

Chapter 6

Escalating Rent

Oil Sands Tenure Regulation, section 15

Non-producing continued leases are subject to payment of escalating rent. Escalating rent serves to stimulate the development of oil sands resources. They provide an incentive for leaseholders to develop these resources at the appropriate time (considering market signals); using appropriate technology (refers to cost-effective alternatives).

A Fair Return

One of the goals of Alberta's oil sands tenure system is to ensure that oil sands agreements are in the hands of those who are committed to developing them. Developers who choose to keep non-producing continued leases may hold these leases indefinitely, but only if they pay escalating rent. In making this accommodation, the Crown forgoes bonus bids it might have acquired had ownership reverted to the Crown, and had the rights been re-leased to a new developer. The escalating rent structure compensates for this foregone opportunity.

Escalating rent areas, escalating rental rates, and doubling periods are designed to capture, on average, the foregone bonus bid value that a lease might have acquired over a 15-year period. Fifteen years is considered an appropriate period for lease development; this is why primary leases are issued for a 15-year term.

The department conducts periodic reviews of the escalating rent structure. These reviews examine a number of factors, including

- the effects of new and improved technology,
- changes in the bonus bid cycle, and
- the effects of the *Oil Sands Tenure Regulation*.

A number of reviews will have been completed before any continued lease is subject to the maximum escalating rent. This ensures that the cap is neither too high nor too low.

Deductions and Credits

Lessees may reduce or eliminate their escalating rent obligations by

- conducting exploration or development work on the non-producing lease,
- conducting research that directly applies to the non-producing lease, or
- earning credits for upgrading oil sands bitumen.

See [Deductible Expenditures](#) and [Upgrader Credits](#) for details.

Paying Escalating Rent

Rent is incurred for each term year in which a continued lease is designated as non-producing.

The department issues a billing statement at the end of each term year in which escalating rent is incurred. If the lessee does not pay or submit an allowable cost credit report within 30 days, cancellation procedures may commence.

See [Cancellation](#) for details.

Payment obligation resides with the designated representative for the lease.

See [Designated Representatives](#) for details.

Note

Escalating rent is payable at the end of each term year.

Annual rent for a lease is due at the beginning of each term year.

Interest is charged on any late payments.

Calculating Escalating Rent Payments

Oil Sands Tenure Regulation, section 16

The amount of an escalating rent payment depends on two factors:

- the oil sands area in which the lease is situated
- the length of time for which the lease has been designated as non-producing

Escalating Rent Areas

Escalating rents apply in two oil sands areas

- **Area A** includes leases in the Peace River Oil Sands Area and in the Athabasca Oil Sands Area, with the following exceptions:
 - leases in the surface mining areas
 - leases in the Wabasca area, defined as the land between ranges 16 to 26 (inclusive), and townships 76 to 86 (inclusive), west of the 4th Meridian
- **Area B** includes leases in the Cold Lake Oil Sands Area as well as leases in the surface mining area (as revised on June 10, 2009, pursuant to ERCB's "Alberta's Reserves 2008 and Supply/Demand Outlook 2009-2018" report) and the Wabasca area, which are defined as exceptions to Area A.

See [map of Escalating Rent Areas A and B](#).

