THE STATE of ALASKA
GOVERNOR MIKE DUNLEAVY

Department of Natural Resources

OFFICE OF THE COMMISSIONER

550 West 7th Avenue, Suite 1400
Anchorage, AK 99501-3561
Main: 907.269.8431
Fax: 907.269.8918

The Honorable Click Bishop, Co-Chair
The Honorable Bert Stedman, Co-Chair
Senate Finance Committee, Rm 532
Alaska State Capitol
Juneau, Alaska 99801

May 3, 2022

Re: House Bill 81- Oil/Gas Leases: DNR Modify Net Profit Share- committee follow up.

Dear Senators Bishop and Stedman:

During the hearing on April 20, 2022, on House Bill 81, the Department of Natural Resources, Division of Oil and Gas (the Division) received a request to provide the "order of operations" in the calculation of royalty, production tax, and net profit payments.

As opposed to the case of royalty, where all State oil and gas leases have a royalty rate, the net profit payments can come only from the 26 Net Profit Share Leases existing on the North Slope. During the hearing on House Bill 81, the Division showed that, as of January 2022, the State has been obtaining a share of the net profits from only 12 Net Profit Share Leases. In other words, 14 Net Profit Share Leases have not yet reached the "payout status," which essentially means the costs allocated to these leases have not yet been recovered from the revenue associated with these leases. The description of the order of operations below will be based only on the Net Profit Share Leases that have reached the payout status.

The example below is a simplification of the calculation of the net profit payments in association with other revenues to the State. This example is based only on the production of oil from the North Slope coming from a single State-owned lease which happens to be a Net Profit Share Lease. In this way, the calculations below are done at the lease level rather than at the field level or at the company level (as is the case for production tax or corporate income tax). Thus, the assumption is that there is only one lessee (producer) in this single lease on the North Slope. Royalty and net profit payments are calculated monthly, so the table below represents the calculation for a given month.

A. Calculating monthly gross revenue (after deducting transportation costs):

[1]	ANS oil price at the U.S. West Coast		$110/bbl
[2]	Transportation costs and other adjustments to compute the ANS oil price at the field		$10/bbl
[3]	ANS oil price at the field	[1] – [2]	$100/bbl
[4]	Production of ANS oil		100,000 bbls
[5]	Gross revenue from the production of ANS oil	[3]*[4]	$10,000,000
[6]	Operating expenditure		$2,000,000
[7]	Capital expenditure		$1,750,000

B. Calculating monthly royalty[1]:

[8]	Royalty rate		12.5%
[9]	Royalty revenue	[5]*[8]	$1,250,000

[1] Note that no production costs are considered in the calculation of royalty.

C. Calculating net profit payments (royalty payment is a deduction for the purpose of calculating net profit payments[2]):

[10]	Net profit for the purpose of calculating net profit payments from the Net Profit Share Lease[3]	[5] – [6] – [7] – [9]	$5,000,000
[11]	Net profit share rate		30%
[12]	Net profit payment[4]	[10]*[11]	$1,500,000

D. Calculating production tax[5]. [Net profit payment is an allowed deduction[6] in the calculation of production tax value (i.e., taxable revenue).]

[13]	Taxable oil production	[4]*(1-[8])	87,500 bbls
[14]	Gross value at the point of production (GVPP)	[13]*[3]	$8,750,000
[15]	Lease expenditures[7]	[6] + [7]	$3,750,000
[16]	Production tax value	[14] – [15] – [12]	$3,500,000
[17]	Production tax rate		35%
[18]	Production tax before any tax credits	[16]*[17]	$1,225,000
[19]	Minimum tax rate applied to the GVPP		4%
[20]	Minimum tax	[19]*[14]	$350,000
[21]	Tax credit for production not qualifying for gross value reduction (i.e., sliding -scale tax credit)[8]		$5/bbl
[22]	Tax credit deductions	[21]*[13]	$437,500
[23]	Production tax after tax credits	Maximum of {[20],[18]-[22]}	$787,500

E. Calculating of remaining profit to the lessee. [For simplicity, we omit property tax and corporate income tax.]

[24]	Profit left to the lessee	[5]-[6]-[7]-[9]-[12]-[23]	$2,712,500

Thank you for this opportunity to explain the order of operations for calculating royalty, production tax, and net profit payments.

Sincerely,

DocuSigned by:
Jhonny Meza
3E8392E585FA4B7...

Jhonny Meza, Commercial Manager
Division of Oil and Gas

DocuSigned by:
Ryan Fitzpatrick
2D52824065FD49E...

Ryan Fitzpatrick, Commercial Analyst
Division of Oil and Gas

---

[2] See AAC 11 83.209(c)(2).
[3] For simplicity, we omit the calculation of the "production tax lease allowance", defined under 11 AAC 83.241, which is another deduction in the calculation of "net profits" for computing net profit payments.
[4] In this example, the lessee generates a "net profit" of $5 million for that month and a net profit payment of $1.5 million is paid to the State *because* we assume that the Net Profit Share Lease is already in "payout status." In other words, we assume that all prior production and development costs associated with this lease have already been recovered by the revenue generated from this lease. If the latter had not happened, then there will not be any net profit payments until such costs are fully recovered, even though the "net profit" for the month is $5 million.
[5] As stated earlier, production tax is assessed at the company level for all assets in the North Slope. In this example, we assume that this lessee generates production from this Net Profit Share Lease. Thus, the production tax calculation can be done at the lease level.
[6] See AS 43.55.165(e)(2).
[7] For simplicity, we assume that lease expenditures are equal to the sum of operating and capital expenditures. However, AS 43.55.165 provides more details about the types of costs not allowed as part of lease expenditures.
[8] See AS 43.55.024(j)(4).