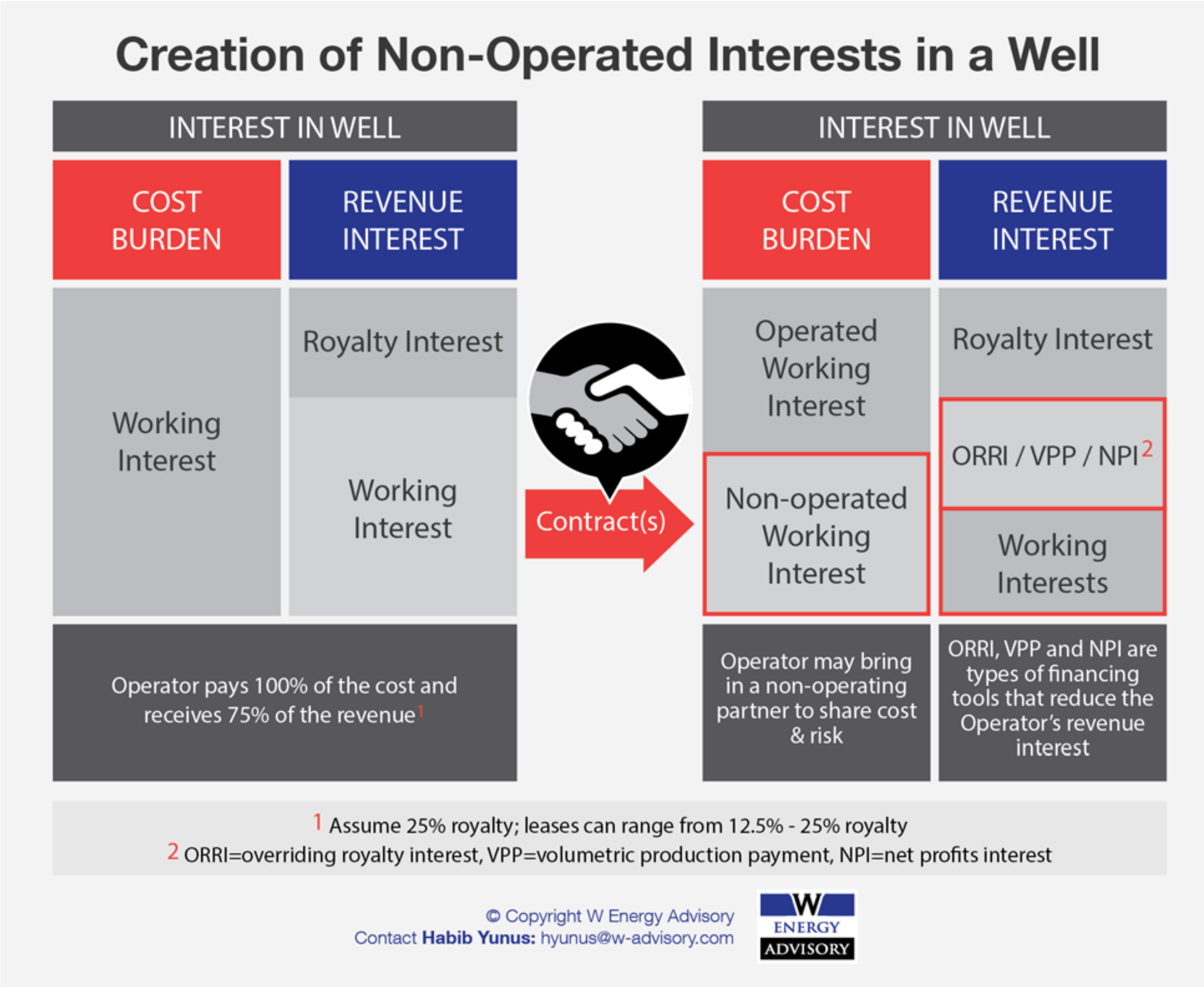
Net Profits Interest (NPI) in Oil and Gas Properties in the US

September 2014

Habib Yunus: hyunus@w-advisory.com



Overview

A net profits interest (NPI) is a share of the "net profits" of the production from an oil/gas lease. It is a non-operating interest that is carved out of the working interest of an oil/gas lease.

Unlike an overriding royalty interest (ORRI) or volumetric production payment (VPP), an NPI is not measured by a fractional share of production free of costs. An NPI is a percentage of the net profits from the operation of the burdened lease. The NPI entitles the owner to only receive revenues when the operations yield net profits.

