

HB 81 –Net Profit Share and Royalty Modifications on Oil & Gas Leases

Senate Finance Committee

Presentation by Ryan Fitzpatrick, Commercial Analyst
Division of Oil & Gas
Alaska Department of Natural Resources
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OUTLINE

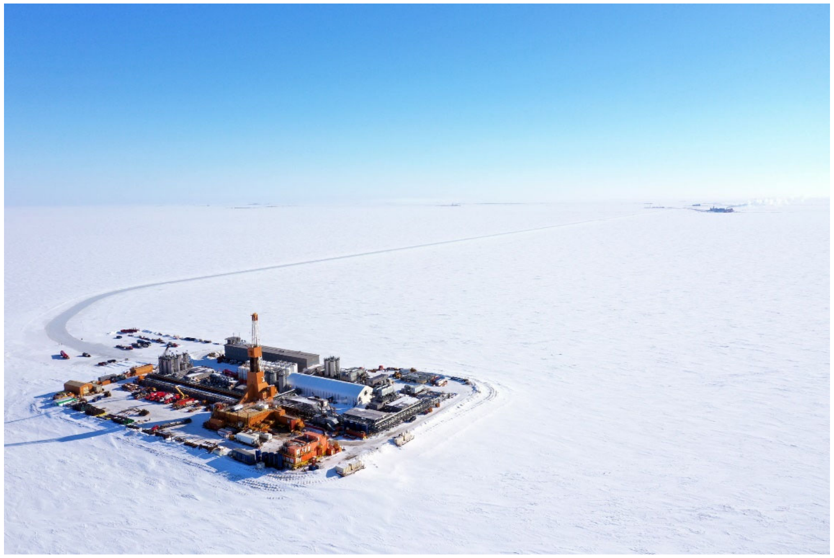
I. **Overview of Net Profit Share Leases**

II. **Overview of the modification process**

III. **Why Allow for NPSL Modifications?**

IV. **Overview of House Bill 81 as amended in the House**

V. **Appendix**



Spy Island Drill Site, Nikaitchuq unit

Royalty and Net Profit Share

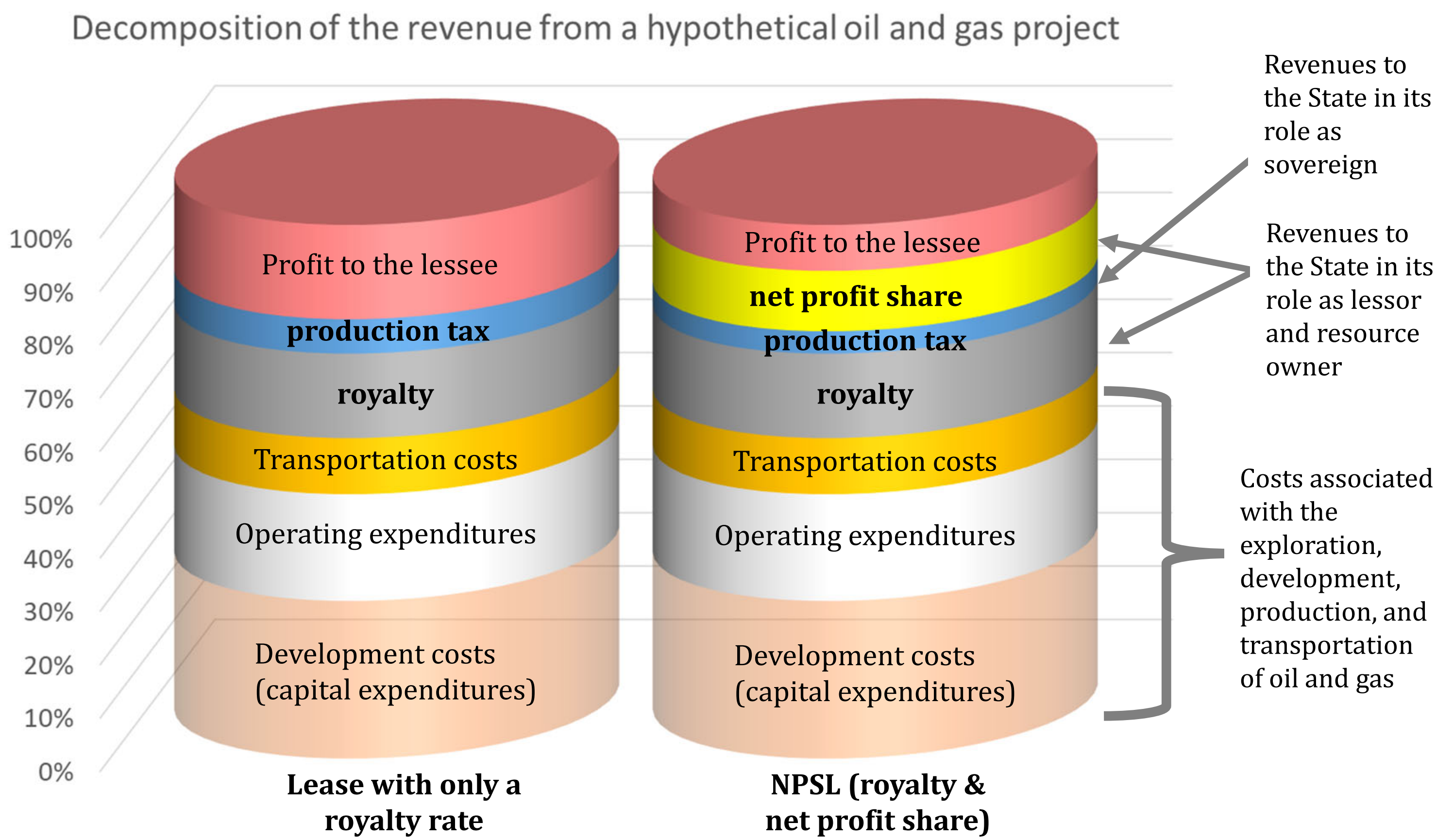
	Royalty	Production tax	Net profit share	Profit to the lessee
Established in the…	Oil and gas lease contract [State as a resource owner]	Production tax statute [State as sovereign]	Oil and gas lease contract [State as a resource owner]	Financial concept
Modification via…	Royalty modification statute: 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**: 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** - The taxpayer's gross value of taxable production less allowable lease expenditures	- **The lease**: 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** - 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 Sharing: A Hypothetical Example