Oil Sands Escalating Rent Areas A & B

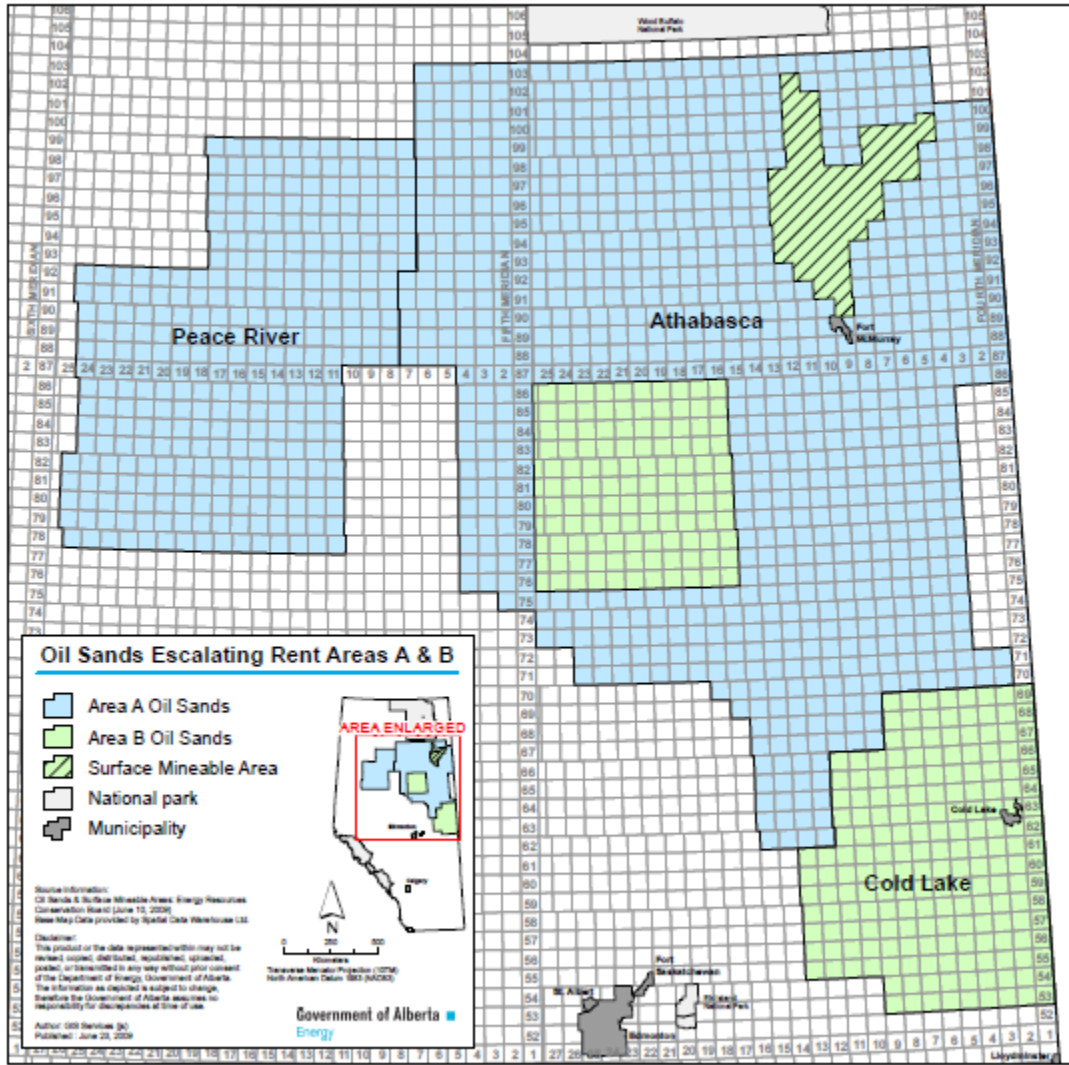


Figure 11: Oil Sands Escalating Rent Area A and Area B (Surface Mineable Area expanded June 10, 2009).

Escalating Rent Amounts

YEAR	AREA A	AREA B
1	\$3/ha	\$7/ha
2	\$3/ha	\$7/ha
3	\$3/ha	\$7/ha
4	\$6/ha	\$14/ha
5	\$6/ha	\$14/ha
6	\$6/ha	\$14/ha
7	\$12/ha	\$28/ha
8	\$12/ha	\$28/ha
9	\$12/ha	\$28/ha
10	\$24/ha	\$56/ha
11	\$24/ha	\$56/ha
12	\$24/ha	\$56/ha
13	\$48/ha	\$112/ha
14	\$48/ha	\$112/ha
15	\$48/ha	\$112/ha
16	\$96/ha	\$224/ha
17	\$96/ha	\$224/ha
18	\$96/ha	\$224/ha
19	\$96/ha	\$224/ha
20 + over	\$96/ha	\$224/ha

Table 1: The escalating rent payment schedule for Oil Sands Areas A and B. The escalating rent for Area A begins at \$3 per hectare and doubles every three years until a cap of \$96 per hectare is reached, when the lease enters its 16th year of non-production.

For example

Over the first nine years of a non-producing continued lease, cumulative escalating rent payments for a 36-section (9,216-hectare) lease would total \$581,000. At this point, the lease would have been in effect for 24 years—for 15 years as a primary lease and for nine years as a continued lease. After 18 years of non-production, the escalating rent payments would total \$5.2 million. More than half this amount would be payable in the last three years. At this point, the lease would have been held for 33 years.

The escalating rent for Area B begins at \$7 per hectare and doubles every three years until a cap of \$224 per hectare is reached, when the lease enters its 16th year of non-production.

For example

Consider a 36-section (9,216-hectare) parcel. Over the first nine years of a non-producing continued lease, cumulative escalating rent payments would total \$1.35 million. After 18 years of non-production, the escalating rent payments would total \$12.2 million, more than half of which would be payable in the last three years.

For leases which straddle Areas A and B, escalating rent calculations are prorated according to the number of hectares in each area.

For example

In its first year of non-production, a lease which has 64 hectares in Area A and 128 hectares in Area B would be subject to escalating rents of \$192 (\$3/ha x 64 ha) and \$896 (\$7/ha x 128 ha) for the two respective portions, for a total of \$1,088.

When a non-producing lease is reclassified as producing, the escalating rent schedule is suspended. If the lease is subsequently deemed non-producing, the original payment schedule resumes. That is, for the purpose of rent payment, the lease is assumed to be in the same year as it was when payments were last required. Escalating rent is paid at the rate which last applied.

For example

Consider a non-producing continued lease in Area A. The lease is designated as producing at the end of its fifth year, at which time the escalating rent calculation is based on \$6/ha. Assume that, nine years later, the lease is reclassified as non-producing. At this time, rent applies as if the lease were in the sixth year of its escalating rent schedule: the payment due is based on a rate of \$6/ha. The following year, escalating rent is calculated at \$12/ha, as if the lease were in its seventh year.

Upgrader Credits

Oil Sands Tenure Regulation, section 20

Lessees can reduce their required escalating rent payments if they are eligible for upgrader credits.

A lessee who is upgrading crude bitumen derived from the oil sands within the location of the lessee's lease using either the lessee's upgrader or, under written contract, another person's upgrader may apply to the Minister for upgrader credit.

This provision of the regulation supports the development of an Alberta-based upgrading sector.

Calculating Upgrader Credits

Oil Sands Tenure Regulation, Schedule 2

The following formula is used to calculate upgrader credits:

$$UC = BI \times 0.1 \times AF$$

or

$$UC = BI \times 0.1 \times (AF \text{ for API of upgraded product} - AF \text{ for API of feedstock bitumen})$$

UC represents upgrader credits, expressed in hectares per year.

