

HB 81 – DNR Modifying Net Profit Shares on Oil & Gas Leases

House Resources Committee

Presentation by Jhonny Meza, Commercial Manager
Division of Oil & Gas, Alaska Department of Natural Resources

March 5, 2021



Outline

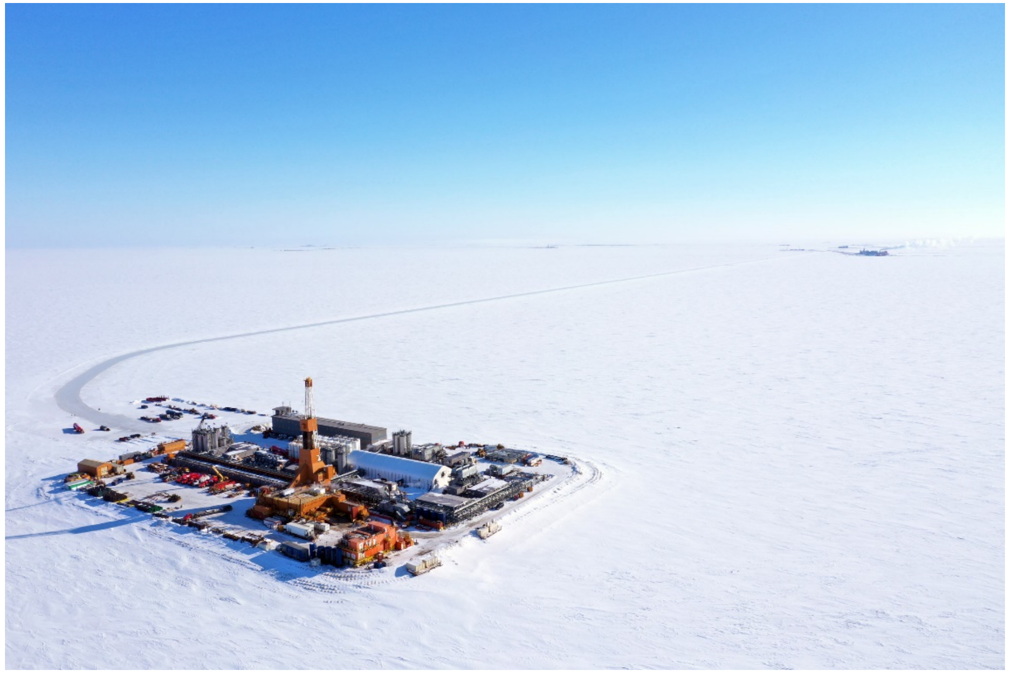
I. **Overview of Net Profit Share Leases**

II. **Why DNR would modify the royalty rate?**

III. **Why DNR would modify the net profit share rate?**

IV. **Overview of the modification process**

V. **Appendix**



Spy Island Drill Site, Nikaitchuq unit

I. Overview of Net Profit Share Leases

Royalty and Net Profit Share

1. **What is royalty?**

   - In its role as owner of the hydrocarbons in the subsurface, and in exchange for allowing a lessee the right to explore and develop said resource, the state reserves for itself **<u>a percentage of the gross value</u>** of that resource when produced by the company.
   - This percentage (the royalty rate) is established in the oil and gas lease contract.
   - All oil and gas leases offered by the state have a royalty provision.

2. **What is a net profit share?**

   - For a small group of leases, the state, also acting as resource owner, reserves for itself, in addition to royalty, **<u>a percentage of the profits from the lease</u>**.
   - A lease with royalty and net profit share is called a "Net Profit Share Lease."
   - The "sharing of net profits" occurs once the exploration and development costs allocated to this lease are recovered through the revenues (net of operating costs) from this lease.

Royalty and Net Profit Share

	Royalty	Production tax	Net profit share	Profit to the lessee
Established in the…	Oil and gas lease contract [State as a resource owner]	Production tax statute [State as sovereign]	Oil and gas lease contract [State as a resource owner]	Financial concept
Modification via…	Royalty modification statute: AS 38.05.180(j)	Alaska State Law: AS 43.55	- Net profit share modification **currently not authorized in statute**, but it can be achieved through direct legislative action - HB 81 proposes to include "net profit share modification" in AS 38.05.180(j)	NA
Assessed on…	- **The lease level**: The royalty rate is defined for each lease - The value of production from the oil and gas pool allocated to the lease. - If the lease is not producing, there is no royalty revenue.	- **The taxpayer level** - The taxpayer's gross value of taxable production less allowable lease expenditures	- **The lease level**: The net profit share is defined for each lease. - The "net profits" associated with the oil and gas production from the NPSL - If the lease is not producing, there will not be any net profits to share.	- **The project level** - Example: Evaluation of an investment to develop an oil and gas pool which contains a group of leases
Beginning of payments to the State	With commercial production	Monthly estimated payments when production starts. Annual true-up and return, taxpayer will owe the greater of the minimum tax and the net production tax.	- When the NPSL reaches the "payout" stage (After the recovery of exploration and development costs plus an allowed return)	- No payments to the State from the "free cash flow"
Considers costs associated with oil and gas exploration, development, and production?	No	Yes (Allowable lease expenditures and, if applicable, carried-forward "excess lease expenditures")	Yes (The costs allowed are determined in regulations, 11 AAC 83.201-295)	Yes (Some of the costs considered here are not allowed for production tax or net profit sharing.)

Net Profit Share Leases

FORM NO. DMEM-1-79A (NET PROFIT SHARE)
(Revised November 5, 1979)

STATE OF ALASKA
DEPARTMENT OF NATURAL RESOURCES
DIVISION OF MINERALS AND ENERGY MANAGEMENT

Competitive Oil and Gas Lease ADL No. 312798

THIS LEASE is made by and between the State of Alaska, acting by and through the Commissioner of Natural Resources or his authorized agent, hereafter referred to as "the State," and

Amerada Hess Corporation

hereafter referred to as "Lessee," whether one or more.

7. SHARE OF NET PROFIT. Lessee will pay to the State 93.20000% of the net profit derived by Lessee from this lease. For purposes of this Paragraph, calculation of the net profit shall be determined in accordance with 11 AAC 83.201 through 11 AAC 83.295 as those regulations exist on the effective date of this lease, copies of ~~which are attached as Exhibit B~~ and by this reference made a part of this lease. The amount of interest to be earned on the net profit share development account pursuant to 11 AAC 83.212 will be the average of the prime rates of the Citibank, NA New York; Chase Manhattan Bank, NA New York; and the Bank of America, NT and SA San Francisco, prevailing during the month.

8. ROYALTY ON PRODUCTION. (a) Except for oil, gas and associated substances used on the leased area for development and production or unavoidably lost, Lessee shall pay to the State as royalty the following:

(1) On oil, twenty (20) percent in amount or value of the oil saved, removed, or sold from the leased area.

(2) On gas, twenty (20) percent in amount or value of the gas saved, removed or sold from the leased area or used on the leased area for the extraction of natural gasoline or other products therefrom.

(3) On associated substances, twenty (20) percent in amount or value of the associated substances saved, removed, or sold from the leased area.

A. The DNR Commissioner issues oil and gas leases via competitive bidding.

B. A NPSL is a State oil & gas lease that contains, **in addition to a traditional royalty percentage**, a provision that the lessee pay to the State a share of the "net profits" generated from the lease.

