very expensive for BlueCrest, because at a 20 percent interest rate the credit is worth half of what it was originally worth.

SENATOR WIELECHOWSKI asked if Mr. Johnson would be open to a system where the state would get an equity position in production for the tax credits. So, if the state provided a 40 percent tax credit it would get a 40 percent stake in the value of the production.

MR. JOHNSON responded that the state already has a one-eighth ownership with no cost basis in terms of the royalty. The North Slope has some higher rates, but it's 12.5 percent in Cook Inlet. An equity interest is entirely different, because with equity one assumes all the risk of everything. The credits were set up for each individual expenditure. The 40 percent credit for a new well expenditure was set up to encourage drilling and clearly the state gets a good return on that investment. From

that standpoint, equity is very different from tax credits or from royalty.

CHAIR GIESSEL thanked Mr. Johnson.

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CHAIR GIESSEL adjourned the Senate Resources Standing Committee meeting at 11:36 a.m.