

9. General Non-Arm's Length Rules

The following rules and definitions apply in the interpretation of the 1997 *Oil Sands Royalty Regulation, 1997* (AR 185/97). They may or may not be applicable in other situations.

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

9.1 Non-Arm's Length Transactions

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

The capital assets, goods and services required to operate an approved oil sands project may or may not be part of the project, as defined in the approved project description. An asset, good or service that is not part of the project may be provided by an independent third party or by an affiliate. If an affiliate is involved, the use of the asset, good or service is considered to be a non-arm's length transaction, which must be valued in accordance with approved non-arm's length business rules.

The business rules for non-arm's length transactions specify the amount that can be charged to a project. The purpose of these rules is to ensure that the transaction is valued in a manner that does not direct payable royalty away from the Crown. The flowchart in Figure 11, "Cost rules for non-arm's-length assets", shows how the rules are applied.

For royalty purposes, all non-arm's length transactions for basic services associated with oil sands project operations are treated as if they are part of the project, regardless of whether they are part of the project description.

9.1.1 Affiliates

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

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:

- 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%.

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

Person Defined

As defined in section 1(v) of the Regulation, the term "person" includes firms, trusts, partnerships, joint ventures, associations, governments or government agencies.

9.1.2 Capital Assets

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 7.4

Assets are considered capital assets if they

- Are used to provide goods and services, rented to third parties, required for administrative purposes, or used for the development, construction, maintenance or repair of other capital assets
- Were acquired, constructed or developed for ongoing use, and
- Are not intended for sale in the ordinary course of business

Capital assets are valued when the asset is delivered to the project site at the lesser of

- The amount charged to the project
- Fair market value (as defined in 9.1.4, "Fair Market Value"), when a reasonable determination can be made, or
- The asset's net book value*

9.1.3 Net Book Value

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 9

The net book value used to determine allowed or non-allowed costs is the remaining undepreciated amount of a capital asset – as recorded in the financial records (consistent with GAAP) of the project owner, operator or other person who provided the asset. In other words, net book value is the original cost less accumulated depreciation.

If a capital asset has been claimed under another royalty regime – such as the *Enhanced Recovery of Oil Royalty Reduction Regulation* or the *Natural Gas Royalty Regulation, 2004* – the Department's records are used to assign net book value.

Capital assets for oil sands royalty projects are depreciated at a rate of 5% per year over twenty years using a straight-line depreciation (in accordance with the Minister's direction given under *section 7.1(2)(c)(i)*.)

9.1.4 Fair Market Value

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 7.3 and 9

Fair market value is determined based on comparable, open-market transactions among unaffiliated parties. Determinations of fair market value are made by the

Minister. The Minister's assessment of what constitutes a comparable open market is made on a case-by-case basis.

Where the Minister is satisfied that a fair market value can be determined, for goods or services other than transportation on pipelines, the Minister may, without limiting any other method of determination, adopt

- the published price of comparable goods or services, if that price is generally adopted by buyers and sellers
- for comparable goods or services, a price that is prescribed in other regulations associated with the *Mines and Minerals Act*
- 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.

Specific cost rules apply in determining fair market value for pipeline services. Refer to 5, "Specific Cost Allocation Rules" for details.

9.2 Cost Rules Associated with Non-Arm's-Length Transactions

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 7.1 to 7.4

9.2.1 Goods and Services

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 7.2 and 7.3

Different cost rules apply to different types of non-arm's length goods and services supplied to a project. The appropriate rule is determined by three factors:

1. whether or not a fair market value can be established
2. whether or not a capital asset was used
 - When a capital asset is used, cost-of-service calculation rules apply.
3. in the case of a service, whether or not the service is considered “**basic**”
 - The classification of a service as “basic” or “non-basic” determines how allowed costs are determined.

9.2.2 Basic Services

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 7.1(2)(b) and 7.2(2)(b)

A basic service is a service performed in order for oil sands or oil sands products to be recovered pursuant to the project or clean crude bitumen to be obtained from oil sands products obtained pursuant to the project, and utilizing a capital asset that is not part of the project.

