November 19, 2012

OIL SANDS INFORMATION BULLETIN 2012-19

Subject: Imperial Oil Sands Dispute Review Committee - Minister’s Decision

On August 11, 2011, the Minister of Energy (“Minister”) established the Imperial Oil Sands Dispute Review Committee (“Committee”) to review and make recommendations with respect to the Department of Energy’s decision to disallow certain costs for the Imperial Cold Lake Production Project. The Committee, upon hearing the parties, made the attached recommendations. The Minister then made a decision in respect of those recommendations pursuant to section 10(2) of the Oil Sands Dispute Resolution Regulation, which is also attached.

In summary:

- A hearing before the Committee was conducted on February 27 and 28, 2012.
- The Committee issued its recommendations on March 30, 2012. Refer to Appendix “A” for the Committee’s report and recommendations.
- The Minister made a decision on the Committee’s recommendations on October 31, 2012. Refer to Ministerial Order 97/2012 in Appendix “B” for the decision.
- This decision only affects the interpretation of costs pursuant to the Oil Sands Royalty Regulation, 1997.

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Oil Sands Division

Attachments
IN THE MATTER of the Oil Sand Dispute
Resolution Regulation A.R. 247/2007

AND IN THE MATTER of the Imperial Oil Resources Oil Sands Dispute
Review Committee, as established by Ministerial Order 84/2011

BETWEEN

Imperial Oil Resources

Applicant

-and-

Alberta Department of Energy

Respondent

REPORT AND RECOMMENDATIONS
OF THE DISPUTE RESOLUTION COMMITTEE

Dispute Resolution Committee
Phyllis A. Smith, Q.C., Chair
Peter Taschuk, Q.C.
James McCartney
I. INTRODUCTION

1. This matter involves a dispute between the Department of Energy of the Province of Alberta ("Alberta Energy") and Imperial Oil Resources ("Imperial") arising from Alberta Energy's 2000-2004 royalty audit assessments for Project 037 ("the Project").

2. The Dispute Review Committee ("the Committee") was appointed by the Minister of Energy to review and provide recommendations with respect to the dispute.\textsuperscript{1}

3. The Committee was directed by the Minister's Order ("the Order") to hear certain matters in dispute between the parties, namely related party marketing fees, head office cost allocations, diluent cost adjustments, EUB administration fees and other costs.\textsuperscript{2}

4. The Order provided that the Committee was bound by decisions made by the Minister flowing from "the recommendations of previous oil sands dispute review committees". That would include the recommendations contained in the Report and Recommendations of the Suncor Dispute Resolution Committee\textsuperscript{4}, dealt with by the Minister in Ministerial Order 32/2010.\textsuperscript{5}

5. Pursuant to the Order the Committee made certain directions with respect to delivery of written submissions and replies and scheduled the hearing for February 27, and 28, 2012.\textsuperscript{6} The schedule with respect to the delivery of written submissions and replies was subsequently amended by agreement between the parties.

6. The parties delivered their submissions and replies in accordance with the agreed upon schedule\textsuperscript{7} and the Committee provided further procedural directions with respect to the oral hearing.\textsuperscript{8}

7. The oral hearing proceeded on February 27 and 28, 2012. All evidence was provided in advance of the hearing in the form of affidavits, and as there were no material factual

\textsuperscript{1} Ministerial Order 84/2011, August 11, 2011
\textsuperscript{2} Schedule A to Order 84/2011
\textsuperscript{3} Section 11
\textsuperscript{4} Appendix A to Oil Sands Information Bulletin, Imperial Authorities, Tab 9
\textsuperscript{5} Appendix B, Oil Sands Information Bulletin, Imperial Authorities, Tab 9
\textsuperscript{6} Letter dated September 19, 2011 from the Chair of the Committee to the parties
\textsuperscript{7} Hard copies of Imperial's written submission and affidavits were delivered on November 18, 2011, Alberta Energy's written reply and affidavits were delivered on February 3, 2012, and Imperial's Reply submissions and supplementary affidavits were delivered on February 13, 2012
\textsuperscript{8} E-mail dated February 19, 2012
disputes, no evidence was called at the hearing, but the parties provided additional submissions and clarifications.

8. The following individuals appeared at the hearing:

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<thead>
<tr>
<th>For Imperial</th>
<th>For Alberta Energy</th>
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<tbody>
<tr>
<td>Clarke Hunter, Q.C., Counsel</td>
<td>Elena Sacluti, Counsel</td>
</tr>
<tr>
<td>Randal Van de Mosselaer, Counsel</td>
<td>David France, Counsel</td>
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<tr>
<td>Bryan Walker, Counsel</td>
<td>Todd Nahirnik, Counsel</td>
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<td>Peter Miller, Counsel</td>
<td>Elizabeth Sanregret</td>
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<td>Randy Gillis</td>
<td>Todd Wonderham</td>
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<td>Ian Walker</td>
<td>Steve Tkalcic</td>
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<td>Larry Mierau</td>
<td>Chris Lawton</td>
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<td>William Jamieson</td>
<td>Joe Ruggiero</td>
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<td>Myron Spilchak</td>
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9. The disputes between the parties were:

(a) as to related party marketing fees including diluent marketing fees, whether a fair market value could be determined for marketing services provided by a related or affiliated party, which services were charged to the Project at the price of [Redacted]:

(b) as to diluent costs, whether Imperial could recover the costs paid to an affiliated party for the purchase of diluents at a cost which was greater than the weighted average cost of natural gas condensate;

(c) as to head office costs, whether certain costs allocated to the Project by Imperial are allowed costs of the Project within the meaning of Schedule 1 of the Oil Sands Royalty Regulation, 1997 ("Schedule 1" and "the Regulation" respectively);

(d) as to the EUB administration fee, whether the general administration fees and orphan well levies paid to the EUB are allowed costs within the meaning of Schedule 1; and

(e) as to certain other costs, whether the costs paid by Imperial with respect to membership in and monitoring costs conducted by the Lakeland Industry and Community Association and certain other costs are allowed costs within the meaning of Schedule 1.

10. The issues to be determined by the Committee in making recommendations to the Minister of necessity required the Committee to interpret the provisions of the Regulation. Imperial argued that to the extent there is any ambiguity in the Regulation, the Committee
could and should consider how Alberta Energy interpreted identical wording in the Agreement between the Crown and Imperial in determining whether costs were allowed under that Agreement. The Crown submitted that the intent of the Regulation was to replace a number of individual agreements for the calculation of royalties to ensure consistency of treatment and that it would be inappropriate to have resort to one of those agreements for the purpose of interpreting a general regulation designed to create a consistent and equitable royalty regime.

