

4. Calculating Oil Sands Royalty

Oil Sands Royalty Regulation, 1997 (AR 185/97), section 16(2)

Under Alberta's generic oil sands royalty regime, royalty is based on the value of oil sands products sold in arm's-length transactions. When developers undertake approved activities related to their oil sands royalty projects, both the cost of these activities and the revenues they generate are included in the royalty calculation.

4.1 The Royalty Calculation Point

Oil Sands Royalty Regulation, 1997 (AR 185/97), section 23

Royalty payable to the Crown is calculated on the volume of oil sands product that is delivered and measured at the applicable royalty calculation point.

For an oil sands royalty project, the royalty calculation point is the last point at which the Crown's royalty share of the project's oil sands products are measured.

If the oil sands product is **crude bitumen** that is not processed into other oil sands products, the royalty calculation point is the last point of measurement before the crude bitumen is permanently removed from project lands.

If the oil sands product is **cleaned crude bitumen**, the royalty calculation point is the last point of measurement before the bitumen leaves the cleaning plant. That is, *the royalty calculation point is the cleaning plant gate*. This royalty calculation point is used whether or not the cleaning plant is part of the project as long as, once the bitumen leaves the plant, it is disposed of, delivered to a non-project upgrader for further processing, or used for non-project-related purposes.

In the case of an **oil sands product other than crude bitumen or cleaned crude bitumen**, the royalty calculation point is the last point of measurement before the oil sands product leaves the processing plant. That is, *the royalty calculation point is the processing plant gate*. This royalty calculation point is used when the processing is part of the project, as long as, once the oil sands product leaves the processing plant, it is disposed of, delivered to a non-project processing plant for further processing, or used for non-project-related purposes.

4.2 Elements of the Royalty Calculation

The royalty calculation for an OSR project includes the following elements:

- the project's **opening balance**, which is the cumulative costs less cumulative revenues as of the project's effective date (see 2.3.10, "Prior Net Cumulative Balance")
- the return allowance (see 4.2.1, "The Return Allowance")
- allowed costs (see 4.2.2, "Allowed Costs" - including operating and capital costs and costs for goods and services)

- project revenues* (see 4.2.3, "Project Revenues")
- the unit price* (see 4.2.4, "Unit Price")

4.2.1 The Return Allowance

Mines and Minerals Act, sections 90(6) to 90(8)

When an oil sands royalty project reaches payout, its cumulative revenues equal or exceed its cumulative costs. Upon payout, the oil sands developer has recovered his initial investment cost, including a return allowance. The return allowance is intended to represent a reasonable return on the developer's investment.

The return allowance is calculated using Canada's **long-term bond rate**, which is the simple average of selected Government of Canada long-term benchmark yields. The monthly long-term bond rate is calculated as follows:

$$\text{Monthly Rate} = (1 + \text{LTBR})^{1/12} - 1$$

The Long-Term Bond Rate (LTBR)

Mines and Minerals Act, sections 90(6) and 90(7)

The weekly LTBR is published by the Bank of Canada each Wednesday and can be accessed on the Bank of Canada website. The heading is identified as 'Government of Canada benchmark bond yields', then select "Long-term-weekly."

[URL: <http://www.bankofcanada.ca/en/rates/bond-look.html>]

Project staff who prepare the royalty reports, may also access the appropriate LTBR from a table on the Department website (navigating through the "Royalty" section of Oil Sands, and choosing "Rates of Return").

4.2.1.1 The Return Allowance for Pre-Payout Projects

For pre-payout projects, the return allowance is an allowed cost. It is calculated monthly—by multiplying the net cumulative balance (the difference between the project's cumulative costs less cumulative revenues) by the long-term bond rate for the month. Together with other allowed costs and royalty paid for that month, it is added to the next month's cumulative cost to get the current cumulative cost for the project.

The return allowance for pre-payout projects is reported once a year, on the end of the period statements.

Project operators use the Pre-Payout Project, End of Period Statement Pre-4 form, to report the return allowance for the period. (Appendix E)

4.2.1.2 The Return Allowance for Post-Payout Projects

For post-payout projects, a return allowance is provided only when the project has a net loss* at the end of a period.

1. **If the project begins and ends a period in a net loss position**, a return allowance is provided on the full period (365 days). The return allowance is the

product of the average long-term bond rate for the period multiplied by the net loss for the period.

2. **If the project transitions to post-payout status, or begins the period in a positive net revenue position, but ends in a net loss position**, a return allowance is provided on half of the period's net loss. The return allowance is the product of average long-term bond rate for the period multiplied by (183/365) multiplied by the net loss for the period.

3. **If the project ends the period in a positive net revenue position**, no return allowance is allowed, regardless of the net revenue position at the start of the period or in the intervening months. The return allowance for post-payout projects is reported annually on the end of period statements.