BI is the average barrels per day of feedstock bitumen derived from the company's eligible oil sands leases and supplied to its Alberta-based upgrader during the term year.

AF is an allocation factor which reflects the level of upgrading that took place during the term year. It is determined by subtracting the API gravity of the feedstock bitumen from the API gravity of the upgraded product. The **API gravities** used to calculate allocation factors represent the **annual averages** for the feedstock and the output respectively.

Upgrader credits cannot be earned for upgraded bitumen produced from a lease that is subject to a development plan, approved under section 9 of the former Oil Sands Regulation, when production is less than what is required by the plan. Only bitumen produced in excess of the production level required by the plan is eligible for upgrader credits. See example 3 in the following section.

ALBERTA OIL SANDS TENURE GUIDELINES
August 14, 2009

API GRAVITY	ALLOCATION FACTOR
10° or less	0.00
11°	0.02
12°	0.04
13°	0.06
14°	0.08
15°	0.10
16°	0.12
17°	0.14
18°	0.16
19°	0.18
20°	0.20
21°	0.24
22°	0.28
23°	0.32
24°	0.36
25°	0.40
26°	0.52
27°	0.64
28°	0.76
29°	0.88
30° or higher	1.00

Table 2: Allocation Factors

Examples of upgrader credit calculations

Example 1:

Company A owns a 150,000 b/d-capacity upgrader in Alberta. It upgrades an annual average of 100,000 b/d of 10° API feedstock produced from its own leases. The upgraded output averages 32° API over the course of a year

Company A has a contract with **Company B**. It upgrades an annual average of 50,000 b/d of 8° API feedstock produced by Company B into a 30° API output. Both companies are eligible for upgrader credits.

Company A's upgrader credits are calculated as follows:

$$\begin{aligned} UC &= BI \times 0.1 \times (AF \text{ for API of upgraded product} - AF \text{ for API of feedstock}) \\ &= 100,000 \times 0.1 \times (1.00 - 0.00) \\ &= 10,000 \text{ ha} \end{aligned}$$

Company B's upgrader credits are calculated as follows:

$$\begin{aligned} UC &= BI \times 0.1 \times (AF \text{ for API of upgraded product} - AF \text{ for API of feedstock}) \\ &= 50,000 \times 0.1 \times (1.00 - 0.00) \\ &= 5,000 \text{ ha} \end{aligned}$$

Example 2:

Company C owns a 100,000 b/d-capacity upgrader in Minnesota. It upgrades an annual average of 80,000 b/d of 12° API feedstock into a 28° API output.

Company C does not earn upgrader credits, as the upgrader is not located in Alberta.

If the upgrader was located in Alberta,

Company C would earn upgrader credits as follows:

$$\begin{aligned} UC &= BI \times 0.1 \times (AF \text{ for API of upgraded product} - AF \text{ for API of feedstock}) \\ &= 80,000 \times 0.1 \times (0.76 - 0.04) \\ &= 5,760 \text{ ha} \end{aligned}$$

Example 3:

Company D owns a 250,000 b/d-capacity upgrader in Alberta. It upgrades an annual average of 240,000 b/d of 10° API feedstock into 30° API output. The bitumen is produced from a company-owned surface mine that is subject to a development plan under section 9 of the former Oil Sands Regulation. The production level approved by the plan is 180,000 b/d.

Company D's upgrader credits are calculated as follows:

$$\begin{aligned} \text{UC} &= \text{BI} \times 0.1 \times (\text{AF for API of upgraded product} - \text{AF for API of feedstock}) \\ &= (240,000 - 180,000) \times 0.1 \times (1.00 - 0.00) \\ &= 6,000 \text{ ha} \end{aligned}$$

Applying Upgrader Credits

Upgrader credits must be applied in the year they are earned. Unused credits cannot be carried forward.

Companies may apply upgrader credits against any lease for which escalating rent is payable. However, credits can be applied to several leases only if the escalating rent for one lease has been reduced to zero first. Any remaining credits can be applied to reduce a second lease payment to zero, and so on.

Examples of how upgrader credits are applied

Example 1:

Company A has earned 10,000 ha in upgrader credits. It owns three non-producing leases. Leases are in either Area A or Area B.

Lease A1— 5,000 ha located in Area B

—the escalating rent requirement is at the start rate of \$7/ha.

Lease A2 — 4,000 ha, and

Lease A3 — 4,000 ha are located in Area A.

—the escalating rent requirement for each are in the 4th year at \$6/ha.

Since 10,000 ha upgrader credits have been earned, Company A can;

- apply 5,000 ha upgrader credits against Lease A1,
- apply 4,000 ha upgrader credits against Lease A2, and
- can apply the remaining 1,000 ha upgrader credits against Lease A3.

Once the credits have been applied, the escalating rent of \$6/ha against the remaining 3,000 ha in Lease A3 is still required.

Example 2:

Company B has earned 5,000 ha in upgrader credits. It owns two non-producing leases. Leases are in Area A.

Lease B1—2,000 ha located in Area A
— the escalating rent requirement is at the start rate of \$3/ha.

Lease B2—6,000 ha in Area A
—the escalating rent requirement is in its 7th year at \$12/ha.

Company B can choose;
- not to apply any credit to Lease B1, and
- apply all 5,000 ha upgrader credits against Lease B2;

Since there is not enough credit to offset all the ha for each lease, escalating rent is still required as follows:

\$3/ha against 2,000 ha in Lease B1 and
\$12/ha against 1,000 ha in Lease B2.