11. In the result the Committee concluded that while there are difficulties in interpreting the Regulation, there is no ambiguity that required or permitted resort to extrinsic evidence such as the manner in which Alberta Energy had interpreted and applied similar provisions in the Crown Agreement.

II. MARKETING COSTS

A. The Dispute

12. Alberta Energy did not allow the costs charged to the Project for marketing fees charged by an affiliate\(^9\) for the sale of blended bitumen to an affiliated company and the purchase of diluent from an affiliated company. Alberta Energy accepted as an allowed cost the fees charged by Imperial for marketing to unaffiliated parties on the basis that the amount charged was less than fair market value\(^10\) and pursuant to the Regulation, where a fair market value can be determined, the allowed cost is the lesser of the actual charge to the project or the fair market value.

13. Alberta Energy concluded that marketing to an affiliate was not the same service as marketing to a non-affiliated company. Since the fair market value of those services must be based upon comparable services\(^11\) and there was no evidence of the fair market value of those services, section 7.2(1)(b)\(^12\) of the Regulation applied. As Imperial did not supply any

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\(^9\) Marketing services were provided to the Project by Imperial Oil through its Crude Oil Supply and Marketing Department: affidavit of Larry Mierau, paragraph 6

\(^10\) Imperial provided information that fees charged by third party marketers reflected prices higher than the amounts charged to the Project: affidavit of Larry Mierau, paragraph 20

\(^11\) Regulation, Section 7.3(1)

\(^12\) That section reads as follows: "Where the Minister is satisfied that a fair market value cannot reasonably be determined for the good or service, and that the service is performed without utilizing a capital asset, the lesser of (i) the amount charged to the Project for the good or service, (ii) the actual cost incurred by the Project owner, operator or affiliate of either to produce the good or perform the service, if it is not obtained by the Project owner, operator or affiliate from another person, and (iii) the actual cost incurred by the person from whom the good or service was obtained by the Project owner, operator or affiliate of either to produce the good or perform the service."
information with respect to the actual cost of the services\textsuperscript{13}, the auditor was unable to determine which was the lesser cost, the actual cost or the amount charged to the project. Consequently the charges to the Project to market to affiliated companies were not allowed.

14. Imperial submitted that marketing blended bitumen to or purchasing diluent from affiliated and non-affiliated companies involved the same functions\textsuperscript{14} and although there were "differences between the services required of a marketing agent on the sale and purchase of offshore oil as compared with Cold Lake Project production, on an overall basis neither is more complex than the other."\textsuperscript{15}

15. Imperial asserts that the disallowance of marketing costs was based upon a misinterpretation of the term "comparable" used in section 7.3(1).

16. Alberta Energy did interpret the term restrictively. It concluded that marketing blended bitumen to or purchasing diluent from affiliates was a different service than marketing to non-affiliates. Based upon that conclusion Alberta Energy says that the Minister was justified in determining that no fair market value could be determined for the marketing services, the fees for which were disallowed.

17. Alberta Energy provided no evidence with respect to the issue of whether the services were comparable. It asserted that it needed actual costs incurred to supply the services to assess the issues of comparability. Imperial provided uncontradicted evidence that the services were comparable. It further asserted that due to its obligations to minority shareholders, and the requirements of the Canada Revenue Agency, transactions between affiliates must be demonstrated to be conducted on a fair market value basis\textsuperscript{16}.

B. The Committee Recommendations

18. The Committee can appreciate the concerns of Alberta Energy with respect to the issue of marketing costs. The Minister is faced with not simply marketing done by an affiliated company but marketing with respect to sales to and purchases from affiliated companies.

19. The thrust of the Regulation is to ensure that the Project owner does not recover a cost for such services which is greater than would be paid if the services were provided by a third

\textsuperscript{13} Affidavit of Elizabeth Sanregret, paragraph 12
\textsuperscript{14} Affidavit of Larry Miera, paragraphs 28-30
\textsuperscript{15} Affidavit of Larry Miera, paragraph 21
\textsuperscript{16} Affidavit of Larry Miera, paragraphs 24-27
party marketer. This is consistent with the balance intended to be achieved by the Regulation and referred to in the Suncor Report\(^{17}\).

20. However, the Regulation also makes it clear that fair market value is an appropriate method to price services and goods exchanged between affiliates, and does not prohibit services and goods being acquired between affiliates for the purpose of determining allowed costs under the Regulation.

21. The issue between the parties is whether the services provided by an affiliate’s marketing department are comparable to services provided by third party marketers, whether supplying to or purchasing from affiliated companies or non-affiliated companies. Alberta Energy says that section 7.2(1)(b) of the Regulation applies because the Minister reasonably concluded that a fair market value could not be determined for the marketing services, the costs of which were disallowed. Imperial says that section 7.2(1)(a) applies because a fair market value of the services could be determined.

22. The Regulation provides guidance with respect to both the meaning of fair market value\(^{18}\) and the method of determining it\(^{19}\). Section 7.3(1) provides that in addition to any other method for determining fair market value, the Minister can adopt the published prices of comparable goods or services, or adopt a price for such goods or services established by regulation, or adopt the average of prices of such goods or services.

23. The guiding principle for the determination of fair market value is the comparability of the goods or services. The Regulation does not define “comparable” but dictionary definitions include “able to be compared with, worthy of comparison, fit to be compared with”\(^{20}\).

24. This definition does not require that the services be identical, but that the services are sufficiently similar so as to meet the comparability test. Applying the test requires an analysis of the content of the services to determine whether there are similar functional requirements, and implicitly similar work demands.

25. Clearly Alberta Energy is of the view at the very least that there cannot possibly be the same amount of effort and work required if the marketing of product or the purchase of product is to or from an affiliated company. The Committee understands how such a

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\(^{17}\) Report, Tab 9, Imperial authorities, Schedule A, p. 5-6, paragraph 21  
\(^{18}\) Section 9  
\(^{19}\) Section 7.3(1)  
\(^{20}\) Shorter Oxford English Dictionary, 2002
conclusion appears intuitively correct and why Alberta Energy wants information of the actual cost to the affiliate of providing the service\textsuperscript{21}.

26. Mr. Mierau admits in his affidavit that the services are not identical. But he also makes clear in his affidavit that the services that are required in connection with the marketing of blended bitumen to affiliated companies and the purchasing of diluent from affiliated companies have the same complexity as the sales to or purchases from non-affiliated companies (if not greater complexity when dealing with affiliates) and contain the same functional elements as are required with respect to marketing to or from non-affiliated companies. Those functions are detailed in his affidavit\textsuperscript{22}.

27. That evidence establishes that the marketing services provided to Project by the affiliated company, whether for purchases of diluent from affiliated or non-affiliated companies or the sale of blended bitumen to affiliated or non-affiliated companies, are comparable.