Project operators use the Post-Payout, End-of-Period Statement PST-6 form, to report the return allowance for the period. (Appendix G)

4.2.1.3 The Return Allowance for Suspended or Abandoned Projects

Oil Sands Royalty Regulation, 1997 (AR 185/97), schedules 1 and 2, section 5

The return allowance may be disallowed if the Minister has notified the operator of the project that the Minister is of the opinion that project operations have been or are substantially suspended or abandoned for a period of time.

The Minister may disallow the return allowance on a retroactive basis, if he is not informed of the "suspended" or "abandoned" operations until some time after they have occurred.

4.2.2 Allowed Costs

Oil Sands Royalty Regulation, 1997 (AR 185/97), schedules 1 and 2

Allowed costs are defined in the Regulation as costs described in Schedule 1 and Schedule 2. For royalty calculation purposes, costs that are directly attributable to the recovery, processing, and transportation of oil sands products to the boundary of the oil sands royalty project, may be eligible for deduction as allowed costs.

For details about cost rules that pertain to specific types of goods and services, see 9.2.1, "Goods and Services"

4.2.2.1 Cost Rules

Oil Sands Royalty Regulation, 1997 (AR 185/97), schedules 1 and 2

Allowed costs must satisfy all of the following criteria. They must be

- directly attributable to the project
- reasonable in relation to the circumstances under which they were incurred
- incurred by or on behalf of the project owner, and

- incurred on or after the project's effective date (see 2.3.9, "The Effective Date")

Note:

In the Schedules:

- Sections 2(a) through 2(e) must be read in conjunction with each other – all sections must be satisfied.
- Subsections 2(e)(i) through 2(e)(x) need not be read in conjunction – only one subsection need be satisfied.

To be allowed, costs must also be incurred for at least one of the following purposes.

- to **recover oil sands** from the project's development area
- to **buy oil sands products** for processing or reprocessing at a processing plant that is part of the project
- to **process or reprocess** oil sands or oil sands products at a processing plant that is part of the project
 - In this case, allowed processing and reprocessing costs are incurred in association with products recovered from the project's development area or from purchased products.
- to **process** oil sands or oil sands products at a processing plant that is *not* part of the project, and before the oil sands products obtained are delivered at a royalty calculation point
 - In this case, the processing costs are allowed if the oil sands or oil sands product was recovered from the development area of a project or if the oil sands product was purchased and previously processed at a plant that is part of the project.
- to **transport** oil sands or oil sands products from one part of a project to another or from the project to a processing plant that is not part of the project
- to **market** oil sands products obtained from the project
- to **plan, design or engineer** project expansions
- to **conduct research** activities that are directly attributable to the project
 - Projects classified as qualifying joint ventures may also deduct the cost of basic research. (For details about allowable research costs see 5.6, "Research")
 - Basic research is not an allowed cost for projects that are not qualifying joint ventures.
- to provide **field, office, administrative or other services*** in relation to the activities described above, with the following exception:

- Unless a project is a qualifying joint venture, these services **are not** allowed costs if they pertain to marketing activities or to planning, designing or engineering expansions of the project.

“Recover Oil Sands from the Development Area of the Project”

This includes costs incurred on project lands directly for the recovery of an oil sands product. It may also include certain costs that are incurred off the project site, or outside the physical recovery process, **if** they are necessary for the production of oil sands products from the project area. For example, the costs of an access road to the oil sands lease could be allowed, even though the road is not on project lands, and is not directly involved in the production of bitumen if it is necessary for the recovery of oil sands products.

Specific Cost Rules

Specific rules apply to the following types of allowed costs:

- solution gas gathering and fuel gas distribution
- pipelines that are not considered basic services*
- co-generation plants
- custom processing
- research

Details about these types of costs are provided in 5, "Specific Cost Allocation Rules"

4.2.2.1.1 Reasonable Costs

Under section 2 of Schedule 1 and 2, a cost must be reasonable in relation to the circumstances under which it is incurred. There have been instances where costs have not been accepted, on the basis of reasonableness. For example, costs for equipment that was sized far in excess of the EUB approved capacity of the oil sands project were rejected. Reasonableness will be assessed on a case-by-case basis; costs related to prudent engineering decisions will not be rejected.

4.2.2.1.2 Directly Attributable Costs

This section provides some clarification on what costs are “directly attributable” to oil sands royalty projects and as such, may be allowable deductions in the calculation of oil sands royalties under the Regulation. (This section relates to both non-qualifying joint ventures and qualifying joint venture projects.)

Directly attributable costs must be solely, completely, entirely or wholly attributable to the Project. Generally, costs that a project operator would fairly (in the Minister’s

view) include in its internal cost-benefit analysis of the project may also be considered as allowable costs for royalty purposes.

The Regulation requires allowed costs to be directly attributable: it does not require assets or individuals (in respect of which the costs were incurred) to be wholly dedicated to the Project. Where an asset is used for Project and non-Project purposes, or where an employee works on Project and non-Project related tasks, a proportion of their costs equal to the proportion they are devoted to Project purposes may be an allowable cost.