What is net profit sharing?

1. Net profit sharing is another source of revenue to the State from oil and gas production.
2. Net profit sharing is a deduction to production tax.

Not shown here for simplicity: oil and gas property tax and corporate income tax



26 Active Net Profit Share Leases

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?	First payout date	Cumulative Net Profit Sharing to the State as of January 2022	Cumulative Royalty Revenue to the State as of February 2021	First royalty payment
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**	Aug. 2009 Sep. 2010 Aug. 2011	**$169.8 million**	**$284.7 million**	April 1999
312828 **312834**	1979 1979	79.59% 48.87%	20% 20%	Duck Island	Endicott and Sag Delta North	**Yes** **Yes**	Oct. 1999 Jan. 2000	**$575.4 million**	**$420.4 million**	October 1987
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	NA	**$0** (because no production and no revenues have been allocated to these NPSLs)		These NPSLs have not yet produced.
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**	Oct. 2002 Feb. 2003 Nov. 2002 Aug. 2005 Sep. 2002	**$457.3 million**	**$381.4 million**	June 1994
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	NA	**$0** (The costs allocated to these NPSLs have not yet been recouped by the revenues.)	**$40 million**	October 1989
355036 **355037** **355038** **355039**	1983 1983 1983 1983	30% 30% 30% 30%	12.5% 12.5% 12.5% 12.5%	Oooguruk	Kuparuk and Nuiqsut pools	**Yes** No **Yes** No	Mar. 2018 NA Nov. 2014 NA	**$15 million**	**$131.1 million**	June 2008
391283	2007 (segregated)	30%	12.5%	Nikaitchuq	Schrader Bluff pool	No	NA	**$0** (The costs allocated to this NPSL have not yet been recouped by the revenues.)	**$108.5 million**	February 2007

History of Royalty Modification Applications

Year	Lessee	Field or pool	Outcome	Sliding-scale mechanism for royalty rates	Status	Revenues to the State (as of Feb. 2022)
1995	BP	Milne Point	Denied			
1996	BP	Northstar	Granted via legislative action	Royalty fluctuates between 20% and 27%. NPSL removed.	Active.	$1.78 billion.
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: $177 million Net profit sharing: $15 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: $639 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
2021	Oil Search	Pikka	Application withdrawn			

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 must be based on a *sliding scale mechanism*.

- It could vary with the price of oil, volume of production, per-barrel costs, etc.
- HB 81 allows use of fixed royalty rates for a modification, but any fixed rate must be coupled with other modification mechanisms that create an integrated sliding scale modification.

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.

DECISION-MAKING PROCESS

A. **HB81 does not propose to change the modification process, but adds oversight for the final decision to grant a modification.**

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. **HB 81 adds an oversight role for the Alaska Royalty Oil & Gas Development Advisory Board.** The Board is required to approve any modification proposed by the Commissioner.

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

Why Allow for NPSL Modifications?

1. ***Increase Production from Otherwise Stranded Resources***

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

2. ***Flexibility for Royalty Modifications***

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

3. ***Streamline Process for NPSL Modifications***

- Current process to modify NPSLs is for DNR to *negotiate a modification package* and submit proposal for legislative action.
- Providing for NPSL Modification in statute would *streamline the NPSL modification process*, while allowing for the Legislature to set conditions and limits on NPSL Modifications.

