SB 61 – Oil/Gas Lease: DNR Modifying Net Profit Shares

Senate Resources Committee

Presentation by Jhonny Meza, Commercial Manager
Division of Oil & Gas
Alaska Department of Natural Resources
February 10, 2021

OUTLINE

I. **Overview of Net Profit Share Leases ("NPSLs")**
   - Map of existing NPSLs
II. **Why Allow NPSL Modifications?**
   - Snapshot of an economic model
III. **Modification Process for Royalty and Net Profit Share**
IV. **Appendices**
   - Sectional analysis
   - Calculation of net profit shares
   - Additional information on NPSLs
   - Additional information from economic model

Spy Island Drill Site, Nikaitchuq unit

I. Overview of Net Profit Share Leases

I. Overview of Net Profit Share Leases

What are Net Profit Share Leases ("NPSLs")?

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

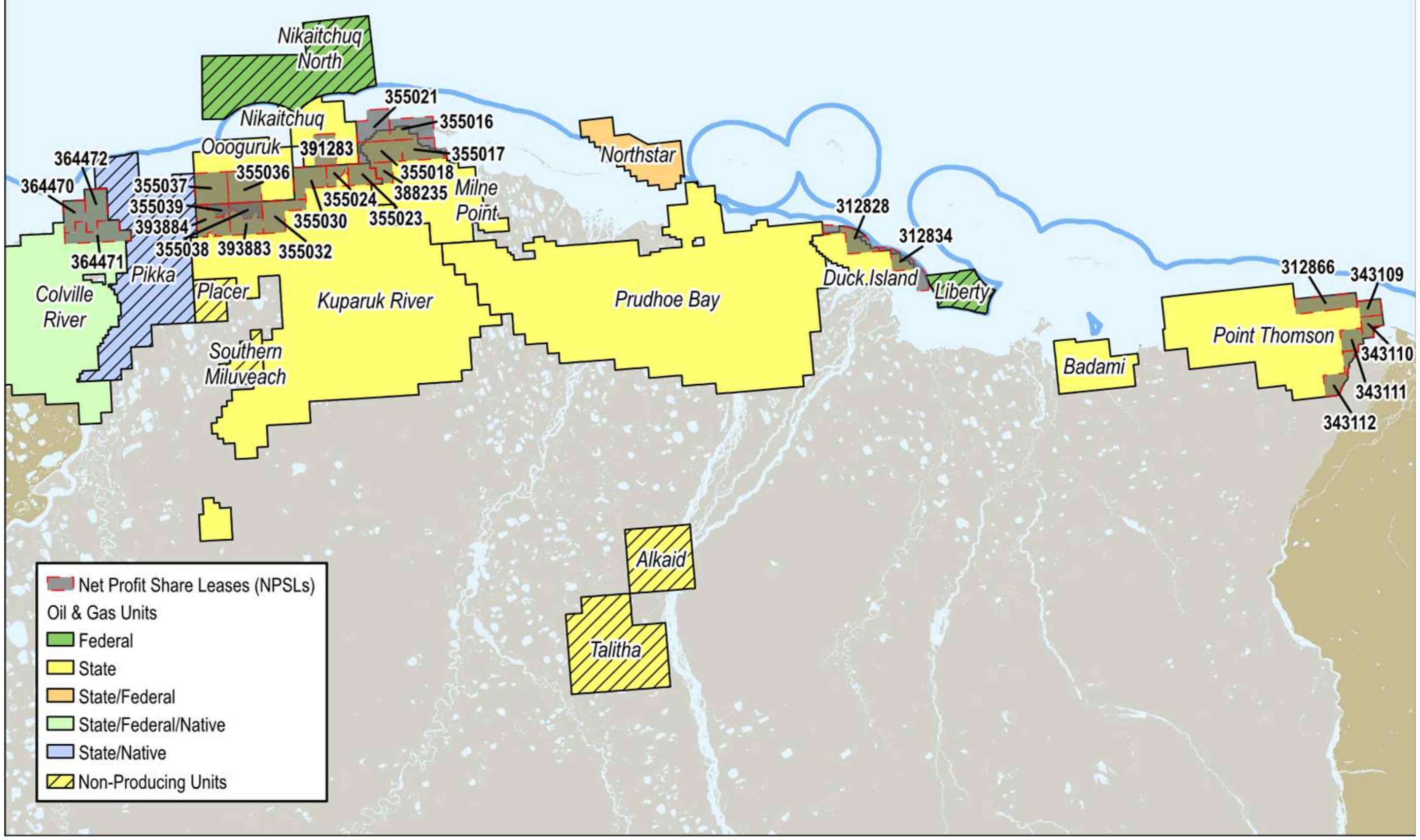
B. Differences between royalty and net profit payments:

	Royalty revenue	**Net profit share revenue**
Beginning of payments	With commercial production	When the NPSL reaches "payout" stage
Payments assessed on	Gross revenue	"Net profits" (if NPSL is in payout)

- "Payout": When the exploration and development costs (with interest) associated with the NPSL are recouped.
- "Net profit": Revenues (net of operating costs) that exceed the cost of exploration and development of the lease.