Generally, overhead* costs are not allowed costs. A project operator may attribute to the project certain "off project" costs for services provided partly to the oil sands royalty project and partly to other corporate activities. The portion of these costs that is directly attributable to the project must be clearly documented by the operator to the satisfaction of the Minister. The Department should be consulted regarding acceptable allocation methods and proper documentation for these types of costs. (see Appendix L for "List of Allowed and Not Allowed Costs")

Note: Cost Allocations

As with any cost, allocated costs will be subject to audit, and must be supportable by accounting records. Under the Regulation, to be allowed as a cost, a cost must be incurred (i.e., paid) and there must be records of that payment and records that support its allocation to the project. For example, in the case of an employee, part of whose time is devoted to the oil sands project, there should be actual evidence that the employee was paid, and evidence from time records (e.g. timesheets) acceptable to the Departmental Auditors, that the employee's time was spent on the oil sands project.

Note: Costs Incurred

Costs incurred are allowed costs (subject to the Schedules), as long as there are records of them being incurred, or other records from which it could be demonstrated that the cost was incurred.

A project operator is obligated under the Regulation to report all costs incurred by the project. For example, an operator should report all project related insurance premiums as allowed costs consequently any related insurance proceeds should be reported as other net proceeds of the project.

For further information on types of allowed costs, see 4.2.2.2, "Types of Allowed Costs" and 4.2.2.3, "Costs That Are Not Allowed" and/or Appendix L, "List of Allowed and Not Allowed Costs".

4.2.2.1.3 Approval

The Minister will determine whether any costs claimed by an operator are allowed costs of a project. All costs claimed are subject to verification and audit.

4.2.2.1.4 Timing

Oil Sands Royalty Regulation, 1997 (AR 185/97), section 7(2)

All project-related costs—including allowed capital, operating, and eligible research costs—are 100% deductible in the year in which they are incurred.

An allowed cost is deemed to be incurred

- in the month in which the cost is payable
 - if the month occurs during a **pre-payout period** and the cost is paid not more than 12 months after the end of that month
 - or
 - if the month occurs during a **post-payout period** and the cost is paid before the end of the calendar year following the period.
- *A post-payout project's year-end is always December 31. If the project owner receives an invoice in July of Year 1, the invoice must be paid no later than December 31 of Year 2 for the cost to be claimed as an expenditure in July of Year 1.*

or

- in the month in which the cost is paid, in any other case

For a **non-arm's-length transaction** for the supply of services or materials to the project by a project owner, operator, or an affiliate of either of them, and for which no invoice has been issued, an allowed cost is deemed to have been incurred in the month in which services were supplied or materials were received. (see 9, "General Non-Arm's Length Rules")

4.2.2.2 Types of Allowed Costs

As identified in Section 4.2.2.1 Cost Rules, allowed costs are costs that must meet the requirements of the Regulation. The list of allowed costs (see Appendix L, "List of Allowed and Not Allowed Costs") is not comprehensive and is provided only for illustrative purposes. If there is uncertainty regarding whether a cost is allowable, the project operator should request an Advance Ruling* (see 7, "Advance Rulings") from the Department

All claimed costs are subject to financial audit by the Department. Research programs are subject to a concept audit* **before** their costs are allowed.

4.2.2.2.1 Example: Road Costs

The Department determines whether or not road costs are allowable by reference to the general principles of the Regulation:

- Are the costs reasonable and incurred by or on behalf of the project owners?
- Are the road costs directly attributable to the oil sands project?
- Are the costs incurred for one of the purposes set out in section 2(e) of the Schedules, in particular, to "recover oil sands from the development area of the project"?

The Department's position is that roads located on project lands and connecting project facilities meet this purpose test. The Department recognizes that some road access to project lands is necessary for the recovery of oil sands, so that "off-project" road costs incurred to obtain access to the project lands may also meet this purpose test.

Project proponents must identify, in their project applications, access roads that would be used for project purposes. To be allowable, road costs (both on and off-project) must meet the "purpose" and "directly attributable" tests to the oil sands project. Those roads that meet the tests will be included in the project description incorporated in the project approval. (Clients can apply to amend their project description if new road costs not identified in the initial description are subsequently required.)

Examples of Road Costs (Allowed / Not Allowed)

- Road costs incurred on project lands for the purpose of accessing non-project facilities, such as an upgrader that is excluded from the project description or conventional oil and gas production facilities, will not be allowed costs of the project.
- Where an off-project road accessing project lands also provides access to non-project facilities or conventional production facilities, only the portion of the road costs that could be reasonably attributed to the oil sands royalty project may be an allowable cost.
- Where a road is identified as serving multiple purposes (i.e. forestry or recreation access as well as oil sands access), only the share of road costs that can be reasonably attributed to the project will be an allowable cost.
- Where the project operator uses oil sands access or on-project roads for non-project as well as project purposes, the road costs must be allocated between project and non-project uses and only those costs directly attributable to the project may be an allowable cost.
- Where the operator permits other companies to use on-project or access roads, it is expected those companies will be assessed reasonable fees for that usage and those fees, or what is deemed to be reasonable fees, will be treated as other net proceeds of the oil sands project.
- Road fees paid by the project operator for the use of other private roads for project purposes may be an allowable cost of the project.