Example 3:

Company C has earned 6,000 ha in upgrader credits. It owns only one non-producing lease. Lease is in Area B.

Lease C1—5,000 ha in Area B
—the escalating rent requirement is in its 13th year at \$112/ha.

Company C can apply 5,000 ha of upgrader credits against Lease C1. This means that 1,000 ha of credits are unused: Unused upgrader credits may not be carried forward.

Deductible Expenditures

Expenditures incurred for research, exploration, and development activities may be used to offset or reduce escalating rent payments.

Oil Sands Tenure Regulation, section 17(3)(h), 18(c), and 19(d)

█ Deductible expenditures cannot be applied more than once.

Eligible Expenditures

Deductible expenditures may not reflect more than fair market value. They must be

- directly attributable to the lease,
- reasonable in relation to the circumstances under which they were incurred,
- incurred by or on behalf of the lessee,
- incurred for actual financial transactions, and
- incurred on or after the effective date of the continued lease.

See [Fair Market Value](#) for details.

Exploration

Oil Sands Tenure Regulation, Schedule 1, item 2

Exploration costs may be used to offset escalating rental if they are incurred to evaluate a lease or to bring it into production.

Evaluation involves more rigorous assessments than exploration. It identifies the quality and quantity of the resource for the purpose of determining if the resource can be economically developed.

Exploration refers to activities undertaken for the purpose of identifying the existence and areal extent of a resource. Exploration activities typically include geological and geophysical work.

- Drilling or other work which exceeds the prescribed minimum level of evaluation (MLE), and which does not qualify as a development cost, may be claimed as an exploration cost and used to offset escalating rent.
See [Chapter 4](#). for details about MLE

All oil sands wells* drilled in a section are considered exploratory until at least one oil sands well has been drilled in each quarter of the section. Subsequent oil sands wells drilled in the section are considered developmental.

An **oil sands well** is one which is drilled to penetrate an oil sands deposit for the purpose of evaluating the deposit or bringing it into production.

The definitions of exploratory and development wells apply to vertical and horizontal wells, regardless of the recovery methodology used (mining, thermal in situ, or primary-cold in situ).

Development

Oil Sands Tenure Regulation, schedule 1, item 3

Development costs may be used to offset escalating rentals if they were incurred to develop the lease, or to bring it into production. For development costs to be eligible, they must be

- physically incurred on the lease site, or
- incurred for the development of oil sands in the location of the lease.
 - In other words, off-lease costs may be allowable. This is not the case for exploration costs.

Development costs are costs incurred to bring a lease into production within the next five years. Specific examples include the cost of

- capital infrastructure such as roads, power facilities, buildings, bitumen processing facilities, well pads, disposal facilities, and tanks,
- observation, test, and disposal wells,
 - Oil sands wells are considered developmental only if a well has already been drilled on each quarter of a section. In this case, the next well drilled within the section is considered developmental. Until there is a well on each quarter section, all new wells are considered exploratory.

- Capital costs incurred to put a well in place or bring it into production are considered development costs.
- mine equipment acquisition and installation,
- surface preparation,
- regulatory approvals for production,
- business case and feasibility studies,
- landowner and stakeholder consultations, and
- environmental studies.

Lessees who use 3D or more sophisticated seismic techniques to assess reservoir production parameters may request that these be accepted as development costs.

Research

Oil Sands Tenure Regulation, schedule 1, item 1

The costs of basic, fundamental or applied research may be used to offset escalating rentals if they are incurred to address economic, environmental or technical problems associated with oil sands recovery.

Costs related to specific, directly applicable consortium research activity may be eligible.

- Funding a specific, university-based project in order to receive the research data and conclusions is an example of an eligible consortium research activity.

Expenditures Which Are Not Allowed

Oil Sands Tenure Regulation, schedule 1, items 4(2) & 4(3)

The following expenditures may not be used to offset escalating rent:

- ongoing operating expenditures associated with recovering oil sands,
- overhead or administrative expenditures, including expenditures incurred by a lessee, operator, designated representative or affiliate for internal audits, in-house legal services or other, similar services,
- borrowing or financing expenditures, or charges for late or deficient payment,
- penalties of any type,
- royalty interest (including Crown royalty), carried interest, net profit interest, or any similar interest,
- annual lease rental or escalating rental expenditures,
- expenditures incurred in acquiring an interest or estate in mineral rights,
- expenditures related to depletion or depreciation,
- expenditures related to the non-arm's-length transfer of research or technology,
- expenditures incurred as a result of acts or omissions which breach the laws, rules or regulations of a government or government agency,
- fees or expenditures related to dispute resolution, including arbitration or litigation of any dispute with any party,
- food, beverage or entertainment expenditures,
- taxes (including GST) paid to municipal, provincial or federal governments,
- credits or discounts awarded to operators, designated representatives or affiliates to offset an eligible expenditure,
- any economic assistance (other than reductions in income tax payable) that is provided to the lessee, operator, designated representative or affiliate by the

Province of Alberta or the Government of Canada (or an agency of either) for the purpose of reducing or offsetting costs, and

- expenditures which have already been used to offset escalating rent for the same or another lease.

All deductible expenditures are subject to a financial audit.
See [Financial Audits](#) for details.

Research costs are also subject to a concept audit.
See [Concept Audits](#) for details.

Exploration

Exploration expenditures incurred before a lease has been designated as continued are not eligible.

Off-lease exploration costs are not eligible.