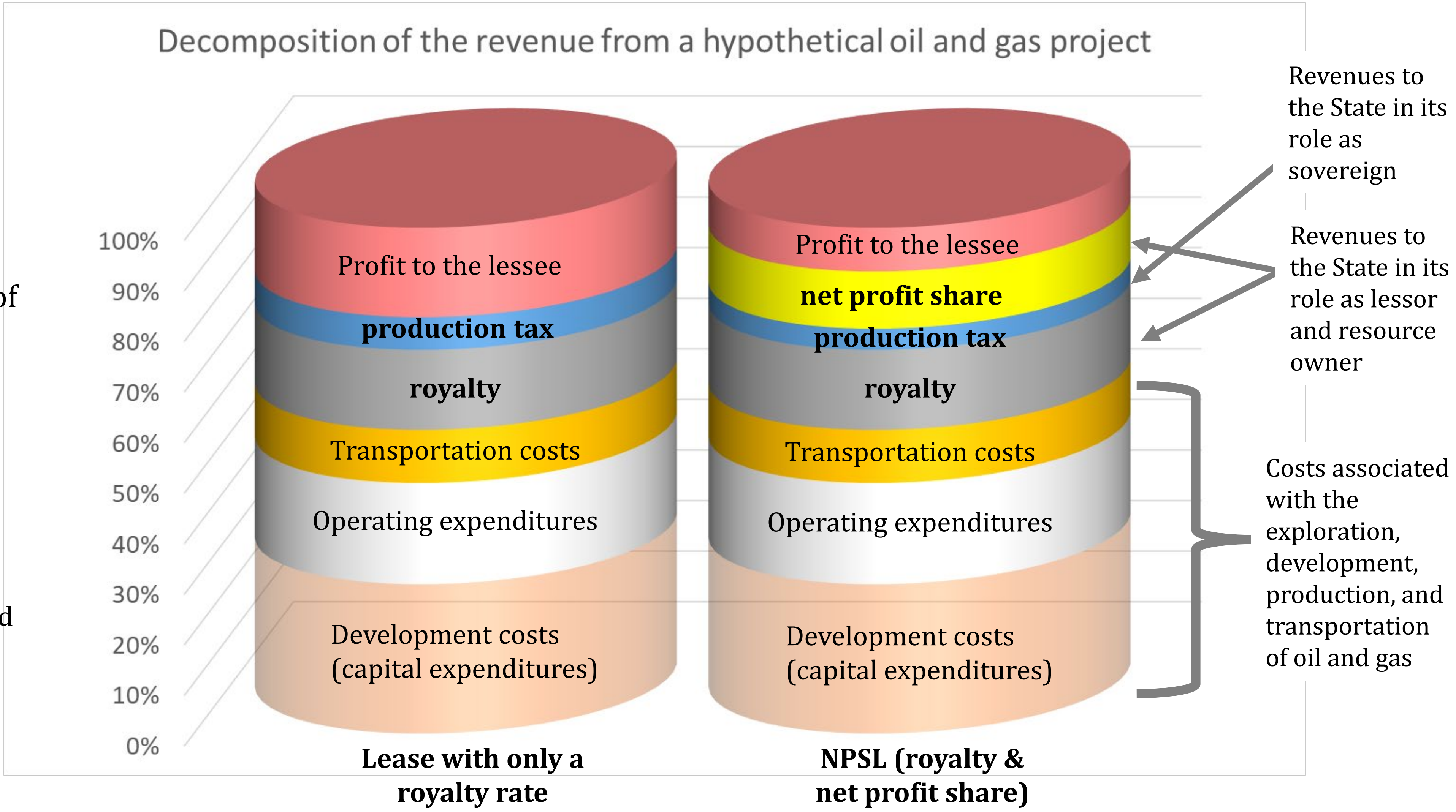
Example:

- NPSL issued in 1979 which later became part of the Northstar unit
- Fixed royalty rate of 20%
- Bid variable was the net profit share with 93.2% as the highest bid.

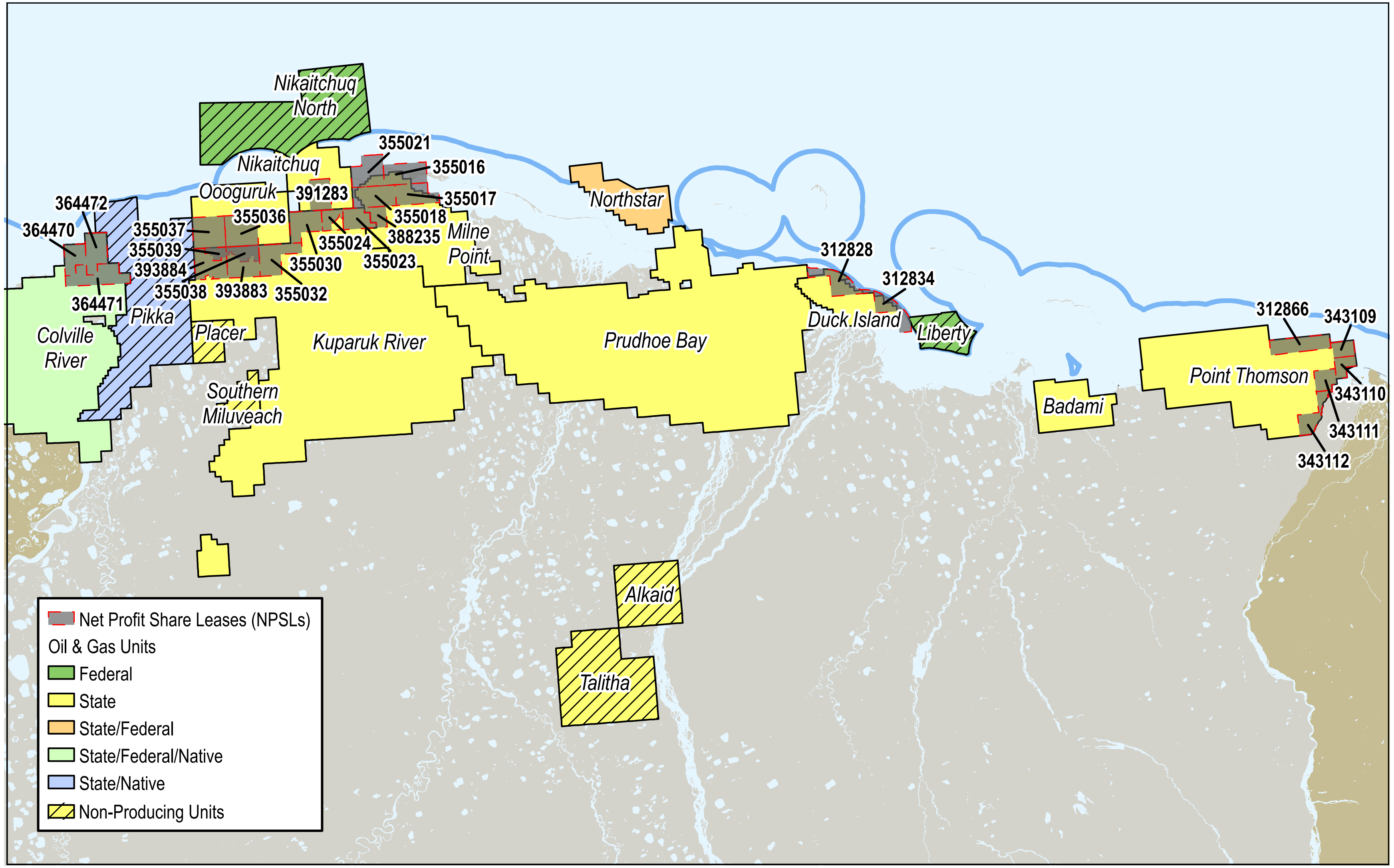
NET PROFIT SHARING

What is net profit sharing?

1. Net profit sharing is another source of revenue to the State from oil and gas production.
2. Not shown here for simplicity:
   - oil and gas property tax and corporate income tax



Map of Net Profit Share Leases



- There are 26 active NPSLs in the North Slope.
- NPSLs were issued between the late 1970s and the early 1980s.
- Net profit share rates range from 30% to 79.59%.
- State has received $1.175 Billion in net profit payments over the life of these leases.
- Some NPSLs are not producing and thus no "net profit sharing" with the State.

