

ROYALTY and RELATED INFORMATION REVIEW

ADDENDUM TO JANUARY 26, 1998 REPORT GAS ROYALTY REGIME RECOMMENDATIONS

The Task Force has been soliciting and consolidating feedback on the January 26, 1998 report since its release. Considerable feedback, both formal and informal, has been received, including responses from the Canadian Association of Petroleum Producers (CAPP), the Small Explorers and Producers Association of Canada (SEPAC) and the Petroleum Services Association of Canada (PSAC).

Resulting from this and other feedback and subsequent meetings with stakeholder representatives, the Task Force has modified some of the recommendations originally put forward in the January 1998 report.

Recommendations Withdrawn:

- 1) Proposal to incorporate the natural gas component of Freehold Mineral Rights Tax into the gas royalty regime
- 2) Proposal to allocate Allowable Capital on a value weighted volume throughput basis
- 3) Proposal to provide a postage stamp allowance for custom processed volumes
- 4) Proposal to pool capital at the EUB facility level thus disconnecting the owner specific relationship
- 5) Mitigating strategy of Corporate Average Price prospective annual election for companies paying under \$30,000 annual gas royalty – withdrawn in conjunction with withdrawal of postage stamp custom processing rates.

The foregoing are summarized on pages 65 and 66 of the Task Force Report dated January 26, 1998.

Alternate or Modified Recommendations

- 1) Eliminate the Custom Processing Adjustment Factor (CPAF) in its entirety
- 2) Streamline the mechanics of Custom Processing Cost claims
- 3) Corporate Effective Royalty Rate (CERR) move to Facility Effective Royalty Rate (FERR)
- 4) Allowable Capital to be Royalty Payer specific, recognized at an EUB facility level

The following pages describe the alternatives in more depth.

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1. Eliminate the Custom Processing Adjustment Factor (CPAF) in its entirety:

The CPAF is a percentage reduction of the amount of Allowable Capital that can be claimed at any facility cost centre by the owners. The CPAF factor is based on the portion of the facility throughput that is being custom processed. The CPAF is meant to keep the same Allowable Capital for processing the Crown's share from being claimed both directly as Capital Cost and indirectly through the custom processing charges levied and paid by the Crown on its share of custom processed gas.

PROPOSAL:

The requirement for calculating a CPAF at any facility would be removed.

ADMINISTRATIVE BENEFITS:

- Eliminates the complex calculation of CPAF. While only a single ratio is filed now, the calculation to ensure and demonstrate accuracy involves significant tracking of capital and of volumes at every plant, gathering system, compressor and dehydrator with custom processing charges. Removal of CPAF eliminates excessive administration for the facility operators providing CP services
- Eliminates significant Crown audit effort checking the calculations from company working papers. Since throughput numbers are not filed for every facility, desk or computer audits cannot be done
- Eliminates an area of significant potential dispute and appeal between industry and the Crown and between companies themselves
- Eliminates administration of "lost GCA" provisions in CP contracts. The capital recognition reduced by the CPAF is considered "lost GCA" by the industry. It is often included as an additional cost in custom processing agreements, including those following the Jumping Pound (JP) '90 and '95 methodologies
- Reduces exposure to penalties due to elimination of complex calculations supporting the reported factor
- Assists in the simplification of the AC5 form – in conjunction with changes to operating cost clawback reporting
- Solves consolidated Business Associates Allowable Capital allocation problems. Currently companies that are consolidated, but report separately for royalty purposes, lose Allowable Capital where there are volumes and Allowable Capital mismatches
- Eliminates annual Allowable Capital clawback calculations and billings

BUSINESS BENEFITS:

- Elimination of "lost GCA" provisions will reduce CP fees to some extent, helping both smaller producers and the Crown. The cost of "lost GCA" is usually passed on to the party receiving CP services and is then claimed via the AC5 filing
- Removes a potential distorting effect: currently it could be more attractive to stream CP gas to depreciated plants to avoid the effects of CPAF while earning return on capital through CP charges.

