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Recommendations Part 1 - Royalty Regime Changes



Royalty and Related Information Review
Task Force Recommendations
January 26, 1998



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Proposed changes to the royalty regime address major concerns for royalty payers of all sizes about operating and capital costs, custom processing...

- Operating Costs
 - Introduce “13th month” UOCR adjustment to correct the difference between estimated and actual
 - Align Allowable Cost definitions with industry standards and practices
 - Eliminate insurance cost recognition
 - Clarify treatment of reclamation/abandonment costs
- Capital Costs
 - Eliminate Corporate Effective Royalty Rate
 - Introduce EUB facility rate, capital allocated based on value weighted volumes (through-put)
 - Align Allowable Cost definitions with industry standards and practices
- Custom Processing
 - Eliminate actual Custom Processing cost filings
 - Introduce Custom Processing Allowances based on gas type
 - Determine custom user status by Gas plant ownership
 - Eliminate concept of de-layered rates
 - Eliminate “excess capacity” custom processing claims

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... Freehold Mineral Rights Tax, Reclamation / Abandonment, Corporate Average Price Election, Minimal Royalty Charges and Deep Gas Holidays

- Freehold Mineral Rights Tax (FMRT) program
 - Natural gas component incorporated into Crown Gas Royalty business rules and processes
- Reclamation/Abandonment costs
 - Commitment to review recognition of these expenditures/obligations as Allowable Costs
- Corporate Average Price (CAP) Election
 - Annual prospective election for royalty payers, who in the immediately preceding production year paid Crown natural gas royalties of less than \$30,000
 - Association rules apply. Election not subsequently revocable by royalty payer. VA1 not filed by prescribed date = late filing penalty/lost election rights. 90% of Reference Price floor retained
- Minimal Royalty Charges
 - Legislation and business rules established to temporarily suspend minimal monthly /annual royalty charges - proposed \$1000/year prorated monthly
 - Royalty held in suspense pending amendments increasing royalty due or time elapses such that suspended royalty becomes statute barred and is waived
 - Associated company rules required and ARTC legislation must be harmonized
- Deep Gas Royalty Holiday Program
 - Eliminating Corporate Effective Royalty Rate will facilitate potential return to net benefits

Note: royalty triggers and royalty formulae remain as per 1994

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The Proposed Regime generates significant benefits by reducing uncertainty, distortions, complexity and dispute

- The changes recommended will result in administrative savings and operational efficiencies to industry and the Ministry:
 - Elimination of Corporate Effective Royalty Rate will reduce uncertainty in valuing capital assets and eliminate distortions caused by unique activities' impact on corporate royalty rates
 - 13th month Unit Operating Cost Rate adjustments will eliminate uncertainty in property valuations by more closely matching costs to revenues. Also ensure results of adjustments accrue to correct royalty period owners and provides increased predictability of future rates
 - Custom Processing Allowance will eliminate need for Custom Processing Adjustment Factors (CPAF), reduce / eliminate custom processing filings(AC5), and remove the complexity of adjustments in excess capacity situations
 - Allowable Cost rules consistent with industry practices/standards and use of established allocation rates in particular situations will reduce administration, filings and disputes
 - Public declaration of the Alberta's position on reclamation/abandonment costs will resolve some current disputes, eliminate future disputes and may encourage timely reclamation activity
 - Provides the opportunity to work toward a "2 year plus current" business window

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Implementing the regime changes will include costs for systems changes, new process and business rule administration and possibly mitigation

- Modifications to existing software applications:
 - 13th Month adjustment capability for Unit Operating Cost Rate (UOCR)
 - capturing of amendments
 - 13th month summary calculations and invoicing
 - Calculation of annual Capital rates x Price Adjusted Volumes
 - Updating of current automated filing penalty mechanisms
- New processes:
 - Calculation of Capital rates
 - Calculation of Custom Processing Allowances by gas type
 - Determination of standardized Allowable Cost allocations for roads, fencing and similar ‘restricted’ costs
 - Minimum royalty processes
- Administration of Business Rules
 - “13th month” invoicing and collection/refund activity
- Mitigation strategies:
 - Development and implementation of necessary computer systems and operational processes
 - Reduced royalty revenues, if any

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The recommended Royalty Regime remains at the plant gate

- Alberta's Natural Gas Royalty Regime remains a "plant gate" calculation of royalty volumes on specified products. It will:
 - Include accurate measurement of segregated natural gas and natural gas products
 - Allow Crown royalty calculations for segregated products, recognizing differing values and processing costs
 - Readily allow the Crown to lift segregated products in kind should such a decision be taken in the future
- The simplest alternative, a wellhead calculation using a single royalty curve, was found to be infeasible due to:
 - Technical limitations of cost effective accurate measurements of two phase fluids
 - Distributional implications associated with the move to a single royalty curve
- Certain radical alternatives, such as the sale of Alberta's royalty interest to private owners OR Crown royalties based on a company's net profits from Alberta operations were not pursued as they violated one or more of the project's non - negotiables (price/production sensitivity, Crown mineral leases made available by bonus bid process, crown royalty share disposed of at Minister's discretion)