Generally, an NPI is computed by deducting the cumulative capital (CAPEX) and operating expenses (OPEX) from the revenues associated with the production of oil/gas. When there is a cumulative positive balance, that amount multiplied by the NPI percentage is the NPI amount.

Creation of an NPI

Like an ORRI or VPP, NPI are usually created (a) by an oil/gas lessee as an additional benefit for the lessor, (b) as a financing tool for the Operator. It is a non-operating interest that is carved out of the working interest of an oil/gas lease. An NPI is sometimes created as an "equity kicker" as part of a credit facility.

Advantages/Disadvantages of an NPI

The NPI is popular with tax-exempt buyers because it allows them to participate in drilling wells without incurring unrelated business taxable income (UBTI). The NPI holder is also permitted to deduct intangible drilling and development costs, which can significantly reduce taxable income.

The main disadvantage of the NPI is that it is not generally a real property interest and would not be protected from attaching to the bankruptcy estate in the event of Operator bankruptcy.

Calculating "Net Profits"

While ORRIs and VPPs have well-defined, judicially recognized characteristics, there is no generally accepted method of calculating net profits. Therefore parties to an NPI agreement should agree what expenses and revenues to include in the net profit calculation to avoid future misunderstanding.

The term "net profits", refers to the excess of the proceeds from the sale of production of oil/gas in excess of the development, operation, production, transportation, marketing costs, and taxes associated with the property.

The NPI holder is never obligated to pay for a share of losses; however, an NPI is cumulative and incorporates losses from prior periods.

For example, Company A, which owns the rights to explore and develop an oil/gas property, leases it to Company B in exchange for a 12% NPI. In period 1 if Company A makes $4 million in negative profits, Company B receives zero. The next period if Company B makes $10 million in net profits after deducting all allowable and applicable expenses from revenue generated from the property, $10 million less the previous loss of $4 million, which is $6 million, would be multiplied by 12% and Company A would receive $720,000 as its share of net profits.

Real or Personal Property

Although owners have argued that the NPI should be viewed as an interest in real property, most jurisdictions have interpreted it as an interest in the proceeds of production and therefore personal property.

US Tax Implications

Under US Tax rules, the sale of an NPI is generally a taxable transaction to the seller of the NPI. The NPI buyer would receive a portion of the basis of the oil/gas properties burdened by the NPI.

The income received from an NPI is considered ordinary income. The NPI owner can deduct depletion expense over the life of the NPI. The NPI owner is also entitled to expense all of the intangible drilling and development costs and claim all depreciation, depletion and amortization (DD&A) attributable to the NPI.

Tax exempt investors often invest in NPI instead of a working interest to avoid receiving unrelated business taxable income (UBTI). Net profits interest payments are not considered UBTI for tax purposes, but still allow the investor to participate in drilling of new wells and access the favorable intangible drilling cost deduction.

An NPI is considered an interest in real property for US tax purposes and would be subject to FIRPTA withholding tax, when sold by a foreign owner.

Financial Accounting Implications

The owner of an NPI is permitted to record the NPI reserves on its balance sheet.

Bankruptcy Implications

There is very little case law regarding how an NPI is characterized in bankruptcy. Because a typical NPI is not a production payment under the Bankruptcy Code it does not receive the same protection as a VPP.

An NPI is often used as a financing tool so it looks like a lien on production. Consequently, a bankruptcy court may consider the NPI a financing and not a conveyance of real property. In that case NPI owner would not be an owner of a real property interest, but simply a personal property owner and another creditor of the debtor.

Environmental Liability

NPI holders have no obligation for any environmental, remediation or plugging and abandonment expenses.

W Energy Advisory	
w-advisory.com	
Phone:	+1 713-518-1126
Fax:	+1 281-617-5819
Email:	hyunus@w-advisory.com
Houston Office:	Tokyo Office:
17385 Village Green, Suite C Houston, Texas 77040 USA	Toranomon 3-18-6 Asahi Toranomon Mansion #705 Minato ku, Tokyo 105-0001 JAPAN

W Advisory offers a range of transaction-based advice to assist our clients with their investments. We generally work with oil and gas investments, but also have experience in software, pharmaceuticals, publishing and financial services. Most transactions we work on are cross-border with Asia and North America (US and Canada).