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- May increase availability of processing capacity thus benefiting smaller clients. Plant owners may see incremental benefit in building extra capacity or new gathering systems themselves as they get full Allowable Capital recognition even if using it for CP volumes in full or in part. Smaller producers sometimes can't afford the capital outlay required to put such infrastructure in place
- May further reduce CP fees as greater access to facilities results in higher throughput and resulting efficiencies

COSTS AND RISKS:

Cost and Risks to Crown:

- Cost currently estimated at \$10-\$20 million Annually – With no “lost GCA” recovery approximately \$20 million but as much as \$10-\$12 million may be recovered as “lost GCA” would no longer be charged and subsequently claimed. (Based on information from 4 major CP providing companies)
- Should offsets be required to cover the balance, potential ones could include:
 - Working capital allowance rate adjustment
 - ARTC replacement program funding levels
 - Recognition by industry that this could be a contribution to reclamation cost recognition
 - Move from CERR to FERR benefits the Crown, so this will serve to further mitigate or eliminate estimated negative impact

REMAINING WORK:

- Identify impact of “lost GCA” now being eliminated. How many volumes are covered by JP'90 and JP'95 based CP agreements? These volumes will see reduced CP charges as this component is no longer billed as part of the CP charge
- Claw back rules for EOR must be determined and implemented

2. Streamline the reporting of annual Custom Processing Cost claims:

The current Custom Processing (CP) filing process has two basic elements that are problematic;

1. A client is required to identify, at each EUB facility where CP charges are filed, whether the gas is processed using owned facilities or custom processed, on a functional basis (i.e. for gathering, processing or compression). This is required to avoid multiple recognition of operating costs, but does not fit well with facilities where there is a mix of owned facilities and custom processing at a functional facility level
2. Recognition of estimated custom processing charges is done through providing all volumes of gas with an estimated unit rate, and then clawing back the estimated unit rate at the end of the year when the actual CP costs are identified. The estimated unit rate is provided on OAS volumes but clawed

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back at the client's CERR. Depending on the distribution of volume across Crown and Freehold properties, these numbers can be different

PROPOSAL:

1. Replace the current estimate process for custom streams with an estimated CP unit rate to account for Allowable Capital and operating costs
2. Replace the determination of ownership or custom processing at a functional facility level with a determination at a functional stream level
3. For gathering and compression of a stream that uses owned capacity and 'rental' capacity (custom processing), a royalty payer can elect to be treated as either an owner or a custom processor
4. For a plant (processing function), all streams of a royalty payer must be treated the same, and if the royalty payer is an owner in the EUB facility, all streams will be considered processed through owned facilities – since excess capacity agreements are generally custom processed on a capital only basis
5. Perform a reversal of the estimate at the end of the year and pay Crown's share of total Custom Processing charges for the custom processed streams using the FERR
6. Develop process for claiming excess capacity charges (which are normally based on capital costs alone) at the EUB facility processing (plant) component

ADMINISTRATIVE BENEFITS:

- Replaces (with the proposed CPAF change) need for AC5 backup information with a stream specific setup document – updates made as status changes
- Reduces auditing required and areas of potential dispute and rule-making
- Most effective process for determination of who is an owner versus custom user

BUSINESS BENEFITS:

- Will significantly reduce the problem of not receiving recognition for custom processing costs, while still protecting the Crown from multiple payment situations without excessive administration
- Eliminates estimated unit rate claw back problem in point 2 of the introduction

COSTS AND RISKS:

- Would require a new setup document (AC5 Backup) to be filed, and maintained by the Department, which would replace AC5 backup calculations
- Some potential for double claiming UOCR and CP on streams with partial CP – will require rules and audit efforts.