WHAT HB 81 ACCOMPLISHES

1. **Expand the royalty modification process to include the modification of net profit shares:**
   - 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. **Creates an *additional qualifying scenario* for modification of NPSLs**
   - For producing pools, where incremental production requires incremental capital expenditures, which, in the absence of modification, would be uneconomic.
3. **Adds Oversight Role for Royalty Board for Royalty and NPSL Modifications**
   - The existing Alaska Royalty Oil & Gas Development Advisory Board would gain an oversight role in the modification process. The Board would be required to review proposed modifications for royalty and/or NPSL, and no modification could be granted without Board approval.
4. **Resolves an existing potential statutory ambiguity**
   - Clarifies that ***test production*** during exploration does not disqualify a field or pool from royalty or NPSL modification based on new production. This merely codifies existing interpretation, and is not a change in policy.

HB 81 vs. CSHB 81(RES)AM

Description	Section	House Bill 81 (originally proposed)	Committee Substitute for House Bill 81 (RES) as amended
Allows for the modification of net profit share under existing eligibility scenarios for royalty modification	AS 38.05.180(j)(1)(A)-(C)	✓	✓
Clarifies that the condition of prior production refers to commercial production	AS 38.05.180(j)(1)(A)(ii)	✓	✓
Creates a new eligibility scenario for modification when additional capital expenditures are needed for future production	AS 38.05.180(j)(1)(D)	Applies to both royalty and net profit share modification	[1] Refinement of language on "capital expenditures" better captures intent by DNR. [2] Restricts applicability of new scenario only to net profit share modification

HB 81 vs. CSHB 81(RES)AM

Description	Section	House Bill 81 (originally proposed)	Committee Substitute for House Bill 81 (RES) as amended
Provides a floor of 10 percent for the modification of the net profit share	AS 38.05.180(j)(4)(C)	✓	Same language but now under AS 38.05.180(j)(5)
Requirements for modification of net profit share under the new eligibility scenario under AS 38.05.180(j)(1)(D)	AS 38.05.180(j)(6)	NA	[1] Requirement that the lessees incur the capital expenditures [2] Requirement that the DNR commissioner determines that such capital expenditures are needed to maximize economic production
Alaska Royalty Oil & Gas Development Advisory Board oversight for modifications	AS 38.05.180(mm), AS 38.06.040(a)	NA	Requires that Royalty Board reviews and approves modifications of royalty and/or NPSL. Amends Royalty Board authorizing statutes to include authority for modification reviews.
Other conforming changes	AS 38.05.180(p), (s), (t)	NA	Existing language refers to the modification of royalty. Proposed language adds references to the modification of the net profit share.

QUESTIONS

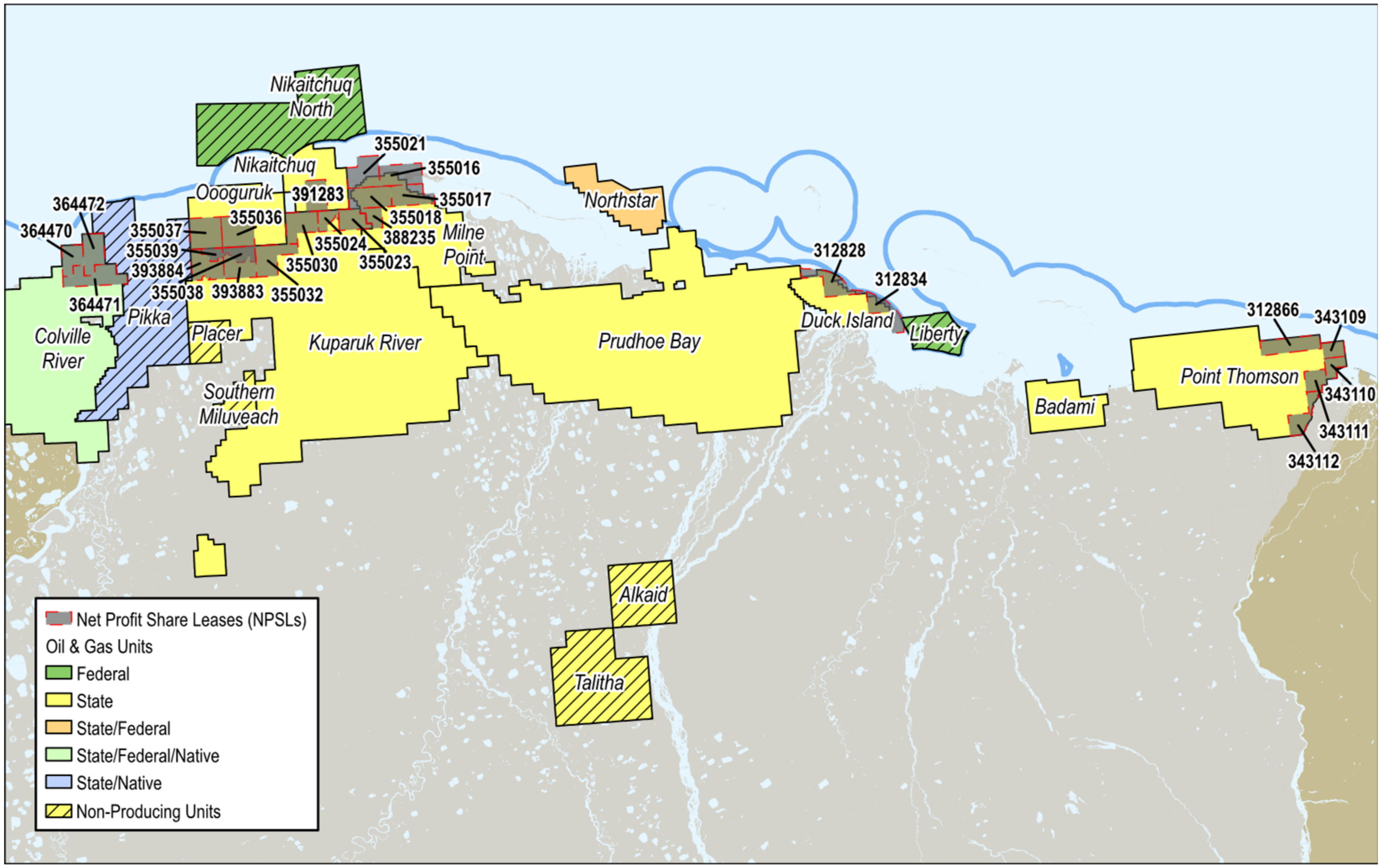
Thank you
on behalf of the Commercial section:

Jhonny Meza, Ryan Fitzpatrick, Weston Nash,
Chalinda Weerasinghe, and Adi Chaobal

Division of Oil & Gas
Alaska Department of Natural Resources

V. Appendix

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 $1.2 Billion in net profit sharing (as of January 2022).
- Some NPSLs are not producing or are not in the "payout stage." Thus, there is no "net profit sharing" with the State.

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:

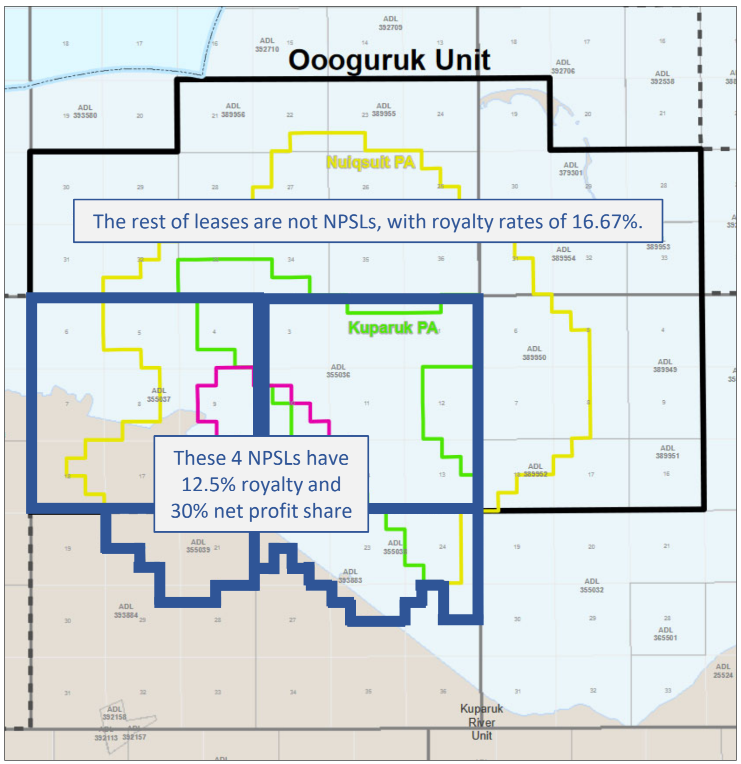
- NPSL issued in 1979 which later became part of the Northstar unit
- Fixed royalty rate of 20%
- Bid variable was the net profit share with 93.2% as the highest bid.

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 as of February 2022
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%.	**$1.78 billion**
312799	1980	91.2%	20%				
312808	1980	85.26%	20%				
312809	1980	85.26%	20%				

- The Legislature approved the modification of the net profit shares and royalty rates.
  - ✓ 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.
  - ✓ Production from this field (and associated royalties) began in October 2001.

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 Ooguruk 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: $162 million.**
- **Net profit sharing from NPSL 355036 and 355038: $14.4 million**

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 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.