26 active Net Profit Share Leases on the North Slope

Net profit share lease	Issuance year	Net profit share rate	Royalty rate	Oil and gas unit	Source of production allocated to these leases	Has NPSL reached payout stage?	Cumulative Net Profit Sharing to the State
364470 **364471** **364472**	1984 1984 1984	30% 30% 30%	12.5% 12.5% 12.5%	Colville River	Fiord Nechelik and Fiord Kuparuk	**Yes** **Yes** **Yes**	**$165 million**
312828 **312834**	1979 1979	79.59% 48.87%	20% 20%	Duck Island	Endicott and Sag Delta North	**Yes** **Yes**	**$556 million**
312866 **343109** **343110** **343111** **343112**	1979 1982 1982 1982 1982	52.35% 40% 40% 40% 40%	20% 12.5% 12.5% 12.5% 12.5%	Point Thomson	No production associated with these leases	No No No No No	**$0** (because no production and no revenues have been allocated to these NPSLs)
355016 **355017** **355018** **355021** **388235**	1983 1983 1983 1983 1983	40% 40% 30% 30% 30%	12.5% 12.5% 12.5% 12.5% 12.5%	Milne Point	Kuparuk pool and Sag River pool	**Yes** **Yes** **Yes** **Yes** **Yes**	**$443 million**
355023 **355024** **355030** **355032** **393883** **393884**	1983 1983 1983 1983 2019 (segregated) 2019 (segregated)	30% 30% 30% 30% 30% 30%	12.5% 12.5% 12.5% 12.5% 12.5% 12.5%	Kuparuk River	Kuparuk participating area	No No No No No No	**$0** (The costs allocated to these NPSLs have not yet been recouped by the revenues.)
355036 **355037** **355038** **355039**	1983 1983 1983 1983	30% 30% 30% 30%	12.5% 12.5% 12.5% 12.5%	Oooguruk	Kuparuk and Nuiqsut participating areas	**Yes** No **Yes** No	**$12 million**
391283	2007 (segregated)	30%	12.5%	Nikaitchuq	Schrader Bluff participating area	No	**$0** (The costs allocated to these NPSLs have not yet been recouped by the revenues.)

Modification of Northstar unit NPSLs through Legislative Action in 1996

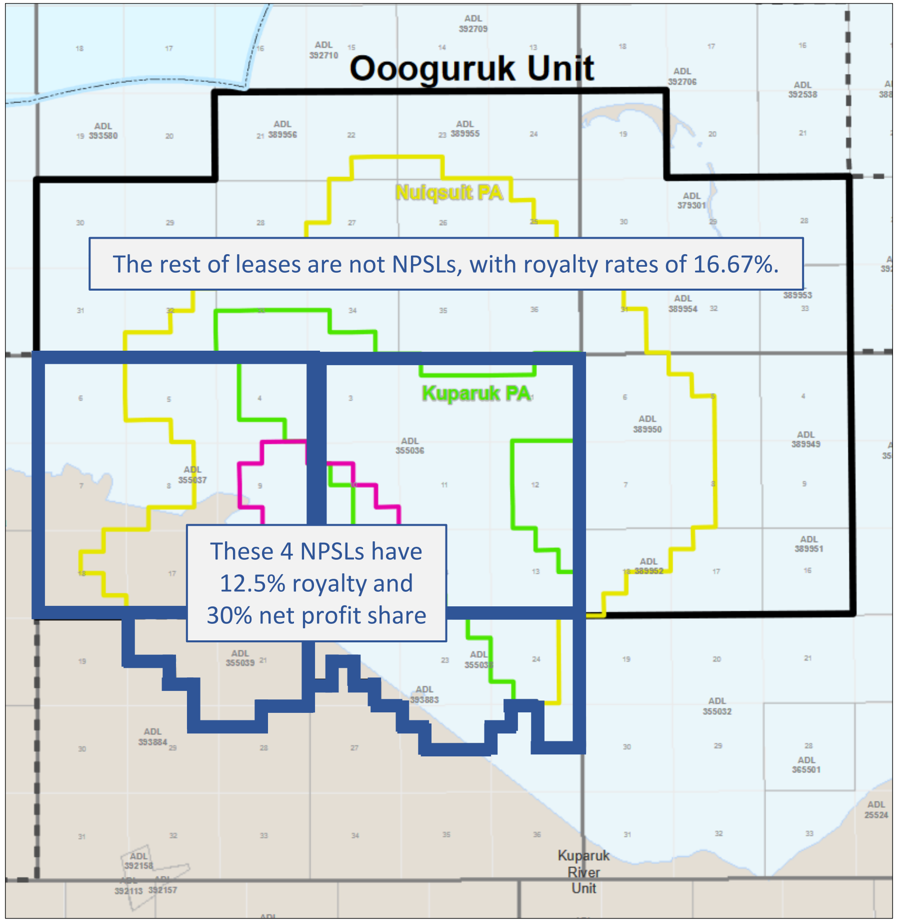
Net profit share lease	Issuance year	Net profit share rate	Royalty rate	Oil and gas unit	Source of production allocated to these leases	Modification type	Cumulative Royalty Revenue to the State
312798	1980	93.2%	20%	Northstar	Northstar pool and Hooligan pool	• Substitution of the net profit share for only royalty. • Sliding-scale royalty rate ranging from 20% to 27.5%.	**$1.73 billion**
312799	1980	91.2%	20%				
312808	1980	85.26%	20%				
312809	1980	85.26%	20%				

- These NPSLs were subject to “net profit and royalty modification.”
- In 1996, DNR and BP proposed to the Legislature that these NPSLs be modified.
- **“Unless the net profit share provisions of the Northstar unit leases are amended, production of oil and gas from the unit is *highly unlikely to begin before 2002, if at all*.”**

  Source: Finding from the Legislature in Senate Committee Substitute SCS CSHB 548(FIN) am S
- The review of this proposal entailed the investigation by committees in the House and Senate before a bill passed both chambers**.**

II. Why DNR would modify the royalty rate

Stranded Resources means Zero Production and Zero Revenues to the State



D. Oil or gas production would not otherwise be economically feasible.

Pioneer has submitted financial and technical data and analyses and requested that they be held confidential in accordance with AS 38.05.035(a)(9). Thus this section does not discuss any confidential information concerning Pioneer's geologic, engineering and cost data. These documents are included and discussed in detail in the Confidential Economic Analysis and Internal Decision Process, (Attachment 10).

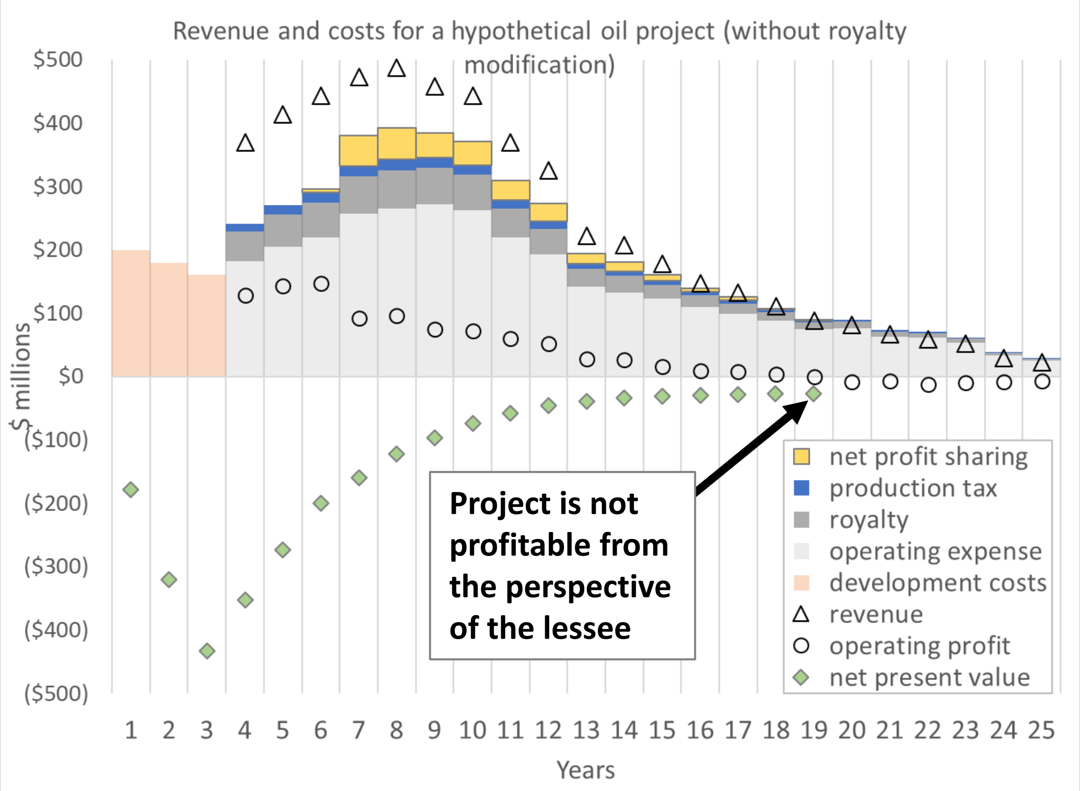
To obtain royalty relief the applicant must show by clear and convincing evidence that without royalty modification the project is not economically feasible. Pioneer has represented to the State that it would not do the project without royalty relief. Other companies that have owned leases in the area and explored there have not developed this prospect. Finally, and most convincingly, Pioneer has shared data with the State showing a project that without royalty modification fails to meet minimal economic targets.