Development

Costs arising from the actual production, handling or sale of product are not eligible. The following are examples of ineligible costs. The list is not exhaustive.

- well operating costs
- maintenance
- trucking or pipelining
- marketing

Research

- Research management costs and fees for membership in associations such as Canadian Oil Sands Network for Research and Development (CONRAD) are not allowed.
- Costs related to non-arm's-length transfers of proprietary research or proprietary technology (including research publications and licensed research or technologies) are not allowed.
See [Fair Market Value](#) for details.

Timing and Carry-Forwards

An eligible expenditure is deemed to be incurred

- in the month in which the cost is payable—that is, when the obligation to pay arises—if payment is made within three months of the time when the cost was incurred,
- or
- in the month in which the cost is paid, in any other case.

For a non-arm's-length transaction where no invoice has been issued, expenditure is deemed to have been incurred in the month in which services were supplied or materials were received.

See [Non-Arm's-Length Transactions](#) for details.

Exploration

If exploration is undertaken during the term of a continued lease, eligible expenditures may be used to offset escalating rent only for the year in which they were incurred.

Development

If development is undertaken during the term of a continued lease, eligible expenditures may be used to offset escalating rent only for the year in which they were incurred.

Like research costs, eligible development costs incurred during the last five years of the primary term of a lease are eligible against escalating rent for the first 10 years of the continued term. This approach recognizes that the company is doing more than what is required for the lease to be classed as continued. The additional development work is helping to put the lease into production as quickly as possible.

Research

The *Oil Sands Tenure Regulation* recognizes that research can occur at any time. Specific timing-related rules have been developed as a result. For escalating rent offsets, the life of a research project is considered five years or less, regardless of the duration of the research project described in the application. See [Making an Application](#) for details.

- Where the life of a research project exceeds five years, the lessee must identify which consecutive five-year period should be considered for determining allowable costs.
- Once a project period has been identified, it is recorded by the department and may not be changed.

If eligible research costs have been incurred during the last five years of the primary term of a lease, the costs are eligible against escalating rent for the first 10 years of the continued term. This approach recognizes that the company is doing more than what is required for the lease to be classified as continued. The research is helping to put the lease into production as quickly as possible.

If research has been undertaken while the lease is classified as continued non-producing, eligible costs may be used in any year of the term of the research project, or carried forward for two years.

ALLOWABLE COSTS	PRE-CONTINUATION		POST-CONTINUATION		
	INCURRED	CREDITED	INCURRED	CREDITED	ALLOCATED AMONG LEASES
RESEARCH	within the last 5 years of the primary lease. must be within the lifespan of the research project	within the first 10 years of continuation	anytime within the life of a project, for a maximum of 5 years	in any term year of the lease that coincides with a project year, plus 2 years after life of project.	subject to the allocation identified in the authorization for expenditure document and DOE approval.
DEVELOPMENT	within the last 5 years of the primary lease	within the first 10 years of continuation	in the term year of the lease.	same year as incurred.	subject to the allocation identified in the authorization for expenditure document and DOE approval.
EXPLORATION	not applicable	not applicable	in the term year of the lease	same year as incurred.	not applicable

Table 3: The Timing Eligibility for Allowable Costs

Making an Application

Lessees or designated representatives who wish to apply offsetting costs to their escalating rent payments must apply to the department by submitting an Escalating Rent Offsetting Costs (EROC) form which

- clearly identifies the lease agreements to which the costs apply,
- describes the costs, and
- is signed by one of the lessee's corporate officers or by the designated representative.

When an application pertains to more than one lease, all lessees and the designated representative must complete the EROC form.

Applications to use research credits or development costs on a carry forward basis or to allocate expenditures to more than one lease must also include

- a Registration of Allocated Expenditures (RAE) form,
- the accompanying approval granted by the department, and

- an authorization of expenditure form or a comparable budgetary approval document which outlines how expenditures will be allocated.

Department pre-approvals, if these have been obtained, should also be attached. See [Pre-approval of Deductible Expenditures](#) for details.

When research and development costs are claimed to offset escalating rent, the allocations must correspond to those approved in the submitted budgetary document.

See [Allocating Costs](#) for details.

All Oil Sands related forms are available from the Oil Sands home page, left menu, Forms & Reporting

Authorization of Expenditure

An authorization of expenditure form (or comparable budgetary approval document) must be submitted when application is made to use research or development expenditures as offsets to escalating rent. This document creates a paper trail which facilitates the audit process and ensures accountability.

The budgetary approval document must accommodate various types of expenditures, including allocations to capital or operating budgets. It must provide

- a statement of intent which supports the “direct connection and application” test, and
- a description of planned expenditures.

Annual and cumulative amounts must be provided.

The corporate officer authorizing the expenditure must sign the document.

In addition to the above-stated requirements, the budgetary document for a research project must also identify

- the purpose of the research,
- the nature of the research project and its scope,
- the research participants,
- the research timeframe,
- expected deliverables and due dates,
- the leases to which the research expenditures are to be allocated,

SUPPORTING
INFORMATION

Supporting information may be provided by more than one document. However, all documents must be linked through a budgetary approval form which outlines the corporate decision to undertake lease activities.

Agreement numbers and lease locations must be provided.

- the location of research , and

Supporting rationale must be provided if the research project is located outside Alberta.

- any financial support which is being provided through Alberta programs or from other jurisdictions.

Note

Individual lessees may each submit their own budgetary approval documents. Although the documents do not need to be identical, each submitted form must be similar in terms of authority, wording, and content.