Basic services include, but are not limited to, services provided through the use of such capital assets as

- wells
- gathering lines
- production and separation facilities
- cleaning facilities
- on-site power transmission and distribution lines, and
- steam generation facilities (including the steam-generating portion of co-generation plants)

Basic services do not include electricity (provided from a co-generation plant), which is defined as a good under the Regulation, or natural gas, which is also considered a good.

Basic services are charged to the project at the lesser of:

- The amount charged to the project by the project owner(s) or affiliate(s); or

- The cost of service, as explained below.

The cost of service calculation provides for a rate of return on capital based on the long-term bond rate, and a depreciation based on the 5% annual straight-line method, in accordance with *section 7.1(2)(c)(i)*.

The Joint Industry Task Force Report on Processing Fees (JP-95) was used as a general guide for the cost of service calculation, but is not binding in determining the cost of service for a facility. The calculation does not include a minimum capital rate base (i.e., 50%) as suggested by the JP-95.

The rate of return and depreciation are allocated based on the capacity of the capital asset. Operating costs for the capital asset are allocated based on annual throughput.

9.2.3 Goods and Non-Basic Services

Oil Sands Royalty Regulation, 1997 (AR 185/97), section 7.2(1)

The costs allowed in respect of goods and non-basic services depends on whether a fair market value can reasonably be determined for those goods or non-basic services, and whether the goods or non-basic services are provided using a non-project capital asset.

9.2.3.1 Fair Market Value for Goods and Non-Basic Services Can Be Determined

For goods and non-basic services that do not use a non-project capital asset, the allowed costs of the goods or non-basic services are the lesser of

- the amount charged to the project; or
- fair market value

9.2.3.2 Fair Market Value for Goods and Non-Basic Services Cannot Be Determined

For goods and non-basic services that do not use a non-project capital asset, the allowed costs of the goods or services are the lesser of:

- the amount charged to the project; or
- the actual cost incurred by the project owner, operator, or an affiliate of either (or the person from whom the good or service was obtained), to produce the good or perform the service.

9.2.4 Non-Basic Services Using Non-Project Capital Assets

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 7.2(3)

The costs allowed in respect of non-basic service provided by a non-project capital asset will depend on whether a fair market value can reasonably be determined for those non-basic services.

9.2.4.1 Fair Market Value for Non-Basic Service from a Non-Project Capital Asset Can Be Determined

Where fair market value can reasonably be determined for a non-basic service provided by a non-project capital asset, the cost of the service will be the lesser of

- the amount charged to the project; or
- fair market value

9.2.4.2 Fair Market Value for Non-Basic Service from a Non-Project Capital Asset Cannot Be Determined

Where fair market value cannot reasonably be determined for a non-basic service provided by a non-project capital asset, the cost of the service will be the lesser of

- the amount charged to the project; or
- the cost of service

The cost-of-service calculation provides for a rate of return on capital based on the long-term bond rate plus a premium to reflect the risk of operating the capital asset. The Minister will periodically assess the risk premium and adjust it as required.

The cost of service calculation provides for depreciation based on the annual straight-line method, with the depreciation rate determined by the Minister.

JP-95 can be used as a general guide, but it is not binding in determining the cost of service for a capital asset. There will be no minimum capital rate base (i.e., 50%), as suggested by the JP-95.

The rate of return and depreciation are allocated based on the capacity of the capital asset. Operating costs for the capital asset are allocated based on annual throughput.

9.2.5 Non-Basic Service Using a Project Capital Asset (Custom Processing)

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 7.2(3)

Where a project provides non-arm's length custom processing to other projects, the net book value of the project capital asset will be used in determining the custom-processing fee.

Where a project provides custom processing to an arm's length operator a fair market value must be charged for the service. The fair market value of the transaction is based on either relative transaction within the region or from an estimate of the project capital asset's value. The latter method would apply only if the company's statements assigned zero or minimal net book value to the project capital asset.

9.2.6 Non-Basic Pipelines

9.2.6.1 Fair Market Value for Transportation Can Be Determined

Where a non-basic pipeline transports oil sands products from a project, and a fair market value can be determined for the transportation service, the pipeline charge allowed as a unit price deduction for the project will be the lesser of:

- the amount charged to the project; or
- fair market value

In determining fair market value of the transportation service, the Minister may adopt one of the following three methods:

(1) A regulated tariff charged for the service.