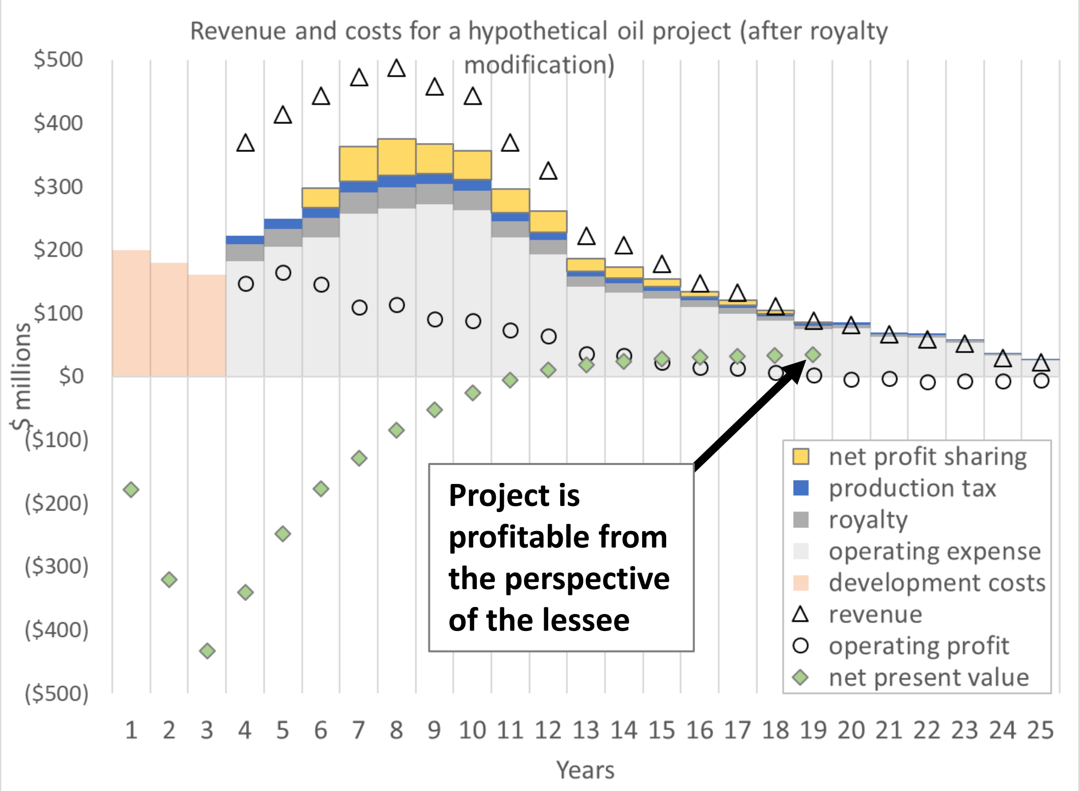
Pioneer represented to the State that the Oooguruk development project was "extremely marginal, and has considerable risk of low investor returns" without royalty relief. It made the representation after modeling and studying the reservoir and estimated costs. Pioneer developed an economic model for the project that considered the field as an

Revenues that would not have been realized but for the modification in royalty:

- **Royalty from the Kuparuk and Nuiqsut pools: $145 million.**
- **Net profit sharing from NPSL 355036 and 355038: $12 million**

Why would DNR allow the modification of the Royalty Rate?





1. **Without royalty modification**, the project does not happen.
   - The net present value of the project is negative.
   - No royalty or sharing of net profits to the State. No profits to the lessee.
   - Resources would be stranded.

2. **With royalty modification**, the lessee sanctions the investment.
   - State gets royalty and net profit sharing as opposed to nothing.
   - The royalty reduction changes the investment decision. The net present value is now positive.
   - Could the same outcome have been achieved with a modification in the net profit share rather than the royalty rate?

History of DNR Royalty Modification Applications

Year	Lessee	Field or pool	Outcome	Sliding-scale mechanism for royalty rates	Status	Royalty revenue and Net Profit Sharing
1995	BP	Milne Point	Denied			
1997	Unocal	10 Cook Inlet platforms	Application withdrawn			
1999	Phillips	1 Cook Inlet platform (Tyonek Deep)	Application withdrawn			
2005	Pioneer and Eni	Oooguruk (Kuparuk and Nuiqsut)	**Granted**	Royalty progressively back to original level when a NPSL reached payout stage	Royalty rates back to their original levels in 2021	Royalty: $142 million Net profit sharing: $12 million
2006	Kerr-McGee and Eni	Nikaitchuq and Tuvaaq	Denied			
2007	Chevron (Unocal)	Fields in West Cook Inlet (Ivan River and Stump Lake)	Application withdrawn			
2008	Eni	Nikaitchuq (Schrader Bluff)	**Granted**	Royalty rate dependent on oil price: If lower than trigger level, then 5%. If equal to or greater than trigger, then original royalty rate.	Modification dependent on price. Mechanism expires in 2036.	Royalty: $567 million Net profit sharing: NPSL has not yet reached payout stage
2014	Caelus	Oooguruk (Nuna Torok)	**Granted**	Royalty progressively back to original after a cumulative gross revenue trigger	Modification rescinded. Applicant did not sanction the project by the established date.	No revenue since project was not sanctioned

III. Why DNR would modify the net profit share rate?

1. Increase Production from Otherwise Stranded Resources

A. Under certain circumstances, *even with royalty modification*, it is possible for continuing or for incremental production from pools which contain NPSLs to be stranded.

- If resources are stranded → Project does not happen → No royalty or net profit sharing to the State
- Modification of the net profit share may make such production economic.

B. Modification of royalty and/or net profit share for pools which would otherwise be stranded could *extend the life* of such field and other existing fields.

- This would result in additional royalties, net profit share, taxes, etc. that the State would not otherwise receive.

2. Flexibility for Royalty Modifications

Currently, DNR can modify royalty but *not* the net profit share.

A. **NPSL Modifications would give DNR flexibility to elect *targeted reductions* and could be a useful tool in environments of high oil price volatility.**

- Under certain circumstances, it may be in the best interest of the State to modify net profit share instead of royalty.
- Royalties are paid sooner than net profit shares and are more predicable over the life of an investment.
- Alternatively, smaller reductions in both royalty rate and net profit share may allow for a more advantageous "blended" incentive structure.