The Department requires:

- The project operator to notify the Department when there is a substantial change in use (between project and non-project purposes) of a road incorporated in a project description, to determine whether an amendment to the project description is required.
- The project operator to use measurable quantities to determine the allocation of road costs between project and non-project uses. For example, at the time of construction of an integrated project where an upgrader is outside of the project, the proportion of capital going to the mine or in-situ portion of the project might provide a measurable basis for the allocation of road costs.

- The project operator to provide formal assurance (such as a statutory declaration) that all other net proceeds have been reported for non-project use of the road.
- The project operator to provide evidence of payment for use, such as road use agreements, for audit purposes.

4.2.2.3 Costs That Are Not Allowed

As identified in 4.2.2.1, "Cost Rules", costs that do not meet the requirements of the Regulation are not allowed costs in the royalty calculation. A list of not allowed costs (found in Appendix "L") is not comprehensive and is provided only for illustrative purposes.

4.2.2.3.1 *Services in support of Marketing and Expansions*

For non-qualifying joint venture (NQJV) projects, Schedule 1, Section 2(e)(x) of the Regulation provides that "field, office, administrative or other services" in support of the purposes listed in 2(e) are allowable costs, except where they are incurred in support of marketing or planning for an expansion of a NQJV project.

This section precludes the Department from accepting such costs related to marketing or expansion planning as allowable costs of a NQJV oil sands project.

4.2.2.3.2 *Overhead*

Section 3(a) provides that a cost incurred "in respect of overhead or an administrative expense, including internal audit, 'in-house legal' and other like expenses" is not an allowable cost unless it is allowed under Schedule 1, Section 2(e)(x).

The Department defines overhead costs as general business costs or expenses of the Project operator or owner not specifically demonstrated to be attributable to the Project. Unless the operator or owner can provide clear documentary evidence that these costs were incurred to provide field, office, administrative or other services directly attributable to the project, they are not allowable. (see Appendix L, L-1 for Examples of Overhead Costs")

4.2.2.3.3 *Costs of Evaluation Wells and Seismic Work Incurred Off-Project*

Costs for wells and seismic incurred on lands located outside the boundary of an oil sands royalty project are not allowed costs under the Regulation.

The term "project", as defined in Section 1(aa) of the Regulation, means

"a scheme or operation for the recovery within Alberta of crude bitumen or any other oil sands product from oil sands ... where the scheme or operation is approved in one or more subsisting approvals under section 16."

[Emphasis added.]

The Department will evaluate the description for each proposed project and decide whether each part of the project as described is economically justified. The

Department establishes a project's boundaries for royalty purposes taking the EUB's approval into consideration – and cannot include any well not approved by the EUB.

Furthermore, under section 2 of Schedule 1, a cost is an allowed cost of a project only to the extent that it meets all of the criteria listed in sections 2(a) through 2(e). And, among other things listed in subsection 2(e),

It was incurred to recover oil sands from the development area of the project.

Exploratory work can be performed over broad areas some distance from, and having no connection with, the development area of the project, and so is not directly attributable to the recovery of oil sands from the project. Evaluation wells (e.g., exploration wells, delineation wells, stratigraphic test holes or core holes) and seismic (whether 2-D or 3-D) are exploratory in nature and do not fit the description under subsection 2(e).

Off-project well costs may eventually be recognized if they are brought into a project through an amendment by including the costs in the PNCR of a project expansion. This would require an amended EUB approval for the expansion lands.

4.2.2.3.4 Evaluation Well Costs Incurred More than 5 Years Before the Effective Date

Oil Sands Royalty Regulation, 1997 (AR 185/97), section 18

The cost of delineation wells incurred more than 5 years before the effective date of a proposed project expansion generally result in costs being excluded from the prior net cumulative balance (PNCR) of a project or of a project expansion. (see 2.3.10.3, "Timing")

The criteria for the inclusion of the Crown's share of the cost of assets of an oil sands royalty project under Section 18(1)(a)(i)(c) can be broken down as follows:

- The Minister must make the determination and must be satisfied that the use of the assets in relation to the project after the effective date will clearly result in significant savings.
- The words "use of the assets" indicates that the assets must be capable of being employed in or applied to the project.
- "In relation to the project" means that use must be directly attributable to the project.
- The assets must be used in relation to the project after the effective date - there must be an ongoing or future utility to the project.
- The Minister must be satisfied there will clearly be significant savings of costs to the project. A potential for possible costs savings is not enough, and the costs savings must be significant. The assets in question must have some actual value and be capable of being consumed or used.

