

1. Alberta's Oil Sands Royalty System

The Alberta Crown owns 97% of oil sands mineral rights*; freehold owners hold the remaining 3%. Mineral rights owned by the Alberta Crown are managed by the Department of Energy on behalf of the citizens of the province.

Oil sands tenure is the system through which Crown-owned oil sands rights are leased* and administered. Alberta's tenure system generates revenue by granting the right to produce oil sands products*.

Oil sands royalty is the system through which the Crown—as the owner of the province's oil sands—receives a share of the economic rent generated from the development of that resource. The Alberta Crown receives a royalty—a share of recovery of oil sands products or equivalent revenue—from its oil sands rights leased to oil and gas companies.

1.1 Oil Sands Royalty: A Look Back

In the 1960s, when the first commercial oil sands projects were launched, oil sands development was a very costly, high-risk exploration of unknown frontiers. Oil Sands technology and engineering were in their infancy and developers faced formidable challenges in extracting bitumen*.

To encourage the development of the oil sands industry in the face of these early challenges, the Alberta government adopted a royalty regime in which the Crown shared* the risk by taking a minimum royalty until profitability occurred. Royalty terms for significant oil sands projects were negotiated on a project-by-project basis and specified in individual Crown agreements. Minimum royalty rates on gross revenue* ranged from 1% to 5%. Royalty on net revenues* ranged from 25% to 50%. Specific development, operating and capital costs were allowed and some gas royalties were waived.

A project-by-project approach to royalty made sense in the formative years of the oil sands sector. It allowed for flexible royalty arrangements to accommodate the unique requirements of each project* and address project-specific concerns. It was manageable because there were few commercially active operations. And it helped to build a body of knowledge and experience that formed the basis of current oil sands legislation.

As oil sands development advanced, research and technological innovations contributed to the development of new tools and processes that increased returns on investment and reduced production costs. More companies got involved in oil sands development and world oil prices and global market forces governed their investment decisions. A different royalty regime was needed to address the different circumstances and needs of a growing oil sands sector.

1.1.1 The Impetus for Change

In 1993 the joint, industry–government National Task Force on Oil Sands Strategies was launched to assess the technical, socio-economic, environmental and marketing aspects of oil sands development and recommend strategies to address these issues.

The task force identified Alberta's ad hoc, project-specific royalty structure as a barrier to oil sands development. The ad hoc structure created uncertainty about what royalty terms would apply to future investments, because the royalty terms had to be negotiated for each new Crown agreement. In addition, since the royalty structure was not transparent, it was difficult for developers to evaluate investment plans.

In its 1995 report, the task force outlined a comprehensive, new royalty approach for Alberta's oil sands industry. A key recommendation was that royalty should be established through legislation rather than individual Crown agreements. That is, the royalty regime should be generic: the same rules should apply in the same situations and the same clear, standardized royalty terms should apply to all new oil sands projects. The task force believed that a generic approach to oil sands royalty would place all new projects on a level playing field. Standard royalty terms would create fiscal certainty and stability, and encourage oil sands investment.

The Government of Alberta accepted that recommendation of the task force and began work to develop legislation and policy to support a generic oil sands royalty regime.

1.2 Generic Oil Sands Royalty

Alberta's current, generic oil sands royalty regime dates to July 1, 1997, when the *Oil Sands Royalty Regulation, 1997* (AR 185/97) came into force.

1.2.1 What Is "Generic" Royalty?

The current oil sands royalty regime was dubbed generic because the same, standard royalty rates and rules apply to all oil sands projects approved under the regime. The royalty rates are established through legislation rather than individual Crown agreements. The rates are the same for all new oil sands projects and are not subject to negotiation.

1.2.2 A "Revenue Minus Cost" Approach

Alberta's project-based generic oil sands royalty regime operates on the principle of revenue minus cost. Royalty is paid at one of two rates, depending on the project's financial status. The deciding factor is the project's **payout date***.

A project has "reached payout" once its cumulative revenues* have exceeded its cumulative costs*.

Before the payout date, the applicable royalty is 1% of the project's gross revenue. This low rate recognizes the high costs, long lead times and high risks associated

with oil sands investment. It prevents undue strain on the developer's financial resources during the most critical, start-up stages of the project.

After the payout date, the applicable royalty is the greater of

- 1% of the project's gross revenue, or
- 25% of the net revenue for the period*

This feature of the generic regime links the Crown's return to the success of the project. The Crown does not receive a significant share of royalty until a project is profitable and the developer has recovered his investment. This approach encourages developers to innovate and maximize the efficiency of their operations.

Reaching Payout: What Are the Implications?