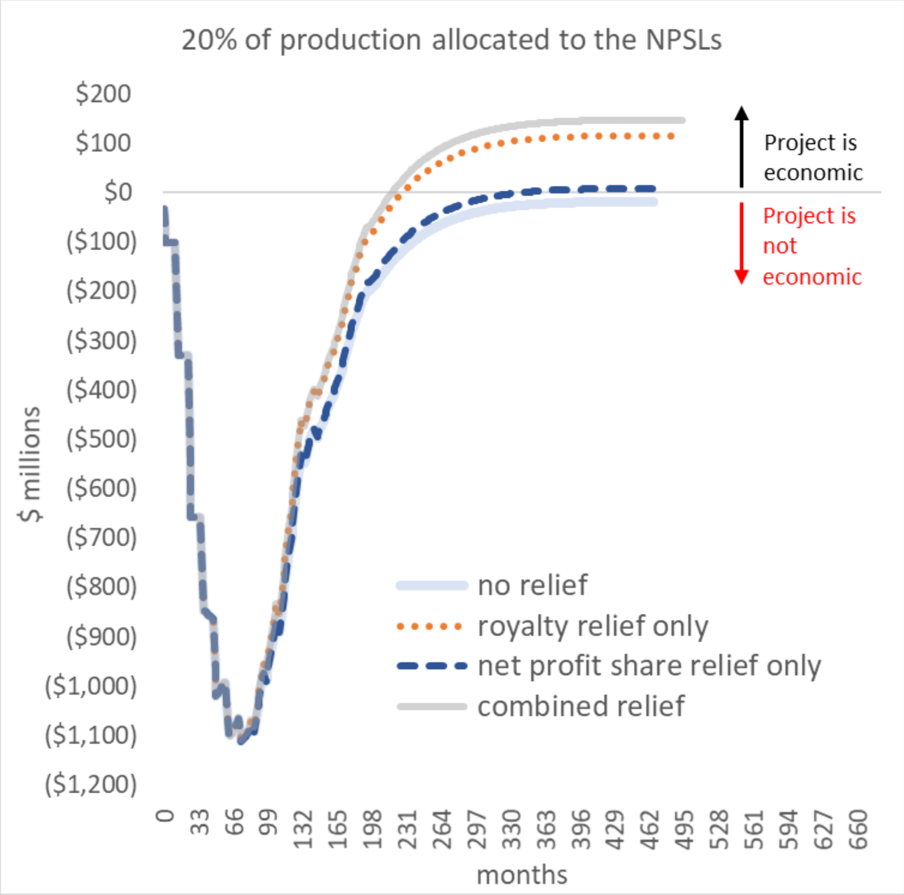
B. **NPSL Modifications would enable DNR to increase net profit shares in scenarios where DNR can structure *potential payback of foregone revenues* in the event of higher prices or production levels.**

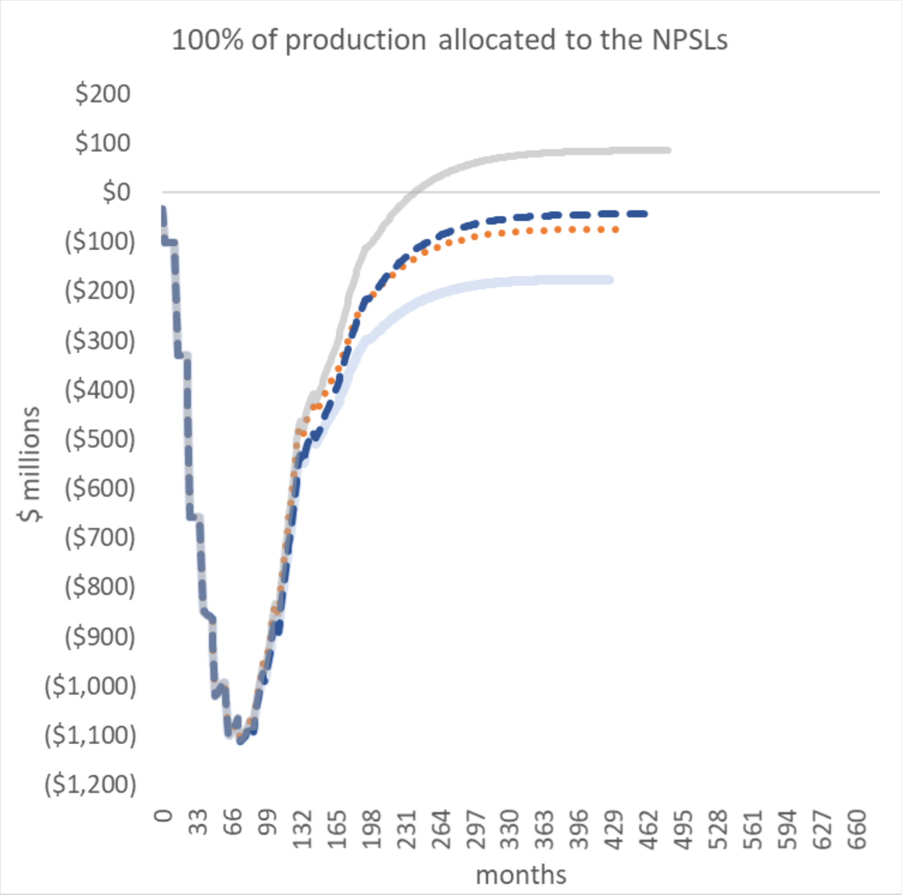
Why would DNR allow the modification of the Net Profit Share Rate? A hypothetical example

The State may find that, to make a project economic, it is in its best interest to…

A. **Modify only the net profit share rate** rather than the royalty rate without giving up too much of its potential revenues

B. **Modify both** if the modification of either is not enough to affect the investment decision of the lessee





3. Streamline Process for NPSL Modifications

A. Current process to modify NPSLs is for DNR *to negotiate a modification package* and submit proposal for legislative action.

- In 1996, four NPSLs in the Northstar Unit. were modified to a sliding-scale royalty.
- The Legislature ratified the modification in HB 548 (Chapter 139 SLA 96).
- The Alaska Supreme Court upheld the modification in *Baxley v. State*, 958 P.2d 422 (Alaska 1998).

B. Providing for NPSL Modification in statute would *streamline NPSL modification process*, while allowing for the Legislature to set conditions and limits on NPSL Modifications.

C. As with Royalty Modification, NPSL Modification decisions are *reported to the Legislature*, which may require hearings or take additional legislative action.

IV. Overview of the Modification Process

What HB 81 accomplishes

1. **Expand the royalty modification process to include NPSLs:**
   A. **Commissioner would have the *authority to modify* net profit share rates in the same manner as royalty rates under AS 38.05.180(j).**
      - Objective is to encourage production of otherwise stranded resources.
2. **Other changes:**
   A. **Creates an *additional qualifying scenario* for modification of either royalty or NPSLs**
      - For producing pools, where incremental production requires incremental capital expenditures, which, in the absence of modification, would be uneconomic.

   B. **Clarifies that *test production* during exploration does not disqualify a field or pool from royalty or NPSL modification based on new production.**
      - This codifies DNR's existing interpretation and is offered **to resolve a potential ambiguity**. It does not constitute a change in current policy.

What type of modification is warranted?

A. **Royalty Modification is capped at certain *minimum* royalty rates.**

- Five percent for .180(j)(1)(A) or three percent for .180(j)(1)(B)–(C).

B. **The proposed NPSL modification also establishes a *minimum* net profit share of ten percent.**

C. **The modification may be based on a *sliding scale mechanism*.**

- It could vary with the price of oil, volume of production, per-barrel costs, etc.

D. **Modifications of royalty or net profit share can be *either lower or higher* than the original percentages. (AS 38.180(j)(3))**

- In certain circumstances, this would allow DNR to recapture foregone royalties or net profit revenue if oil prices rise, or even to participate in "upside" price movements if DNR provides "downside" relief.