Example

If an evaluation well could be converted to, e.g., a water disposal well, the use of which after the effective date results in significant savings to the project by eliminating the need to drill a new water disposal well, a portion of the original costs to drill the well could reasonably be allowed. That would satisfy the

requirement that the asset be capable of being employed in or applied to the project

Section 18(1)(a)(i)(C) is intended to refer to existing tangible assets such as cleaning plants, batteries or other facilities that could be used in the project. "Asset" and "capital asset" are not defined in the Regulation, but the use of the latter term in the Regulation refers to a tangible asset. For example, in section 7.4(1) the cost of a capital asset is the lesser of the choices listed when the asset is delivered to the project site. The five-year restriction is intended to further narrow and limit cost eligibility beyond the limits placed on eligibility of costs incurred within 3 years of the effective date.

Additional Considerations

The Department recognizes costs identified in 4.2.2.3.3 and 4.2.2.3.4 relating to delineation wells through the Oil Sands Tenure Regulation, which sets out the minimum requirements for resource delineation and allows exploration and development costs incurred on continued leases to be considered in reducing escalating rent for non-producing lands.

4.2.2.4 Claiming Allowed Costs

To claim allowed costs, project owners and operators must follow the guidelines outlined in this chapter. When project owners or operators are not sure if a particular cost is allowed under the Regulation, they may request an advance ruling from the Department. For details see 7, "Advance Rulings".

Project operators who are claiming research costs must submit the number of the approved budgetary approval form. For details about research costs, see 5.6, "Research"

4.2.3 Project Revenues

The revenues of an oil sands royalty project are determined by three factors:

- the **project description**, which identifies what resource recovery and processing facilities are included as part of the project
- the type of **oil sands products** that are sold
- the **unit price** calculation (see 4.2.4, "Unit Price"), which determines the revenue obtained from those oil sands projects

4.2.3.1 Types of Revenue

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 1(m), 1(p), 1(ee) and 22

Four types of revenue come into play in the royalty calculation:

- project revenue
- gross revenue
- net revenue

- other net proceeds

Project revenue is the sum of all quantities of oil sands products derived from a project's development area multiplied by their respective unit price

$$\text{Project Revenue} = \sum (\text{Product Volume} \times \text{Unit Price})$$

Gross revenue for a project means the project revenue of a project less the cost of diluent contained in any blended bitumen* included in the calculation of that project revenue.

$$\text{Gross Revenue} = \text{Project Revenue} - \text{Cost of Diluent}$$

Net revenue is the amount by which project revenue exceeds net project costs in a given reporting period. Net project costs are allowed costs less other net proceeds.

$$\text{Net Revenue} = \text{Project Revenue} - (\text{Allowed Costs} - \text{Other Net Proceeds})$$

When net revenue is calculated, the value of other net proceeds is deducted from the allowed costs (see 4.2.2, "Allowed Costs"). For projects that have reached payout, if other net proceeds exceed the allowed costs for the reporting period, the excess amount is carried forward to the next period.

Note: During pre-payout status, other net proceeds are included in the cumulative revenue amount.

Other Net Proceeds generally refers to any considerations received or receivable during the period from the sale, lease, license or other disposition* of any substances or assets (excluding oil sands products derived from the project's development area) or technology of the project.

Examples of other net proceeds include

- proceeds from an insurance policy (to the extent the insurance premium was an allowed cost)
- proceeds from a litigation settlement or threatened litigation, unless the litigation is against the Crown in respect of amounts paid or payable under section 90 of the Act
- pipeline- or transportation-related revenues
- custom-processing revenues
- revenues from the sale of steam, if a cogeneration plant is considered a part of the project

4.2.4 Unit Price

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 1(jj) and 21

The unit price is the net unit value of sold substances measured at the royalty calculation point. It is calculated as follows:

$$\text{Unit Price} = \frac{\text{Total Sales Proceeds} - \text{Handling Charges}}{\text{Quantity Sold}}$$

Total Sales Volume of the Oil Sands Product

Total Sales Proceeds include all money and services received or receivable for third-party dispositions in a specified month of a reporting period.

Handling Charges include all charges incurred in moving the oil sands product from the royalty calculation point to the point of disposition. The disposition point commonly either is the point of sale or the Alberta export terminal (Edmonton, Hardisty or Lloydminster) that is closest to the project. The cost of processing the product at any place between these two points is also considered a handling charge. Handling charges may also include export fees, pipeline tariffs, terminal and processing charges, and other fees.

Handling charges are not considered to be allowed costs, nor are they included in determining the prior net cumulative balance of a project or project expansion.

Total Sales Volume is a measure of the total dispositions of the oil sands product.

If the Minister is of the opinion that the quantity of an oil sands product disposed of in third party transactions is not sufficient to determine a unit price, the Minister will assign a fair market value to the product.

If dirty crude bitumen is disposed of, the unit price will be based on the fair market value of cleaned crude bitumen that could be obtained from that dirty crude bitumen. In determining the unit price, the handling charges will include charges that the Minister is of the opinion would have been incurred to transport the dirty crude to a place where it could have been processed, and the processing charges themselves.

Unit prices are product specific.

A unit price must be calculated for each oil sands product produced by an OSR project.