(2) A tariff charged by the owner of the pipeline, if:

- the conditions under 1 do not apply.
- the pipeline is subject to a complaint-based regulation,
- the tariff is generally agreed to and paid by unaffiliated shippers who obtain the service,
- the pipeline has published tariffs,
- the tariffs and other terms of obtaining service do not unjustly discriminate among shippers seeking service, and
- the tariff is just and reasonable under the circumstances, or

(3) A tariff of either (a) the weighted average of prices paid by unaffiliated shippers for comparable service, or (b) if there is no comparable service, the weighted average of prices for all unaffiliated service on a pipeline, if:

- the conditions under 1 and 2 do not apply,
- the pipeline is subject to a complaint-based regulation,
- not less than 2/3 of the volume of oil sands product shipped on the pipeline is owned by shippers unaffiliated with the pipeline owner, and
- the weighted average price is just and reasonable under the circumstances.

Note

A pipeline is subject to regulation on a complaints basis if a customer or potential customer of the pipeline can, by complaint to a regulatory authority, have the pipeline terms of service and the charges for service reviewed and fixed.

9.2.6.2 Fair Market Value for Transportation Cannot Be Determined

Where a non-basic pipeline transports oil sands products from a project, and a fair market value cannot be determined for the transportation service, the pipeline charge allowed as a unit price deduction for the project will be the lesser of:

- the amount charged to the project; or
- the cost of service

9.2.6.3 Cost of Service Calculation Methodology for Non-Basic Pipelines

The annual depreciation charge, capital return, and operating costs for the non-basic pipeline will be allocated based on annual throughput.

The pipeline's allowed capital costs will be depreciated on a straight-line basis over its useful life, which for royalty calculation purposes is estimated to be not less than 20 years (5% straight-line depreciation). There will be no floor on the undepreciated capital balance to determine the return on capital.

The allowed rate of return on capital (RORC) will be calculated using a pre-tax weighted average cost of capital formula, which is:

$$\text{RORC} = \left(\frac{\text{Deemed Debt Percentage}}{\left(\frac{\text{Deemed Cost of Debt}}{\left(\frac{\text{Deemed Equity Percentage}}{\left(\frac{\text{Deemed Cost of Equity}}{(1 - \text{Deemed Corporate Income Tax Rate})} \right)} \right)} \right) + \left(\frac{\text{Deemed Cost of Debt}}{\left(\frac{\text{Deemed Equity Percentage}}{\left(\frac{\text{Deemed Cost of Equity}}{(1 - \text{Deemed Corporate Income Tax Rate})} \right)} \right)} \right) \right)$$

The parameters used in the previous formula are as follows:

- Deemed debt percentage = 45%,
- Deemed equity percentage = 55%,
- Deemed cost of debt = LTBR plus 1%, and
- Deemed cost of equity = the multi-pipeline rate, as published by the National Energy Board on an annual basis.

Other parameters (capital structure and corporate tax rate) will be revisited at the Department's discretion, or when there are significant market or tax changes.

Note that the RORC is calculated as a pre-tax weighted average cost of capital formula with corporate income taxes payable accounted for within the formula. Accordingly, taxes will not be included in the pipeline's revenue requirement.

Note

The Minister may, at his discretion, periodically revisit any cost of service calculation, whether used in determining the allowed cost for a project or a deduction from unit price.

9.3 Revenue Rules Associated with Non-Arm's-Length Transactions

Oil Sands Royalty Regulation, 1997 (AR 185/97), sections 8 and 9

When any consideration is received for a non-arm's-length transaction, the value of that consideration is the greater of

- Fair market value, or
- The value agreed to by the parties involved in the transaction.

If some or all of the consideration is non-monetary, its value is the sum of the money portion plus the value of the non-money portion.

What is consideration?

Consideration is a legal term that means something of value, such as money or services, given by one party to another in exchange for goods received or services rendered.

Figure 11 Cost rules for non-arm's-length assets