REMAINING WORK:

- Detailed development of mechanisms
- Analysis of impact of optional CP reporting
- Rules regarding double claim for CP and UOCR may be required, or more detail required

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- Standard rules regarding prior period adjustments on both CP and UOCR will be required

DETAILS OF CALCULATION to establish the Custom Processing rate estimate:

1. CP Unit Rate Estimate (3 alternative formulas) – done on delayed basis for custom processed streams

A.

$$\text{CP Unit Rate} = \frac{\text{Prior Year CP Fees Total at Facility (\$)}}{\text{Total Prior Year Client CP Facility Throughput (EAGEV)}}$$

B.

$$\text{CP Unit Rate} = \frac{\text{Prior Yr. CP Fees Total at Facility(\$)} - \text{CP Volumes (Prior Yr Total UOCR + Current Yr.Total UOCR)}}{\text{Total Prior Year Client CP Facility Throughput (EAGEV)}}$$

Intent: Updates estimate for year to year changes in operating costs

C.

$$\text{CP Unit Rate} = \text{UOCR (Simplest but ignores cash flow of capital)}$$

“A” above is the recommended alternative

2. Identification of Stream as Processed Through Owned Facilities or Custom Processed
 - A. Each stream identified on the OAS which is custom processed would be identified on the AC5 Setup Form as being custom processed for the functions of gathering, compression or processing
 - B. Reporting is optional to allow clients with streams both processed through owned facilities and custom processed with anomalies in cost to elect which way to claim (eg. very small individual component CP charges). This assumes there would be very little potential for overclaiming of costs as long as UOCR's do not swing significantly year to year
 - C. An owner in an EUB processing facility is required to treat all streams as being processed through owned facilities. Excess capacity charges, if any are charged on a capital cost basis
 - D. Each stream not identified, and each function not identified for a stream, as custom processed would be considered processed through “owned” facilities

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- E. Timing – Would be a setup document with changes as necessary to reflect business changes

Proposed AC5 related Setup Form

C= Custom user (Could be a tick off box for further simplicity)

Default = Owner Gathered/Compressed/Processed

Stream ID	Gathering	Compression	Processing
EUB Facility 100 OAS Stream 101	C	C	
EUB Facility 100 OAS Stream 102		C	
EUB Facility 100 OAS Stream 103		C	
EUB Facility 200 OAS Stream 201			C*
EUB Facility 200 OAS Stream 204	C	C	C*
EUB Facility 200 OAS Stream 206			C*

* see step 2C

3. Estimated Annual Custom Processing Costs
 - The Crown royalty volume of each custom processed stream would be multiplied by the estimated CP unit rate for the functional processes at that EUB facility

4. Estimated Annual Owners’ Operating Costs
 - The Crown royalty volume of each stream identified as processed through owned facilities would be multiplied by the functional UOCR for the functional processes at that EUB facility

5. Calculation of Custom Processing Actual Costs:
 - A. Total Custom Processing Charges for the Custom Processed streams would be reported and multiplied by the Facility Effective Royalty Rate (FERR)

 - B. Total Excess Capacity and Other Owned stream CP charges capital (only) costs would be filed and multiplied by the Facility Effective Royalty Rate (FERR)

 - C. This claim would be reduced by the total CP estimated \$ provided during the year

6. No filings are required if owner status exists throughout the EUB facility

3. CERR Move To FERR:

Prior to 1994 Capital Costs (depreciation and return on capital) were allocated from all facilities to each reporting entity (wells, groups of wells, or interest in a well or group of wells) tied to that facility. The reporting was exhaustive, cumbersome and

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complex. This was replaced by a system whereby all Allowable Capital Costs of a company were pooled together for net Crown royalty determination purposes. The Crown's share was then calculated by using the company's corporate effective Crown gas Royalty Rate (CERR). This system is relatively simple, but tends to make individual facility decision making and accounting more complex and much less exact.

The January 26, 1998 RRIR recommendations included a move from CERR to an EUB facility allocation related to volume. The concept of moving from CERR to an EUB facility level was supported by industry, but the Allowable Capital allocation mechanism was not. A revised proposal has been formulated.