I. Overview of Net Profit Share Leases

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.

II. Why Allow NPSL Modifications?

II. Why Allow NPSL Modifications?

1. Increase Production from Otherwise Uneconomic Sources

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

- 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 uneconomic could **<u>extend the life</u>** 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.

II. Why Allow NPSL Modifications?

2. Provides DNR with Additional Flexibility for Royalty Modifications

A. NPSL Modifications would give DNR flexibility to elect **<u>targeted reductions</u>**

- 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 **<u>potential payback of foregone revenues</u>** in the event of higher prices or production levels.

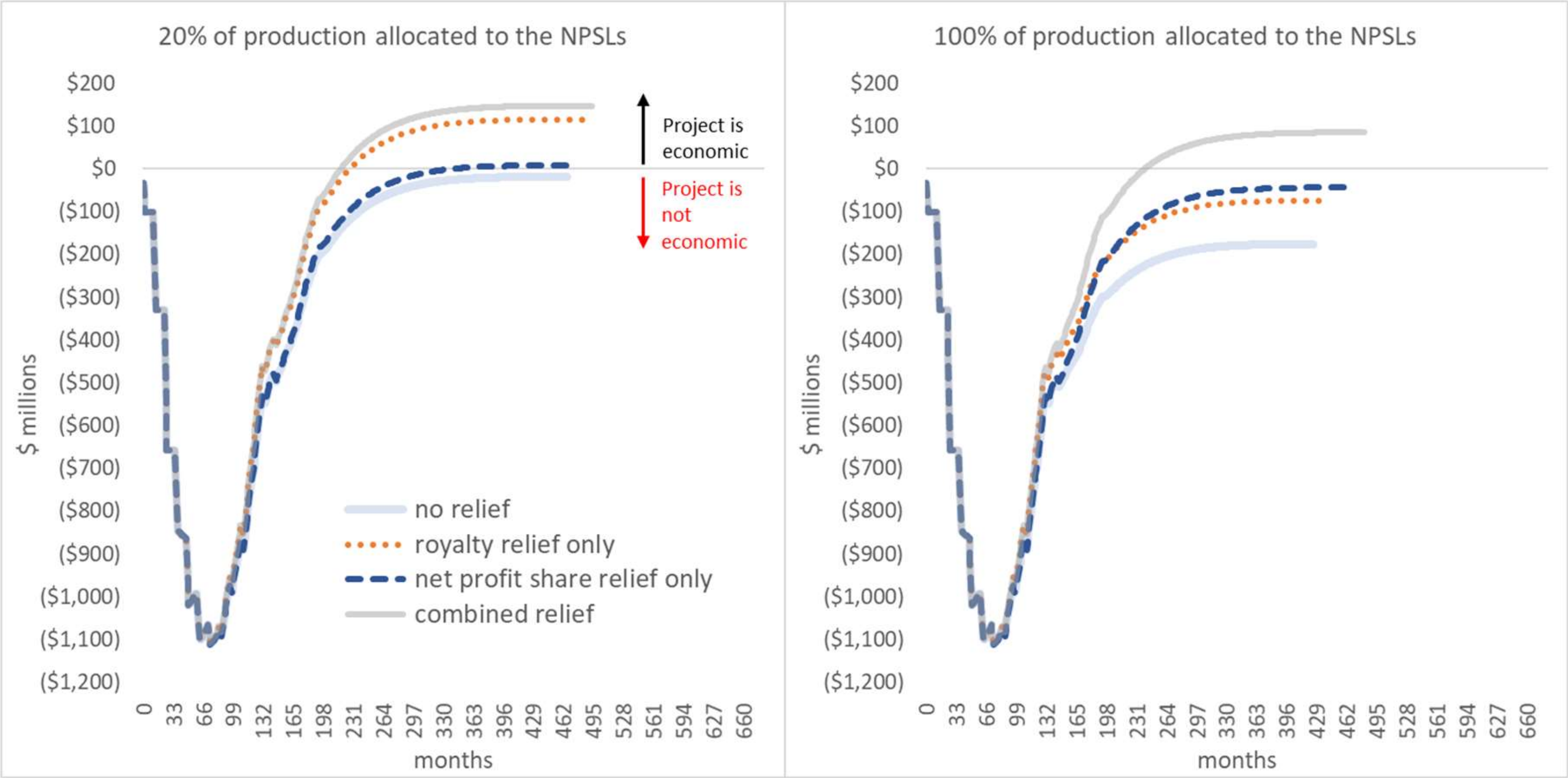
II. WHY ALLOW NPSL MODIFICATIONS?