4.2.4.1 Negative Unit Prices

If handling charges exceed total sales revenues*, the unit price is negative. This means the sales revenue for the particular oil sands product is also negative. In this situation, no royalty payment is made to the Crown for that oil sands product for that month.

How It Works

Under Alberta's generic oil sands royalty regime, royalty is not production based. Rather, it is based on the value of oil sands products sold in arm's-length transactions.

The Crown's royalty share is a percentage of the revenue from each oil sands product: this can only be a positive amount. Nonetheless, the proceeds from selling Crown royalty volumes can be negative if the unit price is negative. In this situation—that is, if handling costs exceed sales revenues—the Crown royalty value defaults to zero.

4.3 The Royalty Calculation for Pre-Payout Projects

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 31(1) and 31(3)

The Crown's royalty share for pre-payout projects is calculated and paid monthly at a rate of 1% of the project's gross revenue. The royalty proceeds from the disposition of the Crown's royalty share are calculated by multiplying the Crown's royalty share quantity by the unit price applicable to that quantity. If the product contains diluent, the Crown's share of the cost of diluent is deducted from the sales revenue of the blended product to determine the royalty payable to the Crown.

For pre-payout projects, negative oil sands product revenues cannot be deducted as allowed costs. Rather, negative revenues increase the payout balance (cumulative revenues less cumulative costs) and earn a return allowance.

In addition, since the Crown royalty share is calculated monthly for each oil sands product, the negative sales revenue for a particular product cannot be used to reduce positive sales revenues for other oil sands products reported in that month. (see 6, "Royalty Reporting and Payment")

Royalty and return allowance are allowed costs for pre-payout projects.

4.4 The Royalty Calculation for Post-Payout Projects

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 31(2), 31(3) and 31(4)

The Crown's royalty share for post-payout projects is based on an estimate of the total royalty payable for the period. It is paid as a monthly instalment, which is adjusted each month based on that month's estimate of the total royalty payable for the period. Estimates must be updated monthly because monthly expenditures and revenues (both actual and forecast) can affect the project's net revenue position.

The royalty payable for the period is the greater of 1% of gross revenue or 25% of net revenue: both amounts must be calculated to determine which is greater. In the latter case, the royalty percentage is calculated as follows:

$$\text{Royalty Percentage} = 25 * \text{Net Revenue} \div \text{Gross Revenue}$$

Note that the royalty percentage, above, is the Crown's royalty share of the oil sands product, expressed as a percentage of the oil sands product on which royalty is payable. To convert it to a dollar amount, the royalty percentage is multiplied by the sum of each oil sands product multiplied by its respective unit price – which is equivalent to 25% net revenue. (see Chapter 6, "Royalty Reporting and Payment")

For post-payout projects where the "1% of gross revenue" royalty rate is in effect, negative oil sands product revenues contribute to a net loss for the royalty-reporting period. As was mentioned in 4.2.4.1, "Negative Unit Prices", no royalty is payable in a month on an oil sands product for which there is a negative unit price for that month.

4.5 Royalty Rules

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 24, 25 and 26

The royalty paid on oil sands products shall be free and clear of all deductions.

The Crown's royalty share must be included in all sales or dispositions of oil sands products. In selling or disposing of these products, the oil sands royalty project holder acts as an agent of the Crown. The terms of this agency are limited: although serving as the Crown's agent, the project holder does not acquire any of the rights, privileges, prerogatives or immunities of the Crown.

4.6 Project Configurations and Royalty

Project Sales and Revenues

For the project examples in this chapter, as for all oil sands royalty projects, project **sales** are sales of all oil sands products obtained from oil sands rights approved as part of the project description.

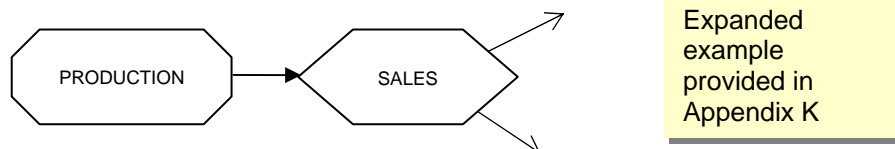
The revenue received from the sale of a product multiplied by the unit price (sales less handling charges) for that product is called the product revenue. The sum of product revenues is the **project revenue**.

Gross revenue is the project revenue less the cost of diluent.

Net revenue is the project revenue less allowed costs of the project less the other net proceeds earned.

4.6.1 An OSR Project that Produces Crude Bitumen

Figure 2: An oil sands royalty project with no processing facilities



Project Output

This type of project produces crude bitumen or bitumen that is cleaned at processing facilities that are not part of the project. Such facilities provide basic services for the project. (see 9.2.2, "Basic Services")

Cleaned crude bitumen is the first marketable oil sands product. Under the provisions of section 21(4) of the Regulation, if dirty crude bitumen is sold, the royalty calculation is based on the Minister's determination of the revenue that could have been obtained had the bitumen been cleaned. In making this determination, the Minister estimates the fair market value of cleaned crude bitumen. This amount—not the amount received for the sale of dirty bitumen—is used to calculate the unit price. The project's handling charges include the estimated cost of transporting the dirty bitumen from the place at which it was disposed of to a place at which could be cleaned and the estimated cost to process the dirty crude bitumen to produce clean crude bitumen.