When an OSR project reaches payout, its **royalty rate** and **reporting obligations change**. In addition, the post-payout* royalty rate is variable. For example, if revenues drop off or if expenses increase as a result of an approved expansion, the "1% of gross revenue" rate might apply even if a project had reached payout in previous years. Royalty payment at 25% of net revenue would recommence when it exceeds 1% of the project's gross revenue. **NB: Once a project reaches payout it is always considered to be in payout, even if it pays royalty at 1% of gross revenue for some period of time.**

Definition of a "Period"

A period is defined in the Regulation as each calendar year, or partial calendar year that occurs between the effective date* of a project and the date the project approval is revoked.

Additionally, since a project typically reaches payout during the calendar year, the part of the calendar year before the payout date, and the remainder of the calendar year following the payout date, are considered separate periods.

Periods include only full months*. The effective date of a project is normally the first day of the month. Likewise, a post-payout period always begins on the first day of the month in which payout occurs.

1.2.3 Objectives

Alberta's royalty systems are designed to maximize and capture a fair share of the value of mineral and energy resources for the benefit of Albertans.

Alberta's generic oil sands royalty regime provides a stable, competitive fiscal framework that supports the major investments needed to develop the province's oil sands resources. The regime is designed to:

- encourage the development of the oil sands while ensuring a fair return to Albertans, who own the province's resources.
- create a stable fiscal and regulatory framework that facilitates oil sands development by private sector companies;
 - development occurs because investors expect to make a reasonable profit from oil sands ventures. The Government of Alberta does not provide grants, loans, loan guarantees, or any other "special deals" to encourage oil sands investment.
- ensure that investment in the oil sands provides developers a rate of return that is competitive with other petroleum development opportunities around the world.

1.2.4 Applicability: Who Pays Generic Royalty Rates?

Oil sands developers who wish to pay royalty at the generic royalty rates **must apply to have their projects approved as oil sands royalty projects** under the provisions of the Regulation (see Chapter 3, "Applying for Generic Royalty Terms").

1.2.5 Components of the Generic Royalty Regime

Alberta's generic royalty regime includes three components:

- the Mines and Minerals Act, RSA 2000, c. M-17
- the Oil Sands Royalty Regulation, 1997 (AR 185/97)
- policies, guidelines and business rules

1.2.5.1 The Mines and Minerals Act

The *Mines and Minerals Act, RSA 2000, c. M-17* was amended in May 1997 to embed oil sands royalty formulas and core rates in legislation:

- *Sections 33 to 39* of the Act* outline general provisions related to royalty.
- *Sections 87 to 90* relate specifically to oil sands. Section 90(2) specifies that the "royalty reserved to the Crown ... during each month of a pre-payout* Period" is 1% of gross revenue. *Sections 90(3)(a)* and *90(3)(b)* specify that the "royalty reserved to the Crown ... during a post-payout Period" is the greater of 1% of gross revenue or 25% of a project's net revenue.
- *Section 90(6)* outlines the allowed return allowance* payable on allowed unrecovered balance* of cumulative costs less cumulative revenues.

Details about royalty calculation are provided in 4," Calculating Oil Sands Royalty".

1.2.5.2 The Oil Sands Royalty Regulation, 1997 (AR 185/97)

The Regulation outlines the following components of the generic royalty regime. Each component is discussed in detail in the following chapters of the *Oil Sands Royalty Guidelines*.

- the “revenue minus cost” approach to oil sands royalty (Chapter 1)
- the components of an oil sands royalty project (Chapter 2)
- the administrative requirements for applying for, amending or approving oil sands royalty projects (Chapter 3)
- the revenues and allowed costs* that are considered in calculating royalty (Chapter 4) and specific cost allocation rules (Chapter 5)
- the requirements for royalty reporting and payment (Chapter 6)
- the requirement for an advanced ruling (Chapter 7) and procedures used to resolve disputes (Chapter 8)
- the general non-arm’s length business rules (Chapter 9)

1.2.5.3 Policies, Guidelines and Business Rules

The policies, guidelines and business rules used to interpret and implement oil sands royalty-related legislation are developed by the Department of Energy in consultation with the oil sands industry.

1.3 Alternative Royalty Regimes

Developers who do not apply for an OSR project approval under the Regulation pay royalty under one of the following regimes, as appropriate:

- the Oil Sands Royalty Regulation, 1984 (AR 166/84)
 - Royalty paid under this regulation will be calculated under the *Petroleum Royalty Regulation* (AR 248/90).
- Existing Crown agreements authorized by the *Mines and Minerals Act*
 - The owners and developers of pre-1997 projects pay royalty according to the terms of their Crown agreements.
 - The Crown will not enter into any new agreements.