Supporting information may be provided by more than one document. However, all documents must be linked through a budgetary approval form, which outlines the corporate decision to undertake lease activities.

Who can submit expenditure information

Applications to offset escalating rent are sometimes made by the designated representative of a lease.

See [Designated Representatives](#) for details.

A lessee who intends to use research or development expenses to offset the escalating rent for a lease must provide the RAE reference number to the designated representative. If this number is not provided when an application is submitted to the department, the costs may be disallowed.

See [Allocating Costs](#) for details.

The RAE and its reference number are intended to protect the confidentiality of each lessee's research and development activities. When submitting an application on behalf of other lessees, the designated representative only needs to know

- the amount by which each lessee intends to reduce its share of the lease's escalating rent , and
- the RAE reference number.

Lessees are not required to share the details of their research programs with their designated representatives. To protect the confidentiality of this information, they may use EROC forms to submit the details of their research or development plans directly to the department.

See [Making an Application](#) for detail or all Oil Sands related forms are available from the Oil Sands home page, left menu, Forms & Reporting

When designated representatives submit their own EROC for the lease, they should

- specify the expenditures they are claiming,
- identify the RAE reference number, and
- note that other lessees will submit separate EROC.

Note

All lessees should be prepared to support their claims of eligibility for escalating rent offset costs. Supporting information must be available for the department's review during concept audits and financial audits.

Pre-approval of Deductible Expenditures

Lessees are strongly encouraged to apply for pre-approval before undertaking research or development activities. This minimizes the risk that expenditures will be disallowed during the department's final audits.

See [Financial Audits](#) for details.

The department typically responds to a formal application for pre-approval within 45 days.

Note

Although costs may be pre-approved, they may nevertheless be disallowed once the department's financial and concept audits are completed. Pre-approved costs may be disallowed when there have been substantial changes to originally submitted research or development plans.

If a cost is adjusted during the department's final audits, escalating rent is recalculated. The designated representative is responsible for resolving escalating rent adjustments. This responsibility is not diminished if the lessee who originally claimed the research costs no longer holds an interest in the lease.

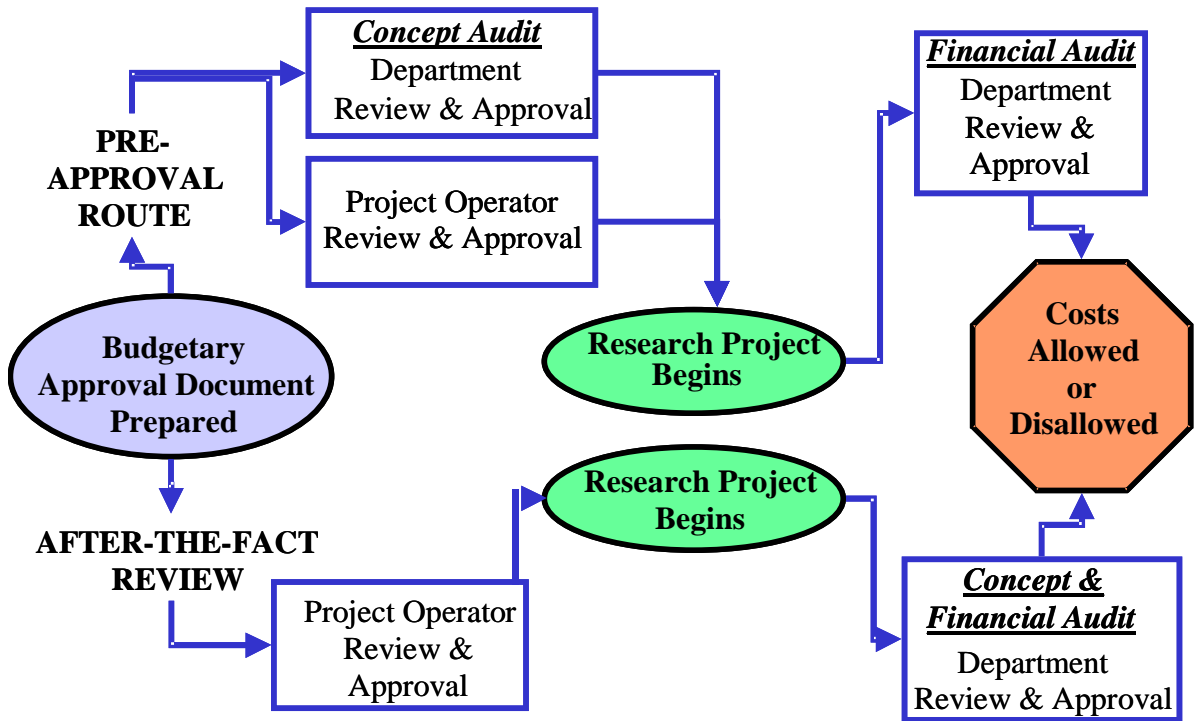


Figure 12: The Research Review Process

Allocating Costs

Lessees who wish to use research or development expenditures to offset escalating rent must submit a RAE form. The RAE must be accompanied by an authorization for expenditure form or comparable budgetary documents which

- approve the proposed expenditures
- identify what percentage of each expenditure will be allocated to each lease

Authorization of expenditure forms are company specific, they must be signed by the appropriate corporate officer.

When applications to offset escalating rents are submitted, actual costs must be allocated in accordance with the proposed plan. If the allocated amounts have not been fully expended, costs will be allocated on a pro-rated basis.

See [Authorization of Expenditure](#) for details.