28. The evidence further establishes that there is a fair market value for those services, a market value that the Minister has accepted for marketing of blended bitumen to non-affiliated companies and therefore section 7.2(1)(a) applies\textsuperscript{23}.

29. Consequently the Committee is of the view, based upon the evidence before it, that the charged to the Project for marketing services provided by an affiliate to the Project for the sale of blended bitumen to affiliated and non-affiliated companies and for the purchase of diluent from affiliated and non-affiliated companies is the cost of those services to the Project.

The Committee recommends that the amount of for marketing services for the sale of blended bitumen and the purchase of diluent, whether the sales or purchases are with affiliated or non-affiliated entities be accepted as an allowed cost of the Project.

\textsuperscript{21}Notwithstanding Alberta Energy’s request for such information and notwithstanding Imperial’s obligation to keep and make available records imposed by section 47 of the Mines and Minerals Act (although the Committee is not entirely certain that the records are those of Imperial as the services are provided by the affiliate, and no argument was addressed to this issue at the hearing), the information has not been provided. However it is clear that the actual costs of providing the service only become relevant if no fair market value of the services can be established thus triggering the application of section 7.2(1)(b).

\textsuperscript{22}Affidavit of Larry Mierau, paragraphs 21 and 28

\textsuperscript{23}Imperial argued that, in addition to the fact that the Minister had accepted a fair market value for a portion of the services, the Minister also used such services, and could have provided information about the market value of such services and therefore an adverse inference should be drawn. The Committee declined to do so in the circumstances.
III. DILUENT COSTS

A. The Dispute

30. The Minister disallowed as a cost of the Project an amount equal to the difference between what was charged to the Project for certain volumes of Pembina 3-28 and manufactured diluent purchased from affiliates, and the weighted average cost of natural gas condensate charged to the Project.

31. Alberta Energy asserts that the additional charges represented an opportunity cost which is not an allowed cost under the Regulation. Implicit in Alberta Energy’s characterization is either that the affiliate was charging a premium to Imperial above fair market value or that Imperial ought not to be able to take advantage of a market price that was driven by scarcity.

32. Imperial provided extensive evidence in the form of affidavit evidence from Ian Walker respecting its purchase of Pembina 3-28 and manufactured diluent including the circumstances of the purchases and the pricing of the purchases.

33. That evidence is as follows:
   (a) such purchases were only made when natural gas condensate prices exceeded prices that would be charged for either Pembina 3-28 or manufactured diluent or when Imperial was unable to purchase natural gas condensate at all thus threatening a shutdown of the Project;
   (b) when Imperial purchased Pembina 3-28 as a diluent, it was purchased at a price necessary to attract it into the diluent pool for the Project which was calculated using equalization scales for either natural gas condensate or light crude whichever was priced higher at the time and which represented the fair market value of the product at the time; and
   (c) when manufactured diluent was purchased it was priced on a basis which afforded the refinery the same economic return as it could achieve by using the source naphtha to manufacture other refined products and was only purchased when it resulted in a lower overall cost to the Project than purchasing natural gas condensate (because less volume

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24 Affidavit of Ian Walker, paragraphs 30, 34
25 The industry has adopted a method of dealing with the differing qualities of various hydrocarbon products injected into a pipeline to reflect the differing value of the various hydrocarbon products using equalization calculations to determine higher or lower value products resulting in payments or charges to shippers depending on those values. This, according to the principles set out in the Equalization Procedures Guide, Exhibit 36 to Ian Walker’s affidavit, section 1.1(1), is intended to reflect market value.
26 Affidavit of Ian Walker, paragraphs 42 and 43
was necessary even if the unit cost was higher it would still be more economic at certain prices than natural gas condensate) or to avoid shutting in production\textsuperscript{27}.

34. Mr. Walker described a process whereby the goal was to achieve the lowest overall cost of diluent necessary to maintain production. There was no contradictory evidence.

35. Alberta Energy agreed that "the cost of diluent sold in blend is a cost that is allowable for calculating royalty under the Regulation" but that "it was the valuation that is in dispute\textsuperscript{28}.

36. Alberta Energy said that it calculated the cost based upon the definition of the cost of diluent set out in the Regulation\textsuperscript{29}, together with the application of sections 7.1, 7.2 and 7.3 of the Regulation because a portion of the diluent was purchased from an affiliate.

37. Alberta Energy further stated that there was a fair market value for the cost of diluent, which was the natural gas condensate price\textsuperscript{30}. Alberta Energy then allowed as a cost to the Project the weighted average natural gas condensate price (which was the only product purchased from third party suppliers) for the volumes of diluent delivered together with the net equalization charges paid by Imperial\textsuperscript{31}.

38. Imperial says this was an error because Alberta Energy has essentially deemed Pembina 3-28, manufactured diluent and natural gas condensate as comparable for the purpose of determining market value but those products have different qualities, values, and markets and are not comparable for the purpose of a fair market value calculation.

B. The Committee’s Recommendation

39. The parties agree that, in general terms, the cost of diluent is an allowed cost under the Regulation. The dispute is with respect to what those costs are.

\textsuperscript{27} Affidavit of Ian Walker, paragraphs 49 and 52
\textsuperscript{28} Alberta Energy’s Reply Submissions, paragraph 17
\textsuperscript{29} The definition is contained in section 1 of the Regulation and reads as follows: "'cost of diluent' means, in respect of diluent blended with cleaned crude bitumen obtained pursuant to a Project to form the blended bitumen that is delivered during a month at a royalty calculation point for the cleaned crude bitumen, the cost determined in accordance with the following formula

\[
\text{Cost} = V x \text{WAC}
\]

Where
\text{V} is the total volume of the diluent;
\text{WAC is the weighted average cost per unit volume of that diluent calculated in accordance with the Minister's directions;..."

\textsuperscript{30} Alberta Energy’s Reply Submission, paragraph 19
\textsuperscript{31} Alberta Energy’s Reply Submission, paragraph 21
40. In particular, at issue is the fair market value of Pembina 3-28 and manufactured diluent purchased from time to time from Imperial’s affiliates.

41. Alberta Energy says that because the purchases are from an affiliate, and because the fair market value of diluent can be determined, and that fair market value of diluent is the weighted average cost of natural gas condensate of natural gas condensate, pursuant to section 7.2(1)(a), Imperial is only entitled to that amount for the purchased Pembina 3-28 and manufactured diluent. It is to be noted that Alberta Energy does not challenge the reasons advanced by Imperial for purchasing diluents other than natural gas condensate but only the pricing of those other products.