ELIGIBLE SCENARIOS FOR MODIFICATION

- Current statute for royalty modification; and
- HB81 would allow net profit share modifications in these scenarios as well

A. **New Production**: If the development of a new field or pool would not be economic without modification, so long as the field or pool is sufficiently delineated. AS 38.05.180(j)(1)(A)

B. **Extend Production**: To prolong the economic life of a field or pool when rising per-barrel costs (due to declining production or otherwise) would make continuing production no longer economic without modification. AS 38.05.180(j)(1)(B)

C. **Restore Production**: To reestablish production of shut-in oil or gas that would otherwise not be economically feasible without modification. AS 38.05.180(j)(1)(C)

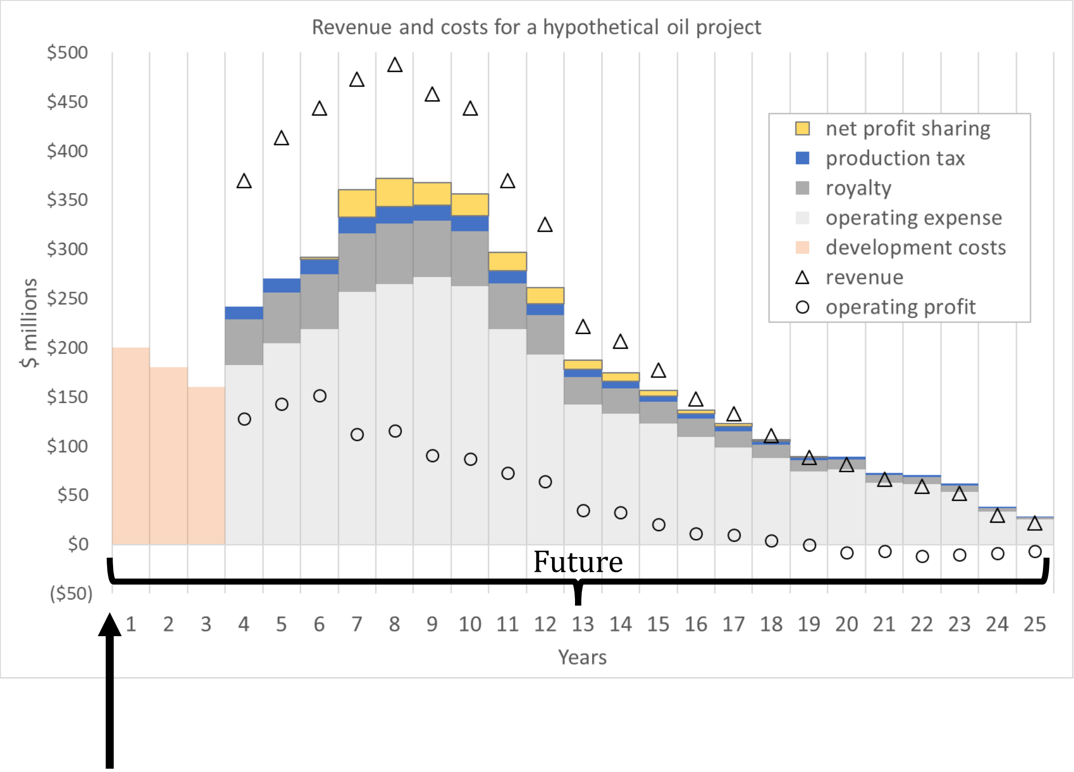
- New scenario under HB81 proposal
- Applies to both royalty and net profit share modifications

D. **Incremental Production**: If incremental production from producing pools requiring incremental capital expenditures is uneconomic in the absence of modification.

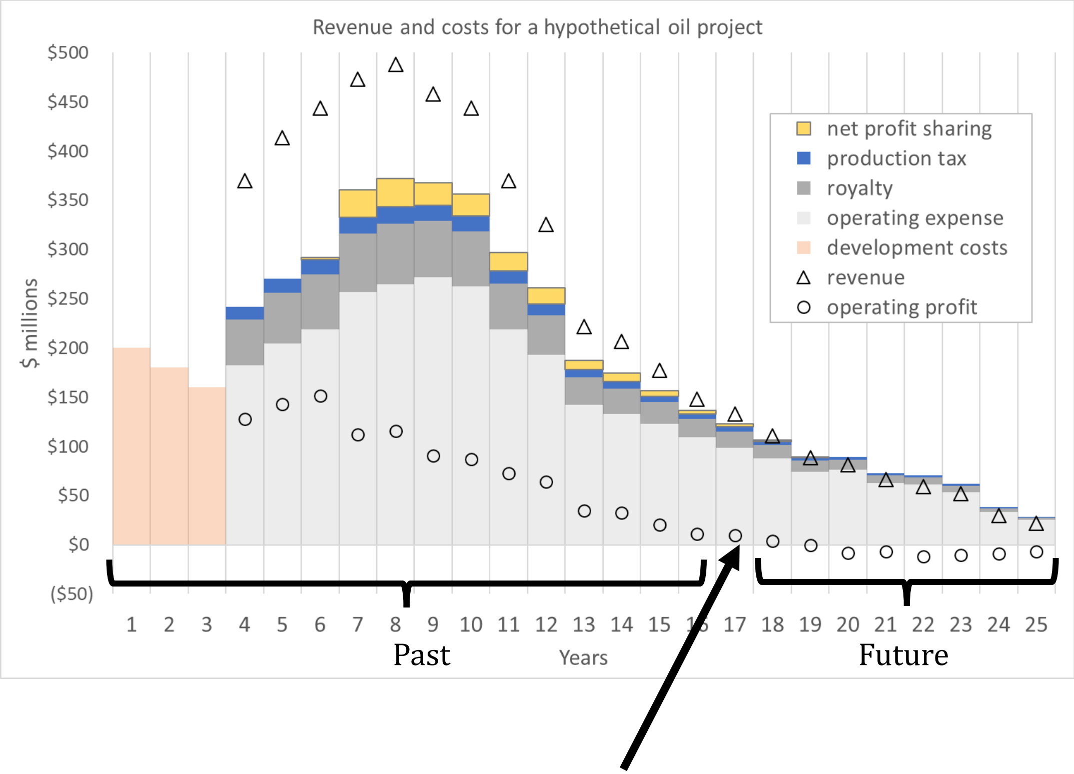
Examples: Expansion of existing pools, additional drilling pads, enhanced oil recovery projects, etc.

ELIGIBLE SCENARIOS FOR MODIFICATION

New Production AS 38.05.180(j)(1)(A)



Extend Production AS 38.05.180(j)(1)(B)