All Oil Sands related forms are available from the Oil Sands home page, left menu, Forms & Reporting.

For example

Consider a research or development proposal for which \$5 million has been allocated to five different leases. This allocation is noted on the RAE form and the accompanying authorization for expenditure. If only \$2.5 million is actually expended, \$500,000 is assigned to each lease to offset escalating rent.

The department confirms acceptance of the RAE and provides the lessee with a reference number. The lessee should retain the original RAE and the department's confirmation letter and record the RAE reference number.

If a lessee cannot provide the RAE reference number when an application is made to offset escalating rent, submitted expenditures may be disallowed.

Note

Research or development expenditures may be applied against more than one lease. In the case of developmental expenditures, the leases must be within reasonable proximity. A general guide is that there must be less than 50 km between the farthest two points of any of the leases.

Transferring Costs

When partial or whole interest in a lease is transferred, costs which can be carried forward may follow the lease if they have been identified on the applicant's EROC form. If such costs are disallowed during a Crown audit, the current lessees or their designated representatives are responsible for making up any shortfall in escalating rent.

See [Timing and Carry-Forwards](#) for details.

When lands are surrendered during a period for which escalating rent is being calculated, a pro-rated portion of the claimed expenditures is deemed ineligible, regardless of why or where the costs were incurred.

Due Diligence

Current lessees or their designated representatives are responsible for acquiring or arranging access to all cost documentation used to offset previous years' escalating rents.

They are responsible for conducting due diligence and making appropriate provisions when transferring leases which are subject to escalating rent charges. This is particularly important when escalating rent charges are offset by costs which have not been audited by the Crown.

Conditions

Congruence with the Royalty Regime

Research and development costs applied against escalating rent may also be eligible as costs under the *Oil Sands Allowed Costs (Ministerial) Regulation*. If research or development costs are to be used under the *Oil Sands Allowed Costs (Ministerial) Regulation* and under the *Oil Sands Tenure Regulation*, the same authorization for expenditure must be used for cost allocation purposes.

See [Authorization of Expenditure](#) for details.

For example

A \$3 million research program is being planned. On the company's authorization for expenditure form, the cost is equally allocated to three leases. Each lease is assigned \$1 million—one third of the projected cost. Only one of the leases is associated with a royalty-paying project.

For royalty purposes, the maximum cost that can be included in the project's royalty calculation is \$1 million. None of this amount could be applied to the royalty calculation for an off lease royalty project.

Lessees may wish to consider the royalty implications associated with allocating research or development expenditures as credits against escalating rent.

Net Expenditures

The Crown recognizes net expenditures only. If a lessee recovers research or development costs from other industry participants, these revenues must be deducted from the expenditures claimed against escalating rent.

If a lessee receives credits or discounts, regardless of the source, these must be used to offset actual research or development expenditures. Any balances can then be applied against escalating rent.

All credits or discounts must be reported to the department.

- Research credits received from programs in Alberta or other jurisdictions in which the research is recognized are included in this condition.
- Economic assistance in the form of income tax reductions is excluded.

Amendments

If a lessee amends an authorization for expenditure after a research activity has begun, the department reviews the entire research activity and re-assesses its scope and applicability to the identified leases.

If the department believes that the intent of the amendment is to re-allocate costs among leases (even if the re-allocation involves the same leases as before), and if the scope of the research has not changed, it may disallow all costs related to the research activity.

Non-Arm's-Length Transfers

Costs related to non-arm's-length transfers (See [Non-Arm's-Length Transactions](#) for details) of proprietary research or proprietary technology (including research publications and licensed research or technologies) are not allowed. Allowing non-arm's-length transfers could undermine the allocation process for distributing research and development costs among different leases.

This condition is not intended to exclude research activities performed by affiliated companies. (See [Affiliates](#) for details) However, eligible expenditures incurred by affiliates are subject to the non-arm's-length rule.

Companies who are concerned that a particular research expenditure falls into a grey area are encouraged to request written clarification from the department.

Assigning Costs

The department can recognize an expenditure only once.

If proprietary research or proprietary technology (including research publications and licensed research or technologies) is sold, the purchaser may be eligible to use the purchase cost to offset escalating rent. In this situation, the purchaser and the seller must agree which of them will have the right to apply the incurred expense against escalating rent. The agreement may take one of two forms.

1. The seller may provide the original authorization for expenditure to the department. This ensures that the department recaptures the revenue resulting from any activity whose cost is used to offset escalating rent. It makes it possible for the department to determine whether the seller is using the expenditures to offset escalating rent.

If the department accepts the purchaser's costs, the revenue received by the seller must go toward reducing the research expenditures the seller is claiming. This may occur retroactively.

2. A sales agreement may include a provision that the buyer agrees not to apply the purchase cost against escalating rent. This has administrative advantages. When this option is used, neither the department nor the seller need to adjust previous years' escalating rent calculations.

Note

By default, in the absence of an agreement explicitly stating that the purchaser can claim the research expenditure, eligibility to claim the expense remains with the seller.

Audits

All audit-related information submitted to the department and its auditors is kept confidential, pursuant to the provisions of the *Freedom of Information and Protection of Privacy Act*.

Concept Audits

All research costs, claimed by a lessee or designated representative, are subject to a concept audit, in which the department verifies that the purpose of the research is directly attributable to the lease.