SNAPSHOT OF AN ECONOMIC MODEL

NPSL modification…

- may increase production from otherwise uneconomic sources
- would provide additional flexibility to the State

Net Present Value of a Hypothetical Project under 2 scenarios for the NPSLs



II. Why Allow NPSL Modifications?

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.

III. Modification Process for Royalty and Net Profit Share

III. MODIFICATION PROCESS FOR ROYALTY AND NET PROFIT SHARE

What does SB 61 accomplish?

1. Expand the royalty modification process to include NPSLs:

A. Commissioner would have the **<u>authority to modify</u>** net profit share rates in the same manner as royalty rates under AS 38.05.180(j).

- Objective is to encourage production of otherwise uneconomic state resources.

2. Other changes:

A. Creates an **<u>additional qualifying scenario</u>** 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 **<u>test production</u>** 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 **<u>to resolve a potential ambiguity</u>**. It does not constitute a change in current policy.

III. MODIFICATION PROCESS FOR ROYALTY AND NET PROFIT SHARE

1. What type of modification?

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.

III. MODIFICATION PROCESS FOR ROYALTY AND NET PROFIT SHARE

2. Eligible scenarios for modification:

Current statute

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)

SB61 proposal

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.

III. MODIFICATION PROCESS FOR ROYALTY AND NET PROFIT SHARE

3. Decision-Making Process

A. SB61 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))

IV. Appendices

Appendix 1:
Sectional Analysis

- **Section 1** of the bill amends AS 36.30.850(b)(32) to make AS 36.30 not applicable to certain contracts between the Department and contractors hired to assist in evaluating royalty modification applications to the net profit share of oil and gas leases.

- **Section 2** of the bill makes the following changes to AS 38.05.180(j):
  1) It allows the DNR commissioner to provide modification of net profit share rates.
  2) It inserts the qualifier "commercial" before "sale" in AS 38.05.180(j)(1)(A)(ii).
  3) It allows modification to be granted in circumstances in which capital expenditures are required to extend the economic life of an oil or gas field or pool or allow for incremental production.
  4) It allows fixed royalty and net profit share to be used as mechanisms for providing modification.

Appendix 2: Calculation of Net Profit Shares

Step 1: Calculate Development Account (11 AAC 83.212)

- Exploration and development expenses are accrued in the Development Account.

  Examples: geologic and geotechnical research, equipment rentals, facilities and equipment installation, drilling, permits, property taxes, cost of capital, etc.

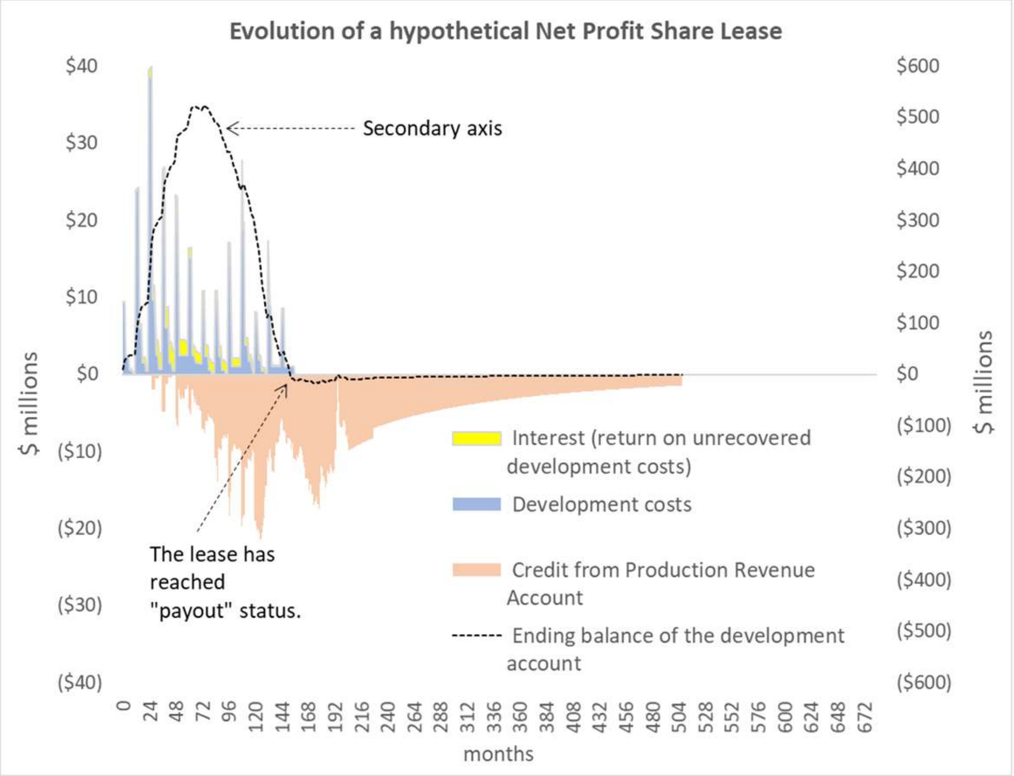
Step 2: Calculate Production Revenue Account (11 AAC 83.222)