Processing Costs: Allowed Costs versus Handling Charge Deductions

Handling charges are those charges, including processing charges, incurred between the royalty calculation point and the point of disposition (see *section 22(2)* of the Regulation). On the other hand, allowed project costs for processing are those costs, in this example, incurred before the oil sands product is delivered to a royalty calculation point (see *Schedule 1, section 2(iv)* and *Schedule 2, section 2(iv)*). A charge cannot be deducted under both categories (see *sections 22(2)* and *3(j)(iv)* of the schedules).

Allowed Costs

To the extent that it was not deducted as a unit price deduction (handling charge), the cost of cleaning crude bitumen may be deducted as an allowed cost. The allowed amount depends on whether or not the processing facility is at arm's length from the project. If an arm's length facility is used, the allowed cost is simply the cost of cleaning charged to the project. And if a non-arm's-length facility is used, allowed cost is the lesser of the amount charged or the cost of service. (see 9.2, "Cost Rules Associated with Non-Arm's-Length Transactions")

Royalty Calculation Point

This is the point at which crude bitumen is permanently removed from project lands, or if the crude bitumen is cleaned, the last point of measurement before it is delivered from the processing plant (that is not part of the project) from which it is obtained.

Project Royalty

Pre-payout royalty is 1% of the project's gross revenue—that is, 1% of the quantity of each oil sands product delivered at the royalty calculation point.

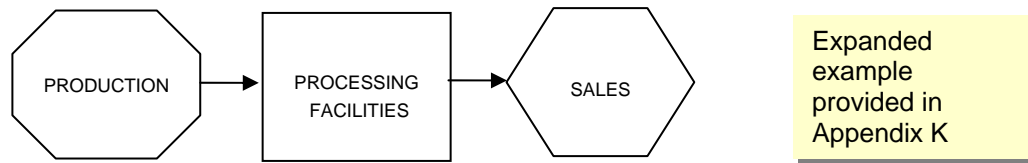
Post-payout royalty is the greater of 1% of the project's gross revenue or 25% of the net revenue for the period.

Net Cumulative Balance

This is the sales revenue *less* allowed costs attributable to production & set-up *plus* other net proceeds. The net cumulative balance is carried forward to the next period.

4.6.2 An OSR Project with Processing Facilities

Figure 3: An oil sands royalty project with processing facilities



Project Output

This type of project produces cleaned crude bitumen or other oil sands products.

Allowed Costs

Costs attributed to the production *and* cleaning or processing of crude bitumen are deducted as allowed costs. The cost rules for non-arm's-length capital assets apply. (see 9.1.2, "Capital Assets")

Royalty Calculation Point

This is at the outlet of the processing plant.

Project Royalty

Pre-payout royalty is 1% of the project's gross revenue—that is, 1% of the quantity of each oil sands product delivered at the royalty calculation point.

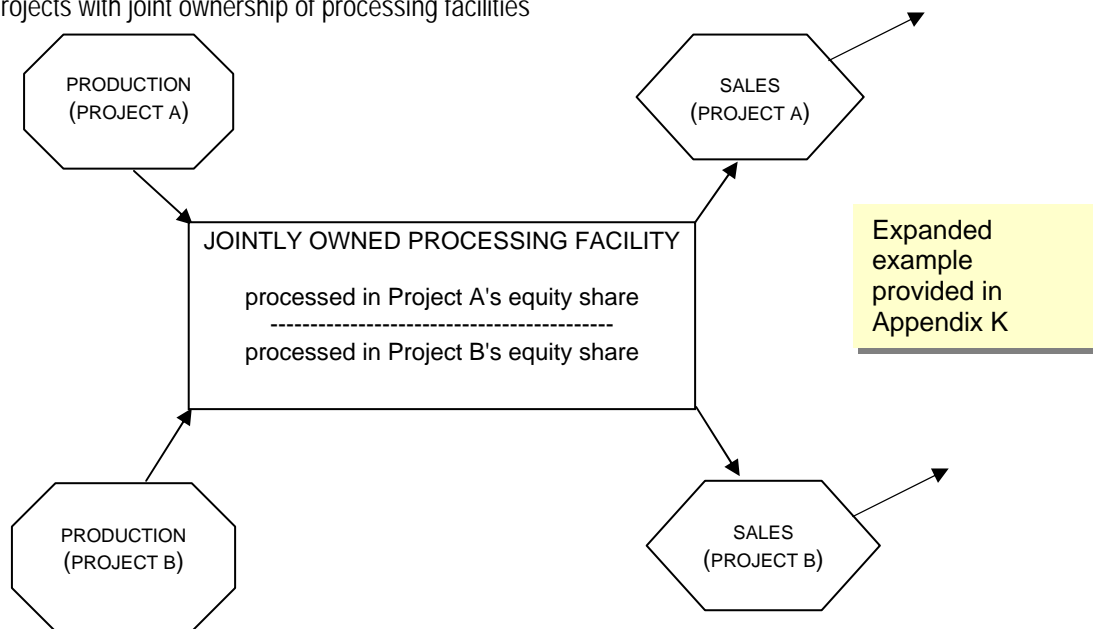
Post-payout royalty is the greater of 1% of the project's gross revenue or 25% of the net revenue for the period.