For example, a lessee may be conducting applied research which has marginal applicability to the lease. A concept audit might conclude that such research does not meet the “direct connection and application” criteria required by the *Oil Sands Tenure Regulation*. In this case, the costs would be ineligible for offsetting escalating rent. Alternatively, the audit might conclude that a proportion of the costs are eligible. In this case, the auditor would verify that the allocation of expenditures to leases was consistent with what was approved by the department when the applicant’s Registration of Allocated Expenditures form was filed.

See [Making an Application](#) for details.

In conducting a concept audit to determine the eligibility of research costs, the department considers

- how the research advances knowledge which has specific, practical application to the lease,
- the type and nature of deliverables, and
- the location of the research activity.

Off-lease research may be eligible if it is directly related to the development of a lease. Supporting documentation must be provided to show why an off-lease location is preferable, especially if the research is being conducted in facilities outside Alberta.

Note:

Research does not have to be successful. However, for the research expenditures to be eligible as offsets to escalating rent, the research must demonstrate the potential to provide meaningful insight or understanding of a problem that is preventing a lease from producing in commercial quantities.

Financial Audits

All exploration, development, and research expenditures claimed by a lessee or designated representative are subject to a financial audit conducted by the department. The audit ensures that claimed expenditures are

- reasonable,
- have specific, practical application for the lease, and
- reflect an actual financial transaction that is supported by appropriate documentation.

The authorized expenditure form (or comparable budgetary approval document) that is submitted when an application is made to offset escalating rent facilitates the audit process and ensures accountability. This document creates a paper trail and supports the link between a corporate decision to undertake a specific activity and the actual expenditure and results.

The department's audit group follow the trail of the authorized expenditure form, which, along with all supporting documentation, is reviewed by the auditors in the lessees' or designated representative's offices.

Definitions

The following definitions apply in the interpretation of the *Oil Sands Tenure Regulation*. They may or may not be applicable in other situations.

Affiliates

A company is considered affiliated with another company if the criteria outlined in subsection 1206(5) of the *Income Tax Regulations* apply. However, in making this determination, paragraph 1206(5)(a) shall be read as if it were replaced by the following:

The **Income Tax Regulations** are governed by the Income Tax Act (Canada).

- a) a person and another person (in this paragraph, referred to as "that other person") are connected with each other if
 - (i) the person and that other person are not dealing at arm's length,
 - (ii) the person has an equity percentage in that other person that is not less than 10%, or
 - (iii) where the person is a corporation, the corporation and that other person are linked by another person who has an equity percentage in each of them of not less than 10%.

Companies are not dealing at arm's length with each other if they would not be considered dealing at arm's length under the *Income Tax Act* (Canada).

Fair Market Value

The determination of fair market value is based on comparable, open market transactions among unaffiliated parties. The Minister makes determinations of fair market value and assesses what constitutes a “comparable open market” on a case-by-case basis.

In determining fair market value for the exchange of goods or services between affiliates, the Minister may consider

- the published price of comparable goods or services, if that price is generally adopted by buyers and sellers, and
- the average price paid for comparable goods or services during transactions by unaffiliated buyers and sellers.

The prices used to determine fair market value may be adjusted to reflect transportation or delivery costs.

Solution Gas

Mines and Minerals Act, section 87.1

Solution gas means gas that is dissolved in crude oil or crude bitumen under initial reservoir conditions, and includes any such gas that evolves as a result of changes in pressure, temperature or both, due to human disturbance.

Solution gas is disposed under agreements granting oil sands rights and not under agreements of petroleum and natural gas. However, solution gas is subject to royalty provisions under the *Natural Gas Royalty Regulation (NGRR), 2002* or *NGRR, 2009*.

Non-Arm's-Length Transactions

If eligible exploration, development or research expenditures involve an affiliate or a non-arm's-length transaction, that transaction must be evaluated in accordance with approved non-arm's length business rules.

The following considerations apply to all items provided to a lessee, operator or designated representative by an affiliate.

Goods and Services

The allowed cost of a good or service is the lesser of

- a) the amount charged to the lessee, operator or designated representative
- b) fair market value, when a reasonable determination can be made
See [Fair Market Value](#) for details.
- c) the actual expenditure incurred by a lessee, operator, designated representative or their affiliates (or by the person from whom the good or service was obtained) to produce the good or perform the service

Capital

Capital assets are valued when the asset is delivered to the lease site. The value is the lesser of

- a) the amount charged to the lessee, operator or designated representative
- b) fair market value, when a reasonable determination can be made
See [Fair Market Value](#) for details.
- c) the asset's net book value to the lessee, operator or designated representative, or to the person from whom the asset was obtained by the lessee, operator or designated representative.
See [Net Book Value](#) for details.

Amount Charged

In relation to a capital asset, good or service, the amount charged is the lesser of

- a) the price that a lessee, operator, designated representative or their affiliates charges other lessees in relation to the capital asset, good or service
- b) the amount charged to a lessee, operator, designated representative or their affiliates by the person who provided the capital asset, good or service
- c) the amount that the lessee, operator, designated representative or their affiliates report to the Crown in relation to the capital asset, good or service

Net Book Value

Net book value used to determine deductible expenditures is the remaining undepreciated amount of an asset—as recorded in the financial records of the lessee, operator, designated representative or other person who provided the asset. In other words, net book value is the original cost less accumulated depreciation.

Note

If a capital asset has been claimed under another tenure or royalty regime—such as the *Oil Sands Royalty Regulation (OSRR), 1997* or *OSRR, 2009*, *Oil Sands Allowed Costs (Ministerial) Regulation*, the *NGRR, 2002* or *NGRR, 2009*—the department's records are used to assign net book value.