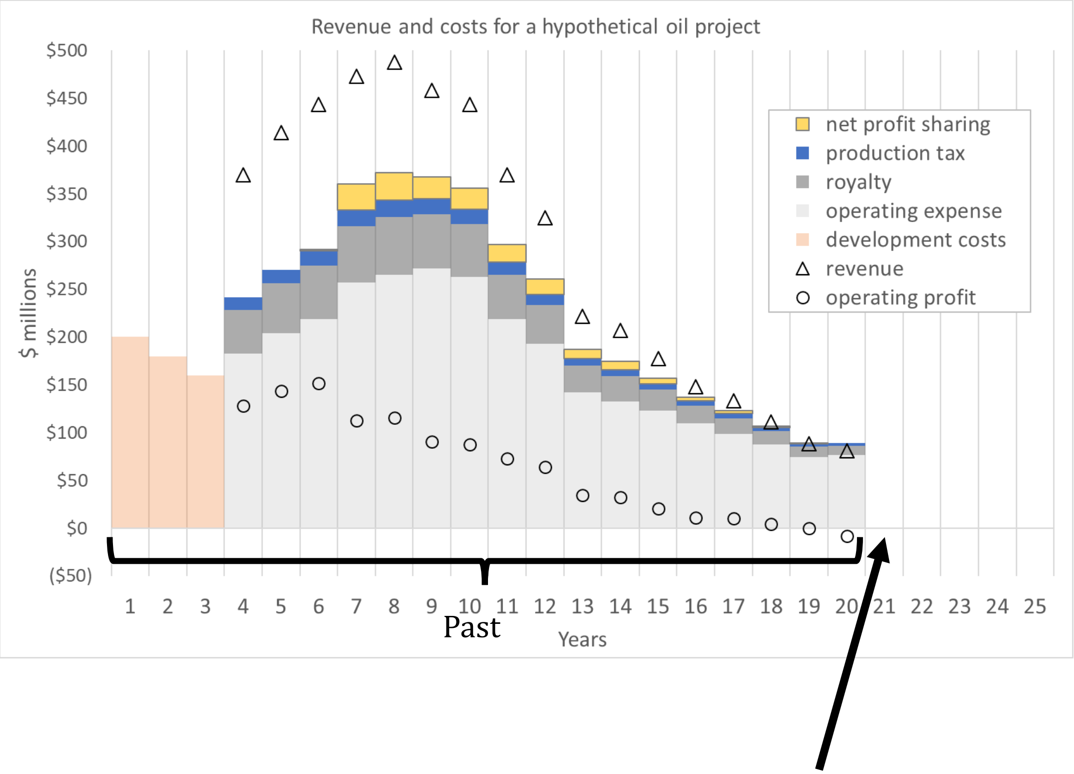


We are in year 0. Without modification, potential state revenues (years 4 – 25) will not occur.

We are in year 17. Without modification, production will cease and potential state revenues (years 18 – 25) will not occur.

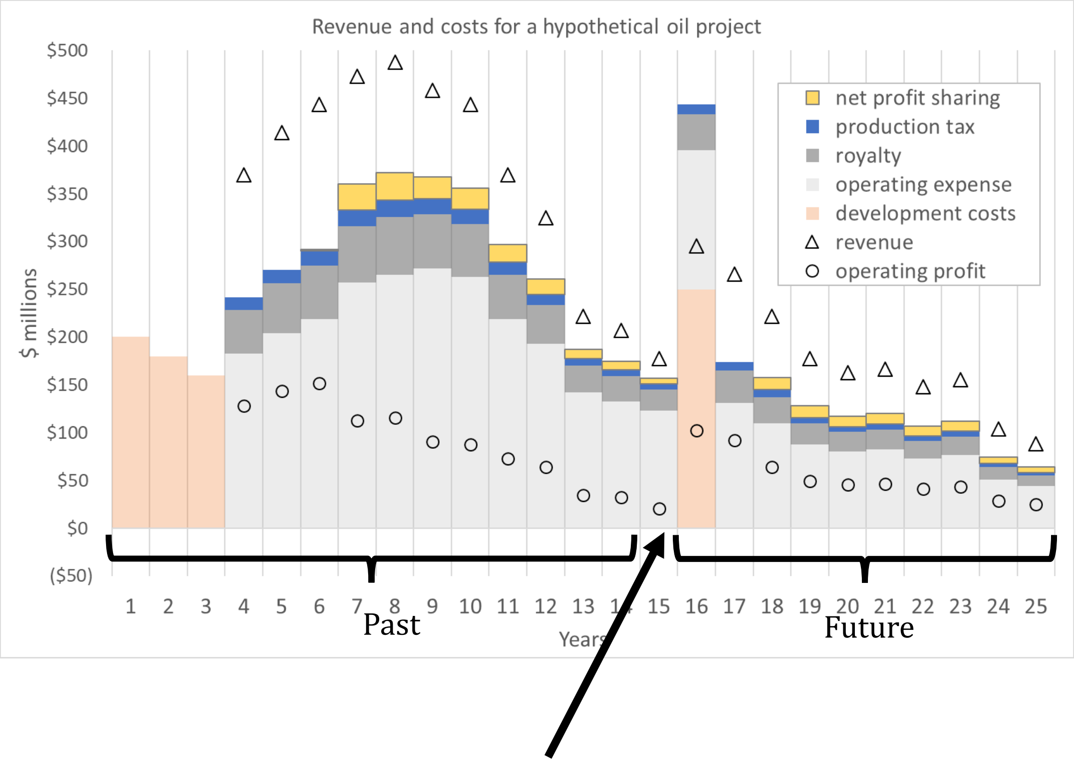
ELIGIBLE SCENARIOS FOR MODIFICATION

Restore Production AS 38.05.180(j)(1)(C)



We are in year 21. Without modification, production will remain shut in. No more revenues to the state.

New: Incremental Production AS 38.05.180(j)(1)(D)



We are in year 15. Without modification, **incremental investment from currently producing pool** will not occur. Potential state revenues (years 18 – 25) will not occur.

DECISION-MAKING PROCESS

A. **HB81 does not propose to change the modification process.**

B. **A producer applying for a royalty modification must provide *a clear and convincing showing* that they meet the statutory requirements.**

- A **higher standard of proof** than required for most other DNR applications.
- Applicants required to **provide abundant evidence** to justify any request for relief.

C. DNR may require (for .180(j)(1)(A)) or request (for .180(j)(1)(B)–(C)) that producers pay up to $150,000 per application for consulting work to support DNR's evaluation of the application.

D. Publication of Best Interest Finding and offer presentation to Legislature (AS 38.05.180(j)(9)-(10))

E. **If granted, modifications are *not transferrable without the authorization of the Commissioner*.** (AS 38.05.180(j)(5))

Questions

Thank you
on behalf of the Commercial section:

Jhonny Meza, Matt Snodgrass, Ryan Fitzpatrick,
Chalinda Weerasinghe, and Adi Chaobal

Division of Oil & Gas
Alaska Department of Natural Resources

V. Appendix

Examples of Oil and Gas Units with NPSLs which were subject to Royalty Modification and Net Profit Share Modification

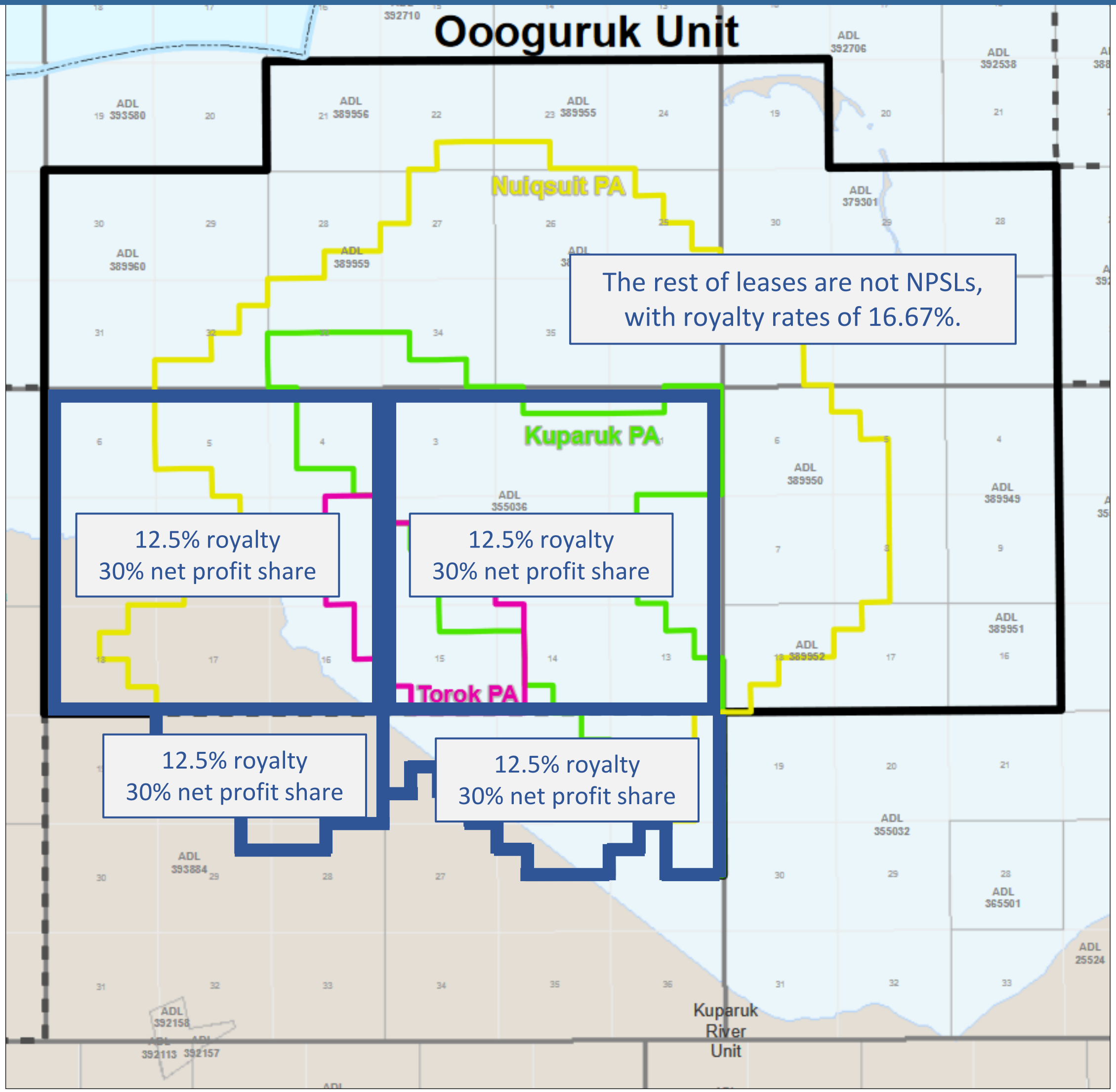
Example 1: Kuparuk and Nuiqsut pools in the Oooguruk unit