Net Cumulative Balance

This is the sales revenue *less* allowed costs attributable to production & set-up and processing *plus* other net proceeds. The net cumulative balance is carried forward to the next period.

4.6.3 OSR Projects with Jointly Owned Facilities

Figure 4: Two projects with joint ownership of processing facilities



Project Output

This type of project produces cleaned crude bitumen or other oil sands products.

Allowed Costs

Each project can deduct allowed costs attributed to production *and* to the proportion of processing costs that corresponds to their ownership share in the facility. The processing done for each project is assumed to be in proportion to the project's share of the processing facility. For example, if each project owner owns a 50% share, the processing for each project is assumed to be 50%.

If the processing is not in the same proportion as the ownership, a cost equalization payment is made to account for the difference. The cost equalization payment ensures that one owner is not covering costs for the other when royalty is calculated. The cost equalization payment is treated as a custom processing charge. (see 9.1.2, "Capital Assets")

If a processing facility that is wholly or partly owned by a project participant (or affiliate) is not included in the project description, the custom processing service provided by the facility is considered a basic service. The cost rules for non-arm's-length capital assets apply. (see Chapter 9, "Cost Rules Associated with Non-Arm's-Length Transactions")

Royalty Calculation Point

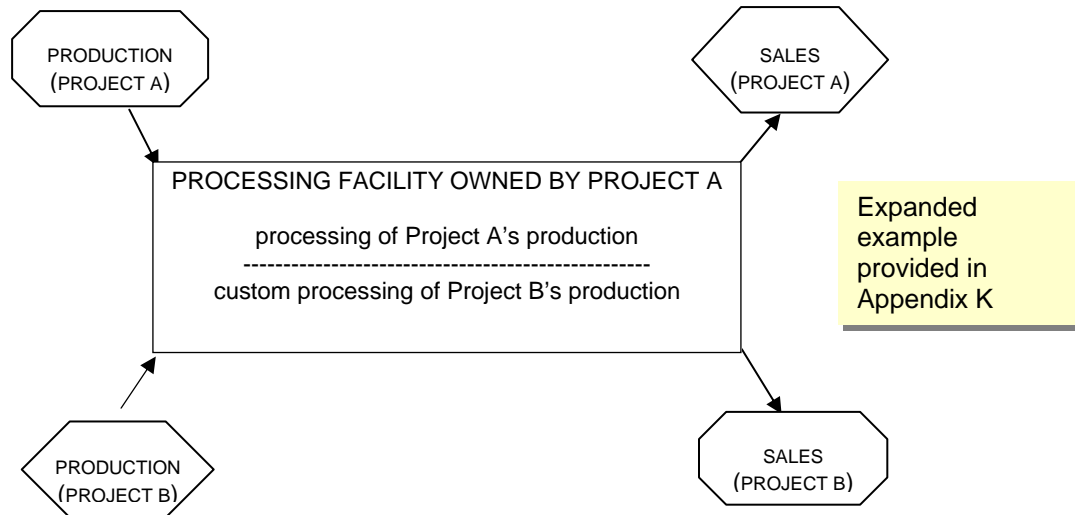
This is at the outlet of the processing plant.

Net Cumulative Balance

For each project, this is the sales revenue *less* allowed costs attributable to production & set-up and to the project's proportion of processing *plus* other net proceeds. The net cumulative balance is carried forward to the next period.

4.6.4 An OSR Project that Provides Custom Processing Services

Figure 5: An oil sands royalty project with processing facilities that processes the output (production) from another project



Project Output

This type of project produces cleaned crude bitumen or other oil sands products.

Costs and Revenues

Each project can deduct allowed costs attributed to production. Project A, as the owner of the processing facility, can also deduct all allowed costs attributed to processing. For Project A, revenues from custom processing fees are other net proceeds, which are deducted from allowed costs in calculating the project's net revenue. For Project B, the custom processing fees paid to Project A are an allowed cost.

If a processing facility that is wholly or partly owned by a project participant (or affiliate) is not included in the project description, the custom processing service provided by the facility is considered a basic service. The cost rules for non-arm's-length capital assets apply. (see Chapter 9, "General Non-Arm's Length Rules")

Royalty Calculation Point

This is at the outlet of the processing plant.

Net Cumulative Balance

For Project A, this is the sales revenue *less* allowed costs attributable to production and processing *plus* other net proceeds, which reduce allowed costs.

For Project B, this is the sales revenue *less* allowed costs attributable to production and processing *plus* other net proceeds. Allowed costs include the custom processing fees.