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A plant gate royalty has a number of distinct benefits based on measurement accuracy and minimized adverse impact

- Consistent with the way the industry operates and does business
- Uses the most accurate product measurement available
- Leverages existing revenue accounting practices to better match royalty to the economic value of each segregated product
- Requires minimal changes in current administrative processes
- Minimal system software changes are required
- Minimizes Crown royalty distributional impacts
- Does not disturb business patterns in lands sales, drilling and service sectors

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Recommendations suggest changes to Operating Cost rules with the addition of a “13th month”

- The “13th month” adjustment will:
 - Reduce UOCR fluctuations caused by ‘roll forward’ of prior period amendments
 - Ensure cost/ benefit of amendments accrue to correct owners rather than subsequent owners
 - Allow better forecasting of UOCR’s to facilitate industry business planning and forecasting processes
- The “13th month” adjustment will be made following the year of production, at a summary level, on two scheduled occurrences. Supporting documentation would be filed May 15 and October 15 with debits/credits reflected in May and October production month invoices
- Each production year will be subjected to the above noted two “13th month” runs. Any amendments to a particular production year identified subsequent to the above noted time frames, would be reflected in the then current year “13th month” adjustment activities

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Introducing the Operating Cost “13th month” adjustment generates substantial intangible benefits for a reasonable cost

- Benefits
 - Elimination of ‘wild’ year to year swings in Unit Operating Cost Rates(UOCR’s)
 - Increased ability to accurately forecast subsequent year(s) UOCR’s
 - Revenues & costs are more closely matched to production year - income certainty
 - Sales of properties can be made without taking into account potential financial windfalls/losses caused by UOCR adjustments being rolled into the following year’s or years’ rate
 - Elimination of confusion over published rates (some of which were negative) which had no reasonable relation to the actual costs being incurred
- Costs
 - Systems coding changes and incremental processing time required by the two “13th month” runs
 - Revisiting previous year rates will involve incremental work for Department. Summary level reporting and one year window will minimize impact
 - Crown will see increased “collection” activity given acquisitions/dispositions

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Problem areas with today's Allowable Capital Costs can be solved by replacing the Corporate Effective Royalty Rate with an EUB Facility Rate

- Corporate Effective Royalty Rate (CERR) will be replaced with an allocation of capital cost allowance (CCA) at the EUB facility level based on value weighted volume. Calculated as:
 - $$\frac{\text{Royalty payer's Crown Royalty Volumes of each product} \times \text{Product Reference Prices}}{\text{total facility volumes of each product} \times \text{Product Reference Prices}}$$
- Introducing the EUB facility level allocation will:
 - Remove CERR administration and the uncertainties caused by the nature of the CERR
 - Remove industry related administration by directly tying Capital Cost recognition to a throughput sensitive measure
 - Facilitate introduction of Custom Processing Allowance thus significantly reducing filing effort/complexity
- Capital cost recognition will occur each month, as a Capital rate is estimated prior to each production year and applied to the price weighted Crown royalty volumes of each client, each month at each EUB facility
- A “13th month” adjustment for additional filings of Capital Costs and amended volumes will be made twice during the year immediately following the production year (May/Oct production month invoices).
- Amendments filed/identified subsequently, will be reflected in the “13th month” adjustments related to the year of identification

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A Facility Effective Royalty Rate introduces new benefits not possible with Corporate Effective Royalty Rate and some accompanying costs

- Benefits
 - Corporate Effective Royalty Rate (CERR) is eliminated
 - Purchase/sale transactions, property values reflect the specific property's characteristics thus eliminating uncertainties caused today by the CERR impacts
 - Allocates capital on a throughput basis, mirroring industry practices that tie costs to use
 - Eliminates necessity for special rules, filings and processes for excess capacity custom processing arrangements
- Costs
 - Some distributional impact occurs - reversal of 1994 impacts caused by move to CERR
 - Computer systems changes for monthly calculations, capture of amendments, and "13th month" adjustments

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Recognition of Custom Processing costs will be over-hauled

- A “gas type” Custom Processing Allowance eliminates the filing of actual custom processing costs (AC5) and the calculation and administration of claw-backs
- Custom Processing Allowances will be based on the 5 plant type operating costs/capital pools
- A Custom Processing Allowance is given to all Crown royalty volumes custom processed on a monthly basis. All Allowances subject to impacts of the “13th month” amendments
- No Custom Processing costs will be recognized for a plant owner(s), including excess capacity situations
- A royalty payer with ownership in the gas plant would be deemed to be an owner in the EUB facility. A royalty payer with no equity in the gas plant, would be deemed to be a custom processor at the EUB facility. Owners receive the benefit of Allowable Costs while producers ‘purchasing’ custom processing services for Crown Royalty Volumes will receive a Custom Processing Allowance
- No de-layered rates will be required for gathering, compression or processing - Custom Processing Allowance will be all inclusive