PROPOSAL:

The Allowable Capital of a company would be rolled-up at an EUB facility level and the Allowable Capital Costs determined. Generally, the current rules for calculating CERR would be applied, but at a client's facility interest level

ADMINISTRATIVE BENEFITS:

- This method more closely aligns royalty business rules with industry business practices, but does not provide major administrative benefits for Crown or industry

BUSINESS BENEFITS:

- Will help make individual facility economics more meaningful as there will not be impacts carried over from other facilities of the same company
- Considered to be more representative of actual processing costs for a particular well or pool
- More manageable calculations at the facility level
- More closely mirrors the business, which is largely individual project driven
- Removes perceived anomalies at the individual facility level based on lack of information of whole corporate business
- Amendments would only affect the facility amended - today all a company's facilities are impacted even for a minor amendment at one facility
- Reduces impact of current UOCR clawback rules

COSTS AND RISKS:

- Change can result in distributional impact depending on a particular company's distribution of capital across Crown and freehold properties
- Distributional impact mainly reversal of move to CERR in 1994 - may not be a significant issue
- Problem of shut-in and stranded Allowable Capital from pre-1994 system returns
- Likely to be more administration, particularly for Crown – both from moving to FERR (more incidents of calculation) and from new shut-in and stranded capital rules

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- May be a cost to industry if claims for Capital Cost (plus operating cost and custom processing charges) greater than the value of royalty (at an EUB facility level) are not allowed (i.e. if the “Allowable Cost Restriction” (ACR) also moves back to a facility level)

REMAINING WORK:

- Rules will be required to solve shut-in and stranded capital situations, including decommissioning and facility reclamation costs and the treatment of custom processing costs incurred in context of reclamation
- Rules regarding appropriate Allowable Cost Restrictions, consistent with the 1994 Corporate level restriction (100%) need to be developed

DETAILS OF CALCULATION:

1. FERR – A client’s facility effective rate
2. Capital Cost would be client’s specific EUB level Allowable Capital rolled-up X FERR
3. Calculation of FERR: Total % =

$$\frac{\text{Crown share \$}}{\text{Total \$ Throughput}} = \frac{\text{Crown Royalty Volumes x Ref Prices}}{(\text{Total OAS volumes X Ref. Prices})}$$

Crown Royalty Volumes (numerator) do not include Freehold, holiday, out of province or purchased volumes – Total OAS volumes (denominator) do

4. Capital to be Royalty Payer specific

Allowable Capital is currently royalty payer specific and is rolled-up to a corporate level before being multiplied by the Corporate Effective Royalty Rate (CERR). The original January 26, 1998 RRIR proposal was to roll up all clients’ Allowable Capital Costs and allocate them using a value weighted volume mechanism. This was not acceptable to the industry

PROPOSAL:

- Allowable Capital to be rolled-up by individual royalty payer at an EUB facility level and multiplied by the Facility Effective Royalty Rate

DETAILS/COSTS/BENEFITS:

- Covered in Recommendation 3

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DISTRIBUTIONAL IMPACT ANALYSIS

The following charts show the potential level of gains and losses to individual royalty payers' based on the following information:

Key Elements of Analysis

Overall

1. The standard RRIR base data as described in the detailed calculation worksheet and the main report was used – 1995 full year data, UOCR Rates with annual rollovers returned to base year, no claw backs, no holidays in the FERR
2. Filings for 1995 current as of September, 1998
3. Clients Amalgamated as shown in MRIS as of that date
4. Most variables unaffected by current regime proposals
5. The base charts for changes to FERR and to removing CPAF do not add up directly to the integrated impact model due to the different impacts of CPAF under a CERR versus a FERR regime
6. The percentage impact charts apply to companies with > \$1000 annual royalty

CPAF Removal

Total Capital for client at EUB facility level allowed
Total CP fees for client at EUB facility level allowed

CERR Replace by FERR

Allowable Cost Restriction of 100% maintained at a total Client level, which means negative royalty at an individual facility was included without restriction. That mirrors current royalty policy.