42. Imperial says that the Minister has erred in determining that natural gas condensate, Pembina 3-28 and manufactured diluent are comparable products. It points to Ian Walker’s affidavit which describes the differences in quality which affect the price (and which is recognized by the industry in the adoption of the equalization scales). It further points to the specific wording of the definition of “cost of diluent” in the Regulation which properly interpreted is intended to permit cost recovery for diluents, and does not, on its face stipulate that there is only one type of diluent, given that the definition of “diluent” refers to “hydrocarbon substances” (emphasis added).

43. From Alberta Energy’s evidence and submissions, it does not appear that it is advancing an argument that the term diluent as defined excludes cost determinations based upon different diluent products. Rather, it is simply excluding the actual costs of affiliate diluent charged to the Project and instead is utilizing the natural gas condensate prices for determination of the cost of diluents. It concludes that those diluents are comparable to natural gas condensate, and because the other diluents were purchased from affiliates, the fair market value was the natural gas condensate price.

44. There are therefore two issues that arise in connection with the cost of diluents supplied to the Project: whether Pembina 3-28 and manufactured diluent are comparable to natural gas condensate within the meaning of section 7.3(1) of the Regulation, and if they are not comparable, is there a reasonable method to determine the fair market value of those products. If the products are not comparable, and there is no reasonable method for determining the fair market value of them, then for the purpose of determining costs, section 7.2(1)(b) applies.

32 Affidavit of Ian Walker, paragraphs 24 and 28
33 Affidavit of Elizabeth Sanregret, paragraph 17
45. While there is comparability with respect to the use of the product, as all three products are and can be used for diluent purposes and are interchangeable for that purpose, the uncontradicted evidence is that there are significant differences with respect to the quality of the three products, and the alternate uses for the products which result in differences in value. In the result, the Committee is satisfied that the three products are not comparable for costing determinations. Consequently, natural gas condensate prices are not representative of fair market value for Pembina 3-28 and manufactured diluent.

46. The issue then becomes whether a fair market value can reasonably be determined for those products.

47. The uncontradicted evidence of Ian Walker is that the goal of Imperial's management of its diluent purchases was to obtain the overall lowest cost of diluent, and to maintain production from the Project. From time to time that required purchases of Pembina 3-28 and manufactured diluent. Additionally Mr. Walker’s uncontradicted evidence is that the price paid for those other products was what was necessary to attract those other products into the Project’s diluent pool. In periods of scarcity, pricing at the margin was higher. Each of the products had other markets which competed with the Project for acquisition of those products.

48. The Committee notes that it is not in the Crown’s interest if a method for determining costs results in higher costs or shut-in production, which may be the case if any incentive to use lower cost products or to purchase products to ensure production is removed. Not permitting cost recovery for the costs of different products, even if those products have a higher cost than the average of prices for an alternative, when the alternative is not available or has spiked in price, is a disincentive for efficient and economic management of diluent costs.

49. However, the difficulty that arises with respect to pricing these diluents for the purpose of the Regulation is that the purchases are from an affiliated company and none of the methods specified in section 7.3(1) are relevant for the determination of fair market value of the product as there was no evidence presented which would have allowed the Minister to utilize the methods specified in subsections (a) or (c), and (b) is not applicable as the Minister has not prescribed a price by regulation.

50. Essentially the evidence is that Imperial paid what was demanded to attract the other products to its diluent pool, which price would vary depending on the market circumstances. In the case of Pembina 3-28, a proxy was used for determination of the price, namely the
equalization scales approved by industry, the goal of which is to reflect market value for different products being shipped by pipeline. At least in that case there is an industry sanctioned methodology for determining the market value of the product.

51. In the case of manufactured diluent, prior to 2005, the price paid was the price which afforded the seller the same economic return as it could achieve using naphtha to manufacture other products. Implicit in the assertion is that the refinery would not sell the product to the Project unless that pricing was achieved, and therefore the test of a willing seller/willing buyer set out in section 9 of the Regulation is met.

52. However the price charged is dependent on the profit expectations and production costs of the affiliate and while those are components that might well be taken into account by sellers into a competitive market in setting the price at which a product will be sold, it does not in and of itself determine the fair market value of a product. The Committee is not satisfied that the prices charged prior to 2005 to the Project for manufactured diluent are sufficiently justified as an appropriate fair market value for manufactured diluent. However, based upon the evidence provided by Imperial, it is satisfied that industry has developed a methodology which is relied upon as a proxy for market value which is generally accepted and is analogous to the methodology recognized in section 7.3(1)(a) of the Regulation as an appropriate method for determining fair market value. That method was used to price Pembina 3-28 and Imperial proposed such pricing for manufactured diluent as a reasonable method for determining fair market value\(^{34}\) and it is the method that has for the most part been used since 2005 to calculate the price for sales of manufactured diluent to the Project\(^{35}\).

53. In reviewing this matter, the Committee also notes that Imperial described the payments that it was required to make as a premium price in order to attract the product to their Project for diluent use. The Committee is of the view that the intent of that description was not to suggest that it was appropriate to charge a premium over fair market value, which pursuant to the Regulation clearly is not permitted, but rather to indicate that in certain market conditions the product will attract a higher price.

54. The Committee notes that Alberta Energy has included equalization payments and charges in determining the costs, but those equalization payments and charges which flow to shippers as a result of shipping products of differing quality in a pipeline do not reflect the prices of the product purchased to ship into the pipeline. In the result, Alberta Energy’s

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\(^{34}\) Affidavit of Ian Walker, paragraph 72

\(^{35}\) Affidavit of Ian Walker, paragraph 73
calculation may reflect the value of the blended product as it comes out of the pipeline but not the costs of the individual products that enter the pipeline.

55. In summary, based upon the evidence provided to it, for the purpose of determining the cost of diluent to the Project, the Committee is satisfied that:

(a) Pembina 3-28 and manufactured diluent are not comparable to natural gas condensate, and consequently the weighted average cost of natural gas condensate is not the fair market value of the product; and
(b) industry has adopted a method for determining the market value of the products with differing qualities which is an appropriate method for determining fair market value of Pembina 3-28 and manufactured diluent.

56. The Committee therefore finds that a fair market value of Pembina 3-28 and manufactured diluent can be determined, using the equalization scales. However, the Committee does not accept Imperial’s submission that the fair market value of Pembina 3-28 can or should be calculated using either the natural gas condensate or crude oil scales whichever is higher. Given that the purpose of the exercise is to determine a value that will attract the product to the diluent pool, the Committee is of the view that the value must be such that the seller is indifferent as to whether the product is sold to the diluent pool or the crude oil pool and therefore the price should reflect crude oil values.