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Establishing Custom Processing Allowances has many benefits when compared with the current method of handling custom processing costs

- Benefits
 - Eliminates two particularly onerous and contentious annual filing requirements: actual custom processing costs (AC5) and Custom Processing Adjustment Factors (CPAF)
 - Removes administration and uncertainty of de-layered rates for pieces of facilities, and complexity and uncertainty of business rules and partial owner elections
 - Provides industry with benchmarks for Custom Processing rates for specific gas types
 - No audit activity required relative to custom processing claims or related claw-backs (CPAF)
 - Removes need for annual filings as well as rules and interpretations regarding excess capacity and other custom processing situations
- Costs
 - Computer systems development to handle identification of custom processed volumes, the calculation and application of Custom Processing Allowances, and recalculation of Allowances as part of “13th month” adjustment process

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Additional recommendations included action to align Allowable Costs definitions with Industry standards and practices

- Natural Gas Royalty Regulations, Policies and Procedures will identify the following principles:
 - Allowable Cost eligibility is based on following parameters:
 - Must be related to gas, including solution gas rather than oil
 - A gathering/compression/processing cost, not a production cost
 - A gathering/compression/processing cost, not a marketing cost
 - A direct cost of gathering/compression/processing, not an indirect cost(e.g. overhead)
 - The logical hierarchy to be followed for making decisions regarding eligibility of a specific cost is:
 - Statutes of Alberta (Mines and Minerals Act, Freehold Mineral Rights Tax Act, etc.)
 - Alberta Regulations(Natural Gas Royalty Regulation 1994, etc.)
 - Specific rules of eligibility as published by Crown (Principles & Procedures)
 - Production Accountants Society of Canada (PASC) model accounting procedures and interpretive bulletins
 - Specific joint venture agreement in question

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By “aligning cost” definitions both industry and the Ministry will benefit

- Benefits
 - Increased clarity of eligibility will result in less dispute and frustration
 - Increased consistency of application of rules and changes in rules
 - Reduced audit efforts, appeals and time spent on related administration
 - Implements a mutually agreed decision making hierarchy
 - Establishing allocation factors for costs such as fencing/roads will add to clarity of business rules
- Costs
 - Potentially increased Allowable Costs, particularly for the 38 large plants. This involves expenditures, both capital and operating, not currently allowable which may become eligible and expenditures identified by Crown audit as being currently ineligible which may become eligible

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An immediate study regarding Reclamation and Abandonment cost recognition is required

- For Alberta Gas royalty purposes, investigate and determine the eligibility of decommissioning, abandonment and reclamation costs incurred in relation to gathering, compression or processing assets
- Recognition of reclamation / abandonment costs to be done in such a manner as to facilitate and encourage timely reclamation and deter orphaning of gathering, compression or processing assets

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Clarity of business rules regarding Environmental expenditures generates both benefits and costs for stakeholders

- Benefits
 - Clarity of business rules regarding eligibility/ineligibility will result in less Crown audit effort and less time consumed by industry and the Ministry resolving disputes
 - May result in better reclamation/abandonment cost forecasting
 - Will result in better appreciation of individual financial responsibility
 - May result in more timely reclamation/abandonment initiatives
- Costs
 - If reclamation/abandonment costs for gathering, compressing and processing related assets are specifically included in Allowable Costs, there may be significant costs shifted from industry to the Crown
 - Business rules associated with reclamation activity restricted to the post production period will be difficult to establish and may be time consuming to manage
 - Precedence associated with other royalty programs and other jurisdictions

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It is not clear that it will be necessary to mitigate negative distributional impacts

- Departmental analysis is based on historical data (1995) and can not capture the significant changes in ownership and operating practices that have taken place over the past two years and that continue today
- The Ministry may need to evaluate alternative strategies and identify appropriate actions for mitigating negative monetary impacts caused by the proposed royalty regime changes

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A number of mitigation alternatives exist but it will be difficult to focus mitigating strategies exclusively on those producers negatively impacted

- Alternative courses of action may include:
 - Removing or enhancing holiday and special case benefits
 - Changes to the Alberta Royalty Tax Credit program via up coming review
 - HAVE RECOMMENDED: Annual, “prior to year” election of Corporate Average Price or Reference Price for companies paying less than \$30,000 per year in Crown gas royalty
 - HAVE RECOMMENDED: Temporary suspension/ultimate waiver of minimal Crown gas royalty charges
 - ‘Top-up’ capital balances at specific EUB facilities
 - Changes to level or timing of various Crown charges
 - Timing of implementation, such as “phased” introduction for all or some of the recommendations
 - New regime features, such as separate costing or royalty rate changes for sulphur
 - Consider net impact of wins and losses from Simplification in 1994
 - Accepting the re-distribution as appropriate