July 12, 2012

OIL SANDS INFORMATION BULLETIN 2012-11

Subject: Arm’s Length Costs Incurred and Costs Accrued Under the Generic Royalty Regime

Costs are an important component of the oil sands generic royalty system. For post-payout Projects, allowed costs incurred in a Period enter into the determination of Net Revenue on which Project royalty is based. For pre-payout Projects, allowed costs incurred in a month enter into the Project’s cumulative balance, and earn a return allowance, which is an allowed cost in the next month. Finally, costs incurred prior to a Project’s effective date are a major component of a Project’s Prior Net Cumulative Balance – which establishes the Project’s opening cumulative balance. Although pre-payout costs do not immediately affect royalty payable, by affecting the Project’s cumulative balance they affect the date the Project reaches payout and total royalty payable over the Project’s life.

The generic royalty regime provides the return allowance on a Project’s cumulative balance to reflect the “price” or cost of the funds the Project owners have invested in the Project. Until the funds are actually committed to the Project, they have no cost, and therefore should not earn a return allowance. It is important that allowed costs of an oil sands Project enter the royalty calculation at the correct time, as well as in the correct amount.

The Oil Sands Royalty Regulation, 2009 defines when allowed costs are “incurred”, and enter into royalty calculation: in general,

18 (1) For the purposes of this Regulation, an allowed cost

(a) is, in the case of a cost that becomes payable on or after January 1, 2009, deemed to be incurred

(i) in the month in which the cost is payable, to the extent of the amount of the cost that is paid within 90 days after the cost becomes payable, or

(ii) in the month in which the cost is paid, to the extent of the amount of the cost that is paid more than 90 days after the cost becomes payable.

An arm’s length cost becomes “payable” only when the true cost liability is known, that is, both the amount of the cost and the date it is due. Receipt of an invoice will likely satisfy these requirements. For example, if an invoice is received in January, specifying the cost amount of $100 and February 28th as the due date, that cost is “payable” and “incurred” in January. To the extent it is paid within 90 days of the receipt of the invoice, it is an allowed cost.
of the Project in January. If $80 of the cost were paid in February, but $20 not until May, then $80 would be an allowed cost of the Project in January and $20 an allowed cost in May.

In some accounting systems, a cost may be “accrued” as a liability on the receipt of a completed work order, or packing slip, but prior to the receipt of an invoice specifying the final amount due and the prescribed due date. This estimated accrued cost will be corrected as more information becomes available, and reversed when payment is made.

However, it is important to recognize that an arm’s length cost is not incurred for royalty purposes until it meets the criteria described in this Bulletin. For example, if an item is purchased in January and an estimated cost accrued then, but the actual invoice setting out the final cost and terms of payment is not received until February, the estimated accrued cost is not an allowed cost of the Project in January: the cost does not become payable until February, and is not deemed to be incurred until then (assuming it will be paid within the specified 90 day period).

For an arm’s length costs which became payable prior to 2009, the provisions of the *Oil Sands Royalty Regulation, 1997* determine when the cost is incurred for royalty purposes. Here the period allowed for payment is longer however, the same rules stated above apply for accruals:

7 (2) For the purposes of this Regulation, a cost described in subsection (1) that becomes payable on or before December 31, 2008 is deemed to be incurred

(a) in the month in which the cost is payable, if

(i) 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

(ii) the month occurs during a post-payout Period and the cost is paid before the end of the calendar year following the Period,

or

(b) in the month in which the cost is paid, in any other case.

Project operators need to ensure that only an arm’s length costs actually “incurred” in a month are classified as allowed costs of the Project in that month. Cost accruals based on estimates are not “payable” or “incurred” according to the Regulation, and are not allowed costs of a royalty Project.
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