57. The Committee observes that it is not entirely clear from the material presented by the parties whether, with respect to the diluent costs charged to the Project, Imperial has provided information which permits calculation of the weighted average cost of each of the three diluents whenever it purchased any of those products in the course of a month. If the products are not comparable, but a fair market value can be determined for purchases of product from the affiliate, then the definition of cost of diluent requires the determination of a weighted average cost of purchases of each of the diluents for cost recovery. In the result, Imperial would not be allowed to recover cost of diluents other than natural gas condensate based on the weighted average cost of natural gas condensate because the products are not comparable.

58. In reviewing Mr. Walker’s evidence it appears to the Committee that Imperial has in fact sought to recover the higher of the natural gas condensate average price or the price of the other diluents calculated using the equalization scales. So, if the price of the other diluents, using the equalization scale is less than the natural gas condensate average price, Imperial uses the average natural gas condensate price. Under the regulation that is not permissible
as the recoverable costs are the lesser of the amount charged to the Project or the fair market value.\footnote{Section 7.2(1)(a)}

59. Additionally, the Committee is concerned that appropriate information be made available to Alberta Energy with respect to affiliate purchases which would allow a productive review of the calculations required for the determination of the allowed cost and which supports the decision to purchase. Alberta Energy has both a review and audit responsibility with respect to the costs claimed for the purpose of royalty calculation, and cannot properly carry out those responsibilities if information is not available to support the claim. With respect to the diluents, the claim is that the products from affiliated companies are only acquired when natural gas condensate spikes in price or is not otherwise available. In order to review or audit both the pricing and the circumstances of purchase, sufficient information has to be provided including purchase invoices from the affiliates, and information relied upon by Imperial for pricing of and availability of natural gas condensate. To the extent that that information has not been consistently kept or provided, and the Committee has no evidence on that matter, the Committee is of the view that it should be kept and provided.

60. The Committee points out that wherever purchases or sales of goods or services involve transactions between affiliated companies, and such purchases on their face appear to result in higher costs, there is a need for greater vigilance and transparency because there is no ability to test these transactions with a disinterested third party. Among the purposes of the Regulation was to introduce a transparent, equitable and consistent royalty regime in which both the Crown and owners of projects are treated consistently and fairly and are seen to be so treated. Transactions with affiliates are to be scrutinized with greater care. To do that requires availability of relevant information.

61. Finally the Committee notes that it has accepted as a proxy for fair market value the equalization scales used by industry to compensate shippers for the differences in quality of products delivered by pipeline in the absence of any evidence of third party market transactions involving the purchase of these products for diluent purposes. The Committee assumes for the purpose of this report that the timing of these purchases makes it unlikely that there is a robust and identifiable third party market for such transactions. That does not preclude a finding that there is a fair market value for such transactions, but such a finding may require the use of a proxy as the Committee has adopted in its recommendations. The goal is to approximate fair market value. If that can be established by reference to third party transactions, it is clearly preferable to the use of a proxy, and the Committee expects
that if there is any evidence of third party transactions involving purchases of either Pembina 3-28 or manufactured diluents for a similar purpose and at similar times that such information would be utilized for the determination of fair market value of the purchases of diluents from affiliates. However, the Committee has no such evidence.

The Committee recommends that the allowed cost of diluents for the project be calculated on the basis of the total cost of natural gas condensate diluent, plus the total cost of Pembina 3-28 and manufactured diluent, calculated in accordance with the definition of "cost of diluent" in the regulation, in any month where any of the three diluents are delivered to the Project, and that for the purpose of determining the weighted average cost of Pembina 3-28, and manufactured diluent, the equalization scales contained in The Equalization Procedures Guide be utilized. With respect to Pembina 3-28, the Committee recommends that the crude oil equalization scale be utilized.

The Committee recommends that to the extent that such information has not been kept or provided to Alberta Energy, Imperial be required to keep and provide to the Alberta Energy appropriate records of purchases from affiliates which specifically identifies the price, its method of calculation, and the timing of purchase, together with information respecting the market circumstances at the time of purchase, including the price and availability of natural gas condensate.

IV. HEAD OFFICE COSTS

A. The Dispute

62. Alberta Energy disallowed a variety of head office costs allocated to the Project on primarily two grounds: that the costs were not directly attributable to the project, and therefore did not qualify as an allowed cost under section 2 of Schedule 1, and/or the costs claimed were overhead costs, which are not allowed costs pursuant to section 3(a) of Schedule 1\(^37\).

\(^{37}\) Section 3(a) reads as follows: "A cost is not an allowed cost of a Project if it is in respect of overhead or an administrative expense, including internal audit, 'in-house' legal and other like expenses, of the operator, a Project owner or an affiliate of either, and is not allowed under section 2(e)(x) of this Schedule."
63. Alberta Energy's written submissions and oral argument assert in general terms that costs that have to be allocated by use of estimates and formulas are simply too remote to be considered directly attributable to the Project, relying on the meaning given to *directly attributable* through dictionary definitions and as interpreted by the Suncor Committee.\(^{38}\)

64. The costs disallowed were with respect to the Development Unit and Procurement, Controller, Human Resources, Safety Health & Environment, Gas Marketing and Treasurer Department costs.\(^ {39}\)

65. Cost disallowance fell generally into the following categories:
   (a) disallowance of costs of rent and IT services with respect to employees in the Development Unit, Safety, Health, and Environment, Human Resources, Gas Marketing, Procurement, and Controller Departments whose wages, salaries and benefits allocated to the Project had been allowed as an expense, on the basis that those costs are not directly attributable to the Project;\(^ {40}\)
   (b) disallowance of the entirety of costs claimed for certain cost centres and departments on the basis that those costs are not directly attributable to the Project or are overhead and not allowed under section 3(a) of Schedule 1 or because Alberta Energy was not satisfied that the allocation methodology reflected the requirement of directly attributable;\(^ {42}\) and
   (c) other miscellaneous reductions in cost, such as a reduction in allowed costs because of a removal of a cost centre but the costs had already been removed for the purpose of allocation.\(^ {43}\)

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\(^{38}\) At paragraph 47 of its submission the Department asserted that: “Upon review of the approved activities listed, it becomes increasingly clear that a direct connection to the activities is not met by a cost allocation of remote head office costs, let alone the close and distinct connection that the words ‘directly attributable to the Project’ require.”