- Production revenues are the product of production volume and the value of the produced oil and gas.
- Direct costs are deducted from revenues.

  Examples: operating expenses such as labor costs, materials, contract services, utilities, fuel, communications, insurance, etc. Royalties, production tax, and oil & gas property taxes are also deducted.

Step 3: Calculate Net Profits

- Production Revenues are deducted from the producer's Development Account until the Development Account reaches a zero balance.
- Once the Development Account reaches a zero balance, the lease is said to be in "payout," and additional Production Revenues are allocated between the State and the producer based on the Net Profit Share rate.



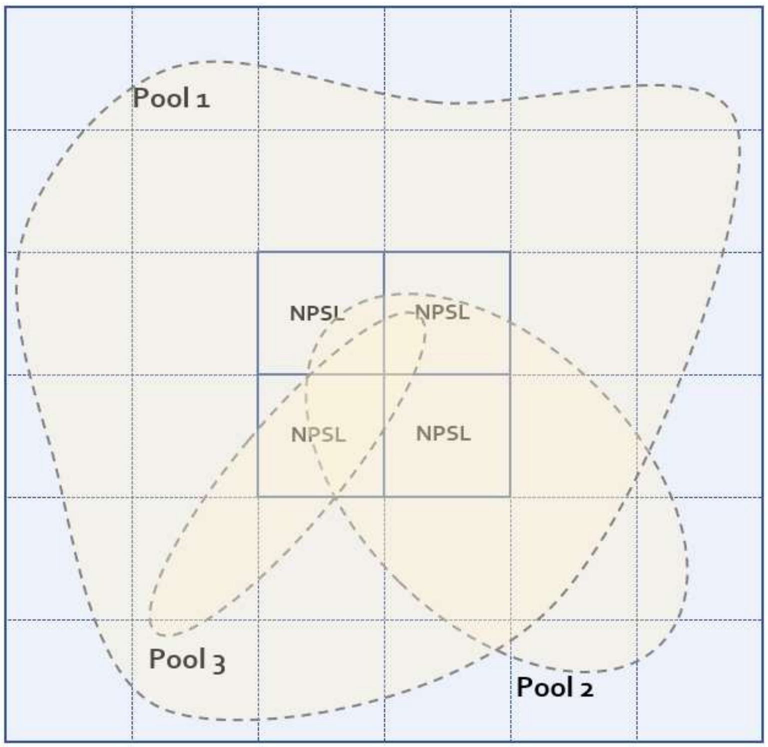
APPENDIX 3: ADDITIONAL INFORMATION ON NPSLS

- There are currently 26 NPSLs in 7 different units (not including four leases in Northstar modified by the legislature in 1996).
- Average Net Profit Share is 36.82%.
- The first NPSL to reach "payout" occurred in 1999.
- Currently there are four units that include NPSLs in payout:
  - Duck Island, Colville River, Milne Point, Oooguruk
- Since 1999, the State has received $1.175 Billion in Net Profit Share payments.