Capital attached to facilities with no royalties (so 0 FERR) receive no capital cost in the model. This affects shut in and decommissioned Crown facilities as well as totally freehold facilities.

Potential Further Work

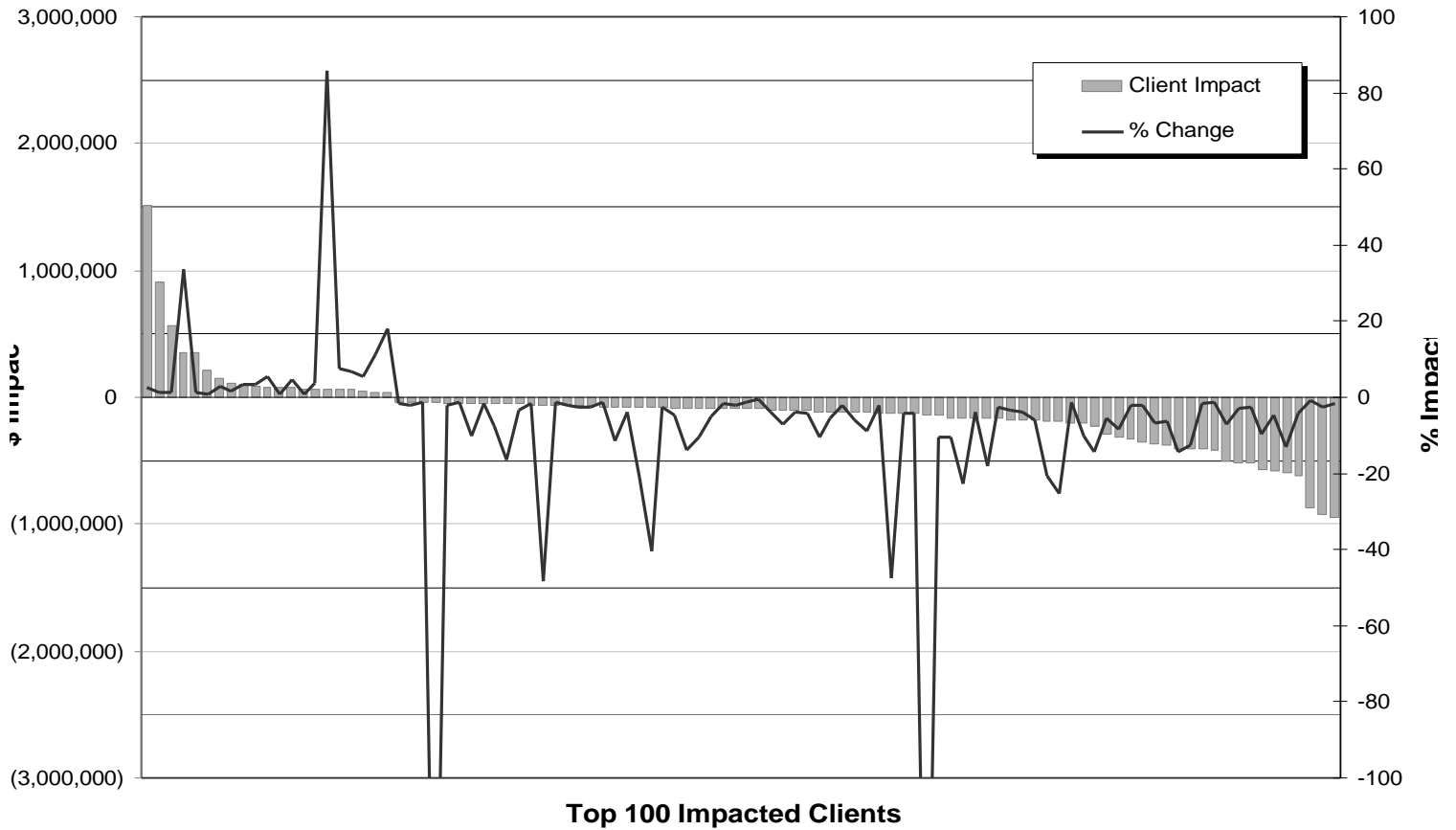
1995 data was used- Before making any offsetting changes to the royalty rates or other factors, several years of data could be looked at to determine trends in the cost of CPAF and CERR.