\(^{39}\) Affidavit of Randy Gillis, Exhibit C

\(^{40}\) Alberta Energy Reply Submission, paragraph 48, Affidavit of Todd Wonderham, paragraphs 25, 32, 39, 43

\(^{41}\) Alberta Reply Submission, paragraph 57, Affidavit of Todd Wonderham, paragraphs 12, 26, 37, 44, 48, 50

\(^{42}\) Affidavit of Todd Wonderham, paragraphs 44, 48

\(^{43}\) The Committee was provided with an example of this which apparently occurred in both the Procurement and the Safety Health and Environment Departments. Imperial determined total costs to be allocated to a business unit based upon a cost centre by cost centre analysis of the Project usage of those cost centres. When the cost centre provided no services to the Project the project was allocated no costs of that centre. Imperial then determined the percentage of the total costs of the business unit that those allocated costs represented. Alberta Energy then audited and if the cost centre provided no services to the Project removed those costs. Imperial says that the allocation in the same percentage to all cost centers in the business unit was merely the application of a percentage calculated as described above. By removing costs that were only notionally but not actually allocated to the disputed cost centre, Alberta Energy failed to recognize that the allocation methodology utilized had not allocated any cost to the Project of that cost centre and consequently reduced the costs allowed below what the appropriate allocation methodology supported. This occurred in the Procurement Department for the year 2003 which is discussed in paragraphs 56 and 57 of the Gillis affidavit and in the Safety, Health and Environment Department which is discussed in paragraphs 34 and 35 of the Gillis affidavit.
66. Imperial submits that its allocation methodology is appropriate to measure the costs of providing necessary support services to the Project, which costs were expressly allowed pursuant to section 2(e)(x) of Schedule 1\44.

67. The detail of the disallowed costs is set out in the affidavit of Randy Gillis. In particular:
   (a) with respect to the Safety, Health and Environment Department costs, Alberta Energy disallowed all costs associated with certain cost centres and all costs except for salaries, wages and benefits for the Medical Services West Cost Centre (except all costs were allowed in 2001 and 2002), and the Industrial Hygiene West Cost Centre;
   (b) with respect to the Human Resources Department costs, in general terms Alberta Energy disallowed all Human Resources costs except for costs associated with the Payroll and Administration Cost Centres, and only allowed the costs of salaries, wages and benefits for those cost centres for the years 2003 and 2004\45;
   (c) with respect to the Controller Department costs, Alberta Energy disallowed all costs except for salaries, wages and benefits for any employees whose time spent on the Project was verified by time sheets\46;
   (d) with respect to the Purchasing/Procurement Department, Alberta Energy disallowed all costs except wages, salaries, and benefits associated with personnel allocated to the Project in various cost centres (except for the year 2001)\47;
   (e) with respect to the Treasurer Department costs, Alberta Energy disallowed all costs\48;
   (f) with respect to the Gas Marketing Department costs, Alberta Energy disallowed all costs except salaries, wages and benefits\49; and
   (g) with respect to the Development Unit costs, Alberta Energy disallowed floor space and information services, but allowed salaries, wages, benefits and specific project costs\50.

68. Imperial asserts that the disallowed costs were incurred to provide support services for the Project and the details of the services provided by the disallowed cost centres are set out in Mr. Gillis’ affidavit. It also provided further detail of the process that Imperial used to determine the level of costs allocated to the Project. While there are objective criteria used for the allocation of the costs (as described by Mr. Gillis) and in some cases a form of time

\44 Section 2(e)(x) reads as follows: "...a cost is an allowed cost of a Project only to the extent that it is incurred to...provide field, office, administrative or other services in relation to the activities described in subclauses (i) to (vi) and (ix)".
\45 Affidavit of Randy Gillis, paragraphs 37, 38
\46 Affidavit of Randy Gillis, paragraphs 43, 44
\47 Affidavit of Randy Gillis, paragraphs 49, 50
\48 Affidavit of Randy Gillis, paragraph 61
\49 Affidavit of Randy Gillis, paragraphs 67 and 68.
\50 Affidavit of Randy Gillis, paragraphs 72 and 73
sheet created by employees in certain cost centres which set out the amount of time spent on Project activities, judgment is utilized by cost centre managers as to how much of the resources of a particular cost centre will be used to serve the Project. Those determinations are reviewed through a budget process which involves examination by both the providers of the service and the business unit being allocated the services such as the Project. From Imperial’s description, each of the units being allocated costs is an individual profit centre within the corporation and is therefore motivated to ensure that only the costs of those services that it requires would be allocated to it. There are review and adjustments during the year if there are significant differences in service levels required.

69. With respect to Alberta Energy’s disallowance of costs, Imperial says firstly, that there is no reasonable basis to exclude the space and IT costs associated with personnel whose salaries, wages and benefits are allowed costs as those costs fit squarely within the provisions section 2(e)(x) of Schedule 1.

70. Secondly, Imperial asserts that to the extent that Alberta Energy has rejected costs because they were performed by a central business unit but allocated to the Project, this is too expansive an application of the overhead prohibition found in section 3(a) and too narrow an interpretation of “directly attributable”, as it ignores the direct relationship of the cost incurrence to the Project. All of the costs allocated relate to functions that provide necessary services to the Project and are specifically contemplated by section 2(e)(x). If the support services had to be provided through stand-alone facilities and staff, such costs would no doubt be greater and the Regulation ought not to be interpreted so as to create an incentive to increase costs.

71. Imperial also notes that Alberta Energy generally did not raise issues about the allocation formulas but only found that with respect to most of the disallowed costs there should not be any allocation of those costs to the Project. Alberta Energy did reject certain costs because they were not supported by time sheets, but that is not a process used by Imperial, and all such costs were subject to the scrutiny of experienced managers, who are in the best position to assess what services are required and what work will be done in the cost centres and for what purpose.

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51 The time sheets were not in the form of a daily record but were essentially an estimate by employees of time devoted to various activities

52 Imperial Submissions, paragraphs 68-71
B. The Committee’s Recommendations

72. The issue raised by the dispute respecting the allocation of head office expense is how one determines which overhead costs are allowed costs and which such costs are not allowed. In general terms all of the costs claimed are overhead costs, but the definition of overhead provides no assistance in the determination of this issue, as Schedule 1 specifically contemplates that certain types of overhead are recoverable and others are not. Overhead is a cost that can be directly attributable to the Project if it is a cost described in section 2(e)(x).53

73. There is no doubt that some support services that are required for the operation of the Project and therefore meet the directly attributable test, are provided to the Project through Imperial Oil Limited’s head office, which services various chemical, upstream and downstream activities including the Project.

74. There is further no doubt that Alberta Energy has allowed some of those costs as, in its opinion, such costs meet the criteria set out in section 2 of Schedule 1 and in so doing it has accepted that the necessity to allocate does not automatically exclude a determination that those costs are allowed under the Regulation.

75. To that extent, Imperial overstates the position of Alberta Energy in asserting that it rejects costs incurred through a central business unit model as meeting the criteria in section 2 of Schedule 1.

76. However, Alberta Energy has disallowed a substantial amount of head office costs on the basis that they are not directly attributable to the project and/or are overhead costs within the meaning of section 3(a), and not saved by the application of section 2(e)(x). Alberta Energy says that these are indirect costs sufficiently removed from the activities of the Project to exclude them from meeting the test of “directly attributable” and that Imperial has over-reached in seeking to have certain costs found to be allowed under the royalty regime.