Active NPSLs			
Unit	**NPSL ADL**	**NPS Rate**	**Royalty Rate**
Duck Island	312828 312834	79.59% 48.87%	20.00% 20.00%
Point Thomson	312866 343109 343110 343111 343112	52.35% 40.00% 40.00% 40.00% 40.00%	20.00% 12.50% 12.50% 12.50% 12.50%
Milne Point	355016 355017 355018 355021 388235	40.00% 40.00% 30.00% 30.00% 30.00%	12.50% 12.50% 12.50% 12.50% 12.50%
Kuparuk River	355023 355024 355030 355032 393883 393884	30.00% 30.00% 30.00% 30.00% 30.00% 30.00%	12.50% 12.50% 12.50% 12.50% 12.50% 12.50%
Oooguruk	355036 355037 355038 355039	30.00% 30.00% 30.00% 30.00%	12.50% 12.50% 12.50% 12.50%
Colville River	364470 364471 364472	30.00% 30.00% 30.00%	12.50% 12.50% 12.50%
Nikaitchuq	391283	30.00%	12.50%

Appendix 4:
Additional information from economic model

- Model is based on a hypothetical oil development in a unit containing 36 leases, of which 4 are net profit share leases ("NPSLs")

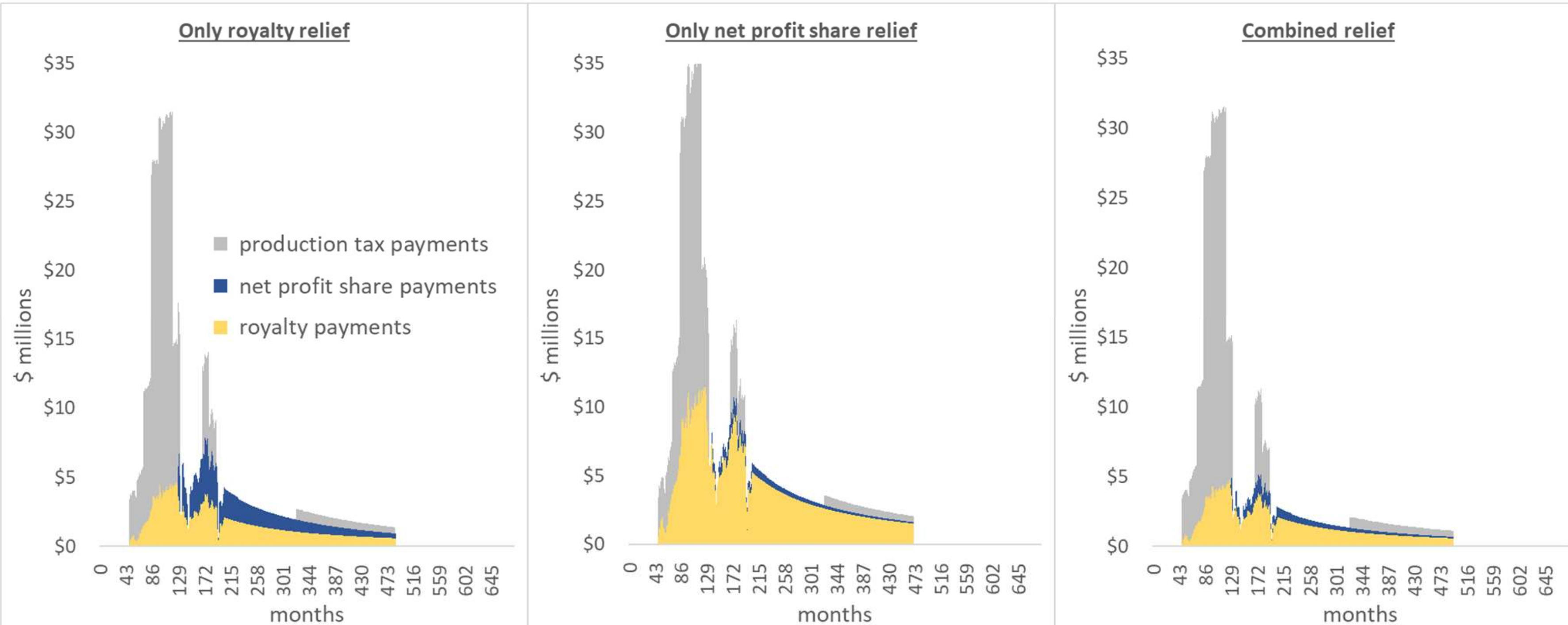


1. All 36 leases have the same royalty rate: 12.5%
2. All 4 NPSLs have the same net profit share rate: 30%
3. The same share of production from each pool is allocated to each NPSL in the following way…

Allocation to each lease	Scenario 1	Scenario 2
NPSL 1	5%	25%
NPSL 2	5%	25%
NPSL 3	5%	25%
NPSL 4	5%	25%
Remaining leases	80%	0%

Appendix 4:
Additional information from economic model

State Revenues from a Hypothetical Project with NPSLs (Scenario 1 only)



- Modifications of royalty rate may have effects on net profit revenues and production tax revenues.
- Modifications of net profit share rates may have effects on production tax revenues.

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
February 10, 2021

ALASKA DIVISION OF OIL AND GAS