The data is as filed in September – Some reporting requirements were changed since then that may have had a retroactive effect. Newer data could be used to once all refiling is complete to verify that there are no substantial differences (there do not appear to be with the FERR so far based on refilings to date).

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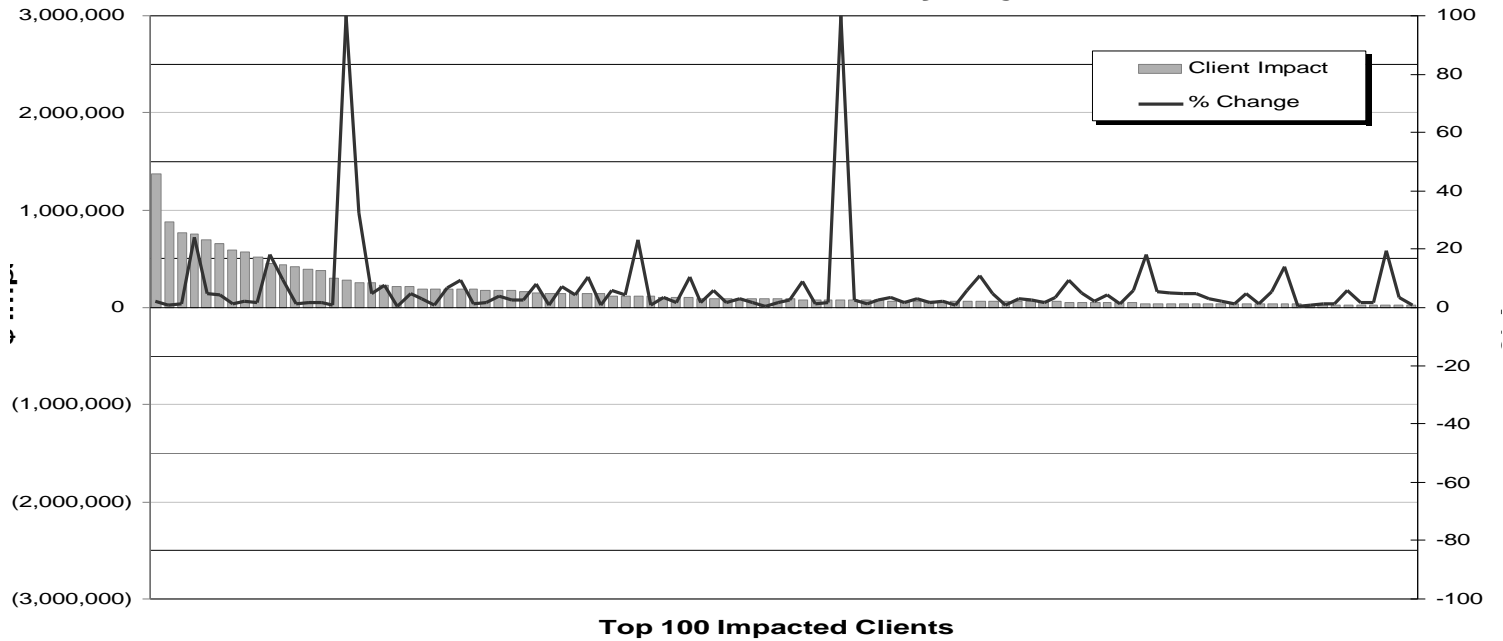
Model #32

FERR, No Neutrality Adjustment



Model #40

CPAF Eliminated, No Neutrality Adjustment



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Model #41

CPAF Eliminated, FERR, No Neutrality Adjustment