77. This dispute necessarily involves an examination of the relationship between section 2(e)(x) and 3(a) of Schedule 1. As noted in the Suncor Committee Report, not all costs that might in some fashion be related to a project are allowed costs for the purpose of royalty

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53 This is consistent with the definition of direct cost in Black’s Law Dictionary, 9th ed., which defines such costs as “The amount of money for material, labor and overhead to produce a product”.

calculation under the Regulation. The Regulation is designed to balance the interests of the resource owner and the resource developer.

78. Both parties recognize this principle but were unable to provide more than very general observations as to where the proper balance should be struck in considering what head office costs should be considered allowed costs, although both agree that some meaning has to be given to section 3(a) of Schedule 1. In that context Imperial pointed out that it had not submitted as allowed costs all of the costs it internally allocated to the Project and that its approach struck the proper balance. Alberta Energy submits that the fact that central office costs can be allocated to the Project does not mean that they should be, as all such costs must meet all of the criteria in section 2 of Schedule 1 to be considered allowed costs for the purpose of the royalty regime.

79. It is difficult to set out general principles with respect to the inter-relationship between section 2(e)(x) and 3(a) of Schedule 1 because determinations as to whether costs are excluded or included overhead for the purpose of determining whether they are allowed costs of necessity are very much fact driven.

80. However, as a general principle, the activities set out in section 2(e) of Schedule 1 and the nature of the Project as described in the Project Approval Order, define the components necessary to carry out those activities and the support services required for those components. The costs of those components and the support services necessary for those components would in general terms be considered as allowed costs. This is confirmed by reference to the Illustrative Table at the end of the Schedules to the Regulation. The Table contains not only examples of the kinds of costs that might be recovered, but also gives some direction with respect to the allocation of overhead costs that is of some use in considering allocation of central office costs for overhead directly contemplated as an allowed cost in section 2(e)(x), using as an analogy the Table’s treatment of costs related to plant construction. In particular, the Table allows an allocation of plant overhead costs in connection with construction of a plant where costs cannot be conveniently identified with a specific plant, but precludes allocation of administrative and other costs that cannot be conveniently identified with plant construction. Similarly, a proper reading of section 2(e)(x) and 3(a) would exclude as an allowed cost one that could not be conveniently identified with the operation of the Project.

54 Imperial submission, paragraphs 78, 79 and 93. The departments for which no allocation of head office costs has been claimed as an allowed cost are Law, Public Affairs, Tax and Audit.
81. Consequently, the fact that some support services are provided through a central business model does not exclude them from the category of allowed costs nor is that the position of Alberta Energy. But not all of the head office costs could be conveniently identified with or directly related to the operation of the Project, nor does Imperial take that position. The question to be asked is: when the functions of the central cost centre being allocated are analyzed, do they primarily relate to support services to various different operational activities including the Project, which, for the purpose of cost and efficiency, are delivered through a central office, or are they cost centres which are primarily serving corporate interests, but whose level of activity may be driven in part by the facility operations. In the former case, the costs would in general terms be costs contemplated by section 2(e), while in the latter case they may be excluded by section 3(a).

82. The determination then required is whether the cost being allocated relates to required support services for the Project which can be allocated on a reasonable basis to the Project or whether it relates to an corporate overhead or expense which may indirectly relate to or be required in part because of the Project but which is not directly related to the activities set out in section 2(e) and therefore ought not to be allocated by any method to the Project. This distinction may be expressed in simpler terms: does the Project need the support service to produce the product, or does the corporation providing the head office services require the services in part because of the Project.

83. With respect to the latter matter of excluded overhead, the only specific guidance available in the Regulation is the criteria set out in section 2 of the Schedule, and in particular subsections (a) and (e) and the examples contained in 3(a).

84. In section 3(a), both in-house legal and audit departments are excluded. While the level of these services and the resulting cost may be driven in part by activities of various operational facilities owned by the corporation and its subsidiaries, these services are services to the corporation and ultimately for the benefit of the corporation. By including those two departments as examples, the legislation is providing guidance as to its intent.

85. Even if cost centres provide support services, the costs of which are properly allocable to the Project, there still may be questions respecting the method of allocating the costs. For the most part there has been no detailed review of the allocation methodology utilized by Imperial because Alberta Energy concluded that the costs involved were not directly attributable to the Project. It is not clear on what basis Alberta Energy concluded that such costs were not directly attributable other than the fact that they had to be allocated. However, it appears that the examination of head office costs requires a two part analysis:
the first step is the analysis set out in the preceding paragraph, that is, is the service one in relation to the activities set out in section 2(e) of the schedule; the second step is to determine if the costs are properly allocated so that only costs directly attributable to the Project are claimed.

86. While for the most part there does not appear to have been any analysis of allocation methodology as noted above, the one notable exception relates to the allocation of Treasurer Department costs. Alberta Energy appears to have taken some issue with the allocation methodology in that case and noted that Imperial provided no additional backup for the allocation calculation other than the formula 55.

87. Having regard to these principles and turning to the disallowed costs, some of the disputed costs are easier to assess than others.

88. The Committee is satisfied that at least two general groups of disallowed costs meet the criteria in section 2 of Schedule 1.

89. Firstly, the Committee is of the view that given the wording of both section 2(e)(x) of Schedule 1 and item (c) of the Table of the Regulation, certain of the costs that the Department has disallowed are costs that meet the criteria in section 2 of Schedule 1.

90. These costs are in relation to support services provided by the Human Resources, Gas Marketing, Procurement, Safety Health and Environment, the Development Unit and Controller Departments, where in some years Alberta Energy has allowed the costs of wages, salaries and benefits of personnel allocated to the operation of the Project but not allowed any other costs related to such personnel. The basis for the denial was that these were overhead costs and excluded as allowed costs by section 3(a).

91. Defining a cost as overhead does not determine whether is allowed or not allowed. Rather it is necessary to determine what the overhead is for.

92. In the case of the disallowed costs in the categories described in paragraph 90 above, those costs were support services for Project activities as listed in section 2(e) of Schedule 1 and therefore are allowed costs under section 2(e)(x). Consequently, the Committee is of the view that Alberta Energy either failed to apply section 2(e)(x) at all or interpreted it too narrowly.

55 Affidavit of Todd Wonderham, paragraph 44
93. Secondly, to the extent that Alberta Energy reduced the amount approved as allowed costs for a particular department based upon a misunderstanding as to how Imperial calculated the total costs, such as may have occurred in the Procurement and Safety Health and Environment Departments in one of the audit years, the Committee is satisfied that the total costs allocated to the Project, that were otherwise acceptable to Alberta Energy, did not include an allocation of any costs from cost centres which were clearly not providing any service to the Project. But by removing costs that were notionally allocated with respect to such cost centres\(^{56}\), Alberta Energy effectively reduced the allowed costs to less than what was reasonably allocated to the Project.