In 2005, Pioneer and Eni applied for the modification of royalty to develop the Kuparuk and Nuiqsut pools in the Oooguruk unit.

a. These pools were not previously produced.
   - The applicants claimed that this project would not occur but for the modification of royalty.

b. The net profit share rates were not modified (not allowed in existing modification statute).

c. After an extensive review of technical and commercial information, DNR granted royalty modification.
   - With the beginning of production in 2008, the royalty rate on a group of leases subject to the decision were reduced to 5%.
   - Royalty rate remained at 5% until NPSL 355036 reached payout stage in 2018.
   - Since then, the royalty rate increased progressively back to their original levels (12.5% and 16.67%).
   - Cumulative production is 9.4 mmbbls from Kuparuk pool and 30.3 mmbbls from Nuiqsut pool.



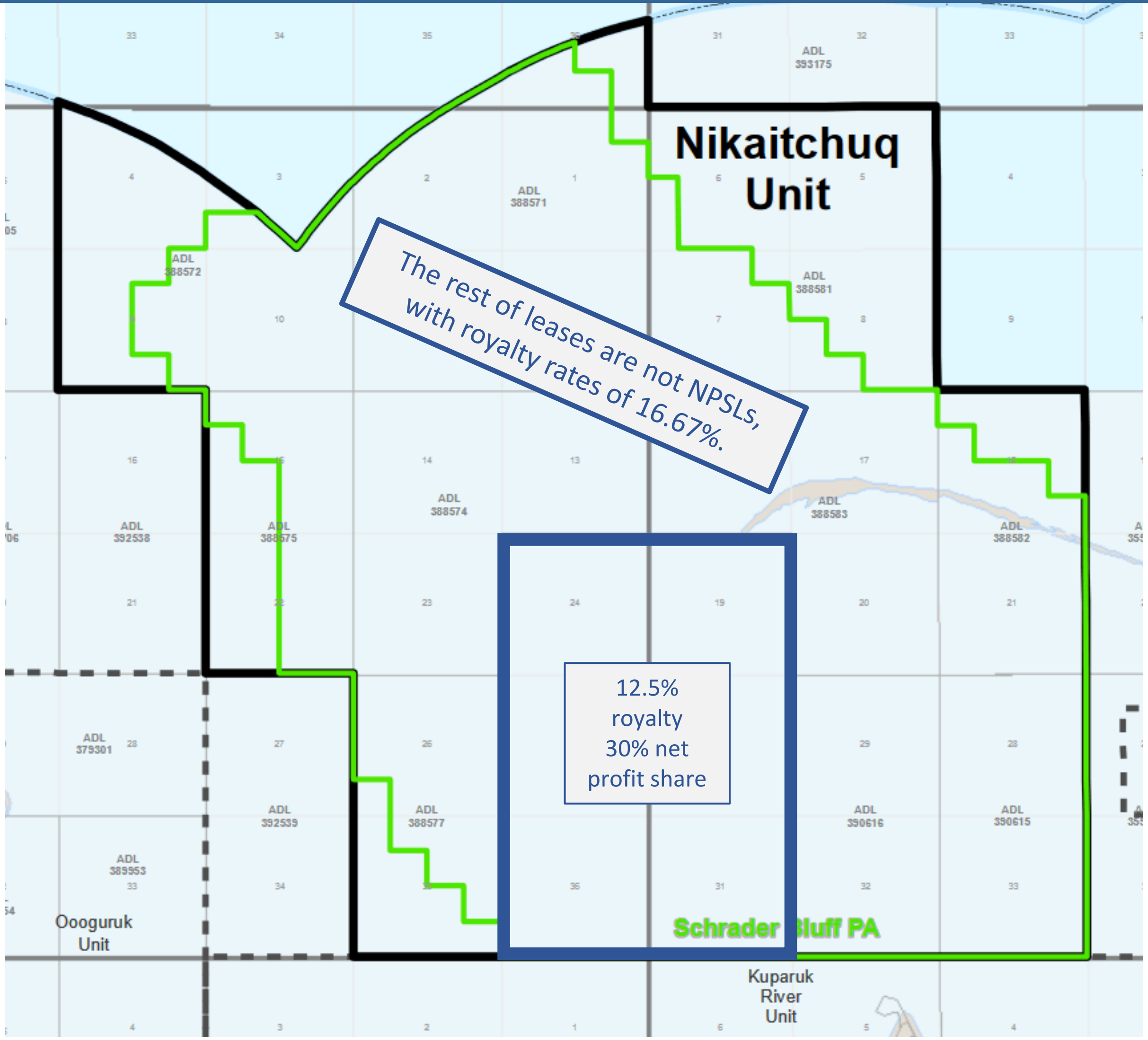
Example 2: Schrader Bluff in the Nikaitchuq unit

In 2011, Eni applied for the modification of royalty to develop the Schrader Bluff pool in the Nikaitchuq unit.

a. This pool was not previously produced.
   - The applicants claimed that this project would not occur but for the modification of royalty.

b. The net profit share rates were not modified (not allowed in existing modification statute).

c. After an extensive review of technical and commercial information, DNR granted royalty modification.
   - With the beginning of production in 2011, the royalty rate on a group of leases subject to the decision were reduced to 5% if production was less than 4,000 bpd for the first 10 years.
   - Once production is above 4,000 bpd, the royalty rate will be based on a price trigger of $42.64/bbl adjusted to inflation for a period of 25 years.
   - If price is less than or equal to the trigger, then the royalty rate is 5%. Otherwise, the originally royalty rate applies.
   - Cumulative production from Schrader Bluff pool is 62.6 mmbbls.



Example 3: Northstar

In 1996, BP approached DNR to discuss the economic viability of the proposed development of the Northstar pool in the Northstar unit.

a. The applicants claimed that this project would not occur but for the modification of **the net profit share**.

b. After an extensive review of technical and commercial information, DNR negotiated terms with BP and proposed them to the Legislature (HB548).

- The royalty modification statute was enacted in 1995 and amended in 2003.
- The net profit share be modified to encourage production which would otherwise be stranded
- The NPSLs were transformed into leases with a sliding-scale royalty rate, ranging from a minimum of 20% to a maximum of 27.5%, depending on a formula based on the price of oil.
- Production from Northstar began in 2001.
- Cumulative production to date is 178 mmbbls.