THE STATE of ALASKA
GOVERNOR BILL WALKER

Department of Natural Resources
DIVISION OF OIL AND GAS
550 W.7th Avenue, Suite 1100
Anchorage, AK 99501
Main: 907.269.8800
Fax: 907.269.8939

April 30, 2018

Alaska House of Representatives
House Finance Committee
120 4th Avenue
Juneau, AK 99801
Via Email

Honorable Representative Neal Foster
Co-Chair

Honorable Representative Paul Seaton
Co-Chair

Honorable Representative Tammie Wilson

Dear Representatives Foster, Seaton and Wilson,

This letter is in response to requests from the committee for additional information regarding the overriding royalty interest (ORRI) agreements House Bill 331 (HB 331) would authorize the Department of Natural Resources (DNR) to accept.

HB 331 would allow a company with a tax credit certificate that wishes to have the Department of Revenue (DOR) purchase the certificate from bond proceeds at a higher price to propose an ORRI from the company. Specifically, section 10 of HB 331 in proposed AS 43.55.028(m)(2) would allow DOR to apply a lower discount rate if the company has agreed to an ORRI accepted by DNR. Section 11 of HB 331 amends AS 44.37, relating to DNR functions and duties, to add new statute AS 44.37.230. This new statute provides the mechanism for DNR to obtain ORRIs. An explanation of these subsections follows.

Subsection (a) requires DNR to consult with DOR regarding discount rates. This is necessary because DNR will need to know the difference between the purchase amount at the 10 percent discount rate and the lower discount rate if an ORRI is accepted in order to conduct the net present value analysis required in subsections (b) and (f).

Subsection (b) authorizes DNR to enter ORRI agreements in favor of the State.

Subsection (c) starts the process for a company to obtain a lower discount through an ORRI agreement with DNR. This subsection requires the company to propose the agreement, which must include the leases and percentage of interest offered as an ORRI. An example is provided below.

Subsection (d) provides the monthly payment calculation to be used in any ORRI agreement. Importantly, the price is fixed in statute and no deductions are allowed. This will simplify negotiations as the main issue for any negotiations will be whether the percent offered is enough to meet or exceed the amount from the net present value analysis required in subsection (b).

Subsection (e) provides the interest to apply to an underpayment or overpayment.

Subsection (f) requires DNR to evaluate a company's proposed agreement based on several factors. This will likely require DNR to consider sensitive and proprietary information about the company's finances, development plans, geological, geophysical and engineering information and resources under its leases.

Accordingly, subsection (g) allows DNR to enter confidentiality agreements to evaluate that information.

Subsection (h) as amended directs the revenues from an ORRI agreement to the general fund and DNR maintain an accounting of the funds collected. ORRI revenues are not royalty owner shares and therefore not directed to other accounts.

(i) provides some definitions for terms used in the statute.

The following is an example of how a company and DNR might enter an ORRI agreement.

> OilCo Oil Company has $100 million in tax credit certificates. When DOR solicits interest in the Tax Credit Bond Program, OilCo would notify DOR of its interest and request DOR to purchase the certificates with bond proceeds. DOR could purchase the certificates for $84 million if the standard 10 percent discount rate applies. If OilCo is interested in a smaller discount and therefore more cash for the certificates, OilCo may propose an ORRI agreement with DNR which would allow DOR to purchase the certificates for $93 million in exchange for an ORRI on some or all of its leases.
>
> OilCo has working interests in leases in various stages of development throughout the state and has earned the tax credit certificates for its work as a lessee on some leases where the State is the lessor in the Cook Inlet. OilCo also is a lessee on eight leases in National Petroleum Reserve-Alaska (NPR-A) where the federal government is the land owner lessor. The federal government as the landowner lessor has reserved a royalty interest in 16 $^{2/3}$ percent of the oil produced from those leases. This means OilCo as the sole lessee and working interest owner has a 100 percent interest in the remaining 83 $^{1/3}$ percent of the oil produced. If OilCo produces 30,000 barrels of oil per day from those leases, 5,000 barrels belong to the federal government as royalty and 25,000 belong to OilCo.
>
> OilCo proposes an ORRI agreement on its eight leases in NPR-A. The proposed agreement, in accordance with AS 44.37.230(c), is expressed as an offer to DNR for 0.1 percent interest in the total oil production from those leases for the duration of the leases. Under OilCo's proposed agreement and production profile,

DNR would receive 0.1 percent of 30,000 barrels, or 30 barrels per day without incurring any of the expenses of the development or operation or tax liability associated with that production. DNR would consider the criteria in AS 44.37.230(f) to determine whether the anticipated net present value of OilCo's proposed ORRI agreement would meet or exceed the $9 million-dollar difference between the purchase amount of the certificate at the lower discount rate with the ORRI agreement and the high discount rate without the ORRI agreement. The 30 barrel per day ORRI is nearly 11,000 barrels annually for the life of the lease. At $50 per barrel, that is approximately $550,000 per year.

This example highlights several unique features of the ORRI provisions of HB 331. First, DNR does not currently have ORRIs because DNR as a landowner is a lessor. DNR receives royalty it has reserved as a landowner. If DNR holds an ORRI on a lease under HB 331 the interest will come from the interest of the lessee. Second, the ORRI agreement could be proposed for land not owned by the State but owing to the payment structure in AS 44.37.230(d), the ORRI would need to come from leases located within Alaska.

Sincerely,

James B. Beckham
Deputy Director

Copy: Andrew T. Mack, Commissioner, Department of Natural Resources
Mark Wiggin, Deputy Commissioner, Department of Natural Resources
Sheldon Fisher, Commissioner, Department of Revenue
Ken Alper, Director, Tax Division
Chantal Walsh, Director, Division of Oil and Gas
Darwin Peterson, Governor's Legislative Director