94. The remaining disputed amounts require further analysis. In some cases the information provided is sufficient to reach a conclusion with respect to the appropriate treatment of the cost. In other cases it is not. While all of the criteria in section 2 of Schedule 1 must be satisfied for a cost to be an allowed cost, it is clear that in the case of the disallowance of head office costs two of the criteria are of primary importance: that the cost must be incurred with respect to one of the activities listed in section 2(e) and, that the costs must be directly attributable to the project. There is an inter-relationship between these two criteria. With respect to the “incurred for” test, the costs claimed must be for functions necessary for the activities listed in section 2(e). With respect to the “directly attributable” test, the method of allocating costs provided through cost centers that provide services to many units must be one that fairly determines the portion of the costs for which the Project is responsible.

95. Costs were disallowed in six departments. Of those departments Alberta Energy disallowed all of the costs allocated to the Project from one department, Treasurer, and with respect to four other departments, Alberta Energy disallowed all or a portion of costs allocated from various cost centres in addition to the support costs for personnel clearly providing services required for the Project and discussed in paragraphs 90-92 above. With respect to the Gas Marketing Department, the disallowed costs were those dealt with in paragraphs 90-92. There are therefore four departments where costs were disallowed in addition to the support costs for personnel involved directly in providing services to the Project.

96. With respect to some of those departments and cost centres, there is a clear prima facie connection to the Project in that the cost centres and services provided are required by the Project in order to carry out the activities listed in section 2(e). In other cases the

\(^{56}\) Notionally in the sense described in footnote 43 – using the % of total department costs which were allocated to the Project and applying that percentage to all of the costs in each individual cost centre.
connection is not as clear as Imperial asserts. In particular, it is necessary to distinguish between services that are necessary to carry out the section 2(e) activities and services that may be useful to the Project but not required to support those activities. In is further necessary to distinguish between those cost centres and departments which provide services to the Project, and those departments and cost centres, where one of the drivers of the level of cost may be the operational activities of the parent corporation, including the Project, but the services are not support services for the activities listed in section 2(e).

97. The Committee has considered each of the five departments where there were disallowances of costs in addition to disallowances discussed in paragraphs 90-92.

98. Turning first to the Treasurer Department, all costs allocated to the Project from the Treasurer’s department were disallowed. This disallowance appears to be related to both the allocation method utilized and the nature of the Treasurer Department. Implicitly, Alberta Energy appears to be of the view that this department is akin to internal audit and in-house legal departments which were the examples of departments in section 3(a) for which costs would not be allowed and further that the costs are not incurred with respect to any of the activities in section 2(e).

99. The activities in the Treasurer Department which were allocated to the Project were described by Mr. Gillis as Pension Services, Insurance Services, Corporate Finance, Cash Operations, and Credit Management Services. As described by Mr. Gillis, at least some of the services appear to be operational support in function and would be support services required in connection with the Project such as Pension Services, Insurance Services, and Credit Management. However some of the functions included in the descriptions of the cost centres appear to include functions within the cost centre that are corporate in nature, including Corporate Finance, and Cash Operations. Nevertheless it appears that all of the Imperial Oil Limited’s costs from the cost centres are allocated to operational activities including the Project.

100. In order to determine whether the costs allocated to the Project from the Treasurer's Department are allowed costs, further information would be required which provides greater detail with respect to what the costs are incurred for and whether any of Treasurer Department’s costs are excluded from allocation.

101. There are other difficulties with the allocation of Treasurer Department costs. Alberta Energy raises a general concern about the allocation formula. The Committee, having
reviewed the allocation formula described by Mr. Gillis\(^7\) has reservations about the robustness of the methodology proposed to allocate Treasurer Department costs to the Project, even if some of those costs appear to have a clear and direct connection to the activities required for the Project.

102. Imperial's allocation involves three steps:

(a) first, the total costs are divided between ExxonMobil Canada ("EMC") and Imperial Oil Limited (parent company of Imperial) based on the percentage of costs of each of them, for all cost centres, except Corporate Finance, where the allocation is based on the effort and resources each provided. There is no more detail with respect to how the costs are determined for the purpose of the allocation between the two;

(b) then Imperial Oil Limited's share of the costs is allocated to upstream, downstream, and chemical functions in accordance with different allocation methods. In the case of Pension Services and Insurance Services (both of which *prima facie* may provide services the costs of which may be an allowed cost under the Regulation) and Corporate Finance, the allocation is made using a formula that "reflects the key drivers and business activities in each of these lines" and involves "a calculation of the percentage of capital expenditure, operating expenses and production volumes that each business segment has as compared to the whole"\(^8\) (the "Allocation Formula"). With respect to the other two cost centres, Cash Operations is allocated to upstream, downstream and chemical based upon their share of cash requirements, and there is no description of how Credit Management is allocated between those three functions; and

(c) the upstream costs are then allocated to the Project\(^9\)

- with respect to Pension Services, on the Project's proportion of the total workforce;
- with respect to Insurance Services and Cash Operations using the Allocation Formula which permits an allocation based on the Project's relative size compared to total upstream size;
- with respect to Credit Management based on credit management's assessment of the work effort expended on Cold Lake Business;
- with respect to Corporate finance no method of allocation is described.

103. The Committee shares Alberta Energy's view that the above described allocation methodology does not on its face demonstrate that costs resulting from the use of that

\(^7\) Affidavit of Randy Gillis, paragraph 62(a).
\(^8\) Affidavit of Randy Gillis, paragraph 62(a)
\(^9\) Affidavit of Randy Gillis, paragraph 62
methodology are directly attributable to the Project and thus qualify as allowed costs under the Regulation.

104. For example while Pension Services may be a necessary service with respect to the Project’s workforce, the allocation of head office costs between Imperial Oil Limited’s chemical, upstream and downstream activities is not based on workforce counts, unlike the upstream allocation to the Project. There is no explanation of what the key drivers and business activities in each of these lines are and why those key drivers and business activities and the Allocation Formula are a reasonable allocator for these costs. Therefore while a portion of Pension service costs may be incurred to provide support services to the Project, there is insufficient evidence upon which to determine whether the Imperial allocation is reasonable.

105. A similar observation may be made about the allocation of Insurance Service costs. Costs are first allocated between EMC and Imperial Oil Limited based on the percentage of insurance costs attributable to each. Then the Allocation Formula is used to both allocate between upstream, downstream and chemical business units, and to further allocate the allocated upstream costs to the Project. There is no evidence as to why this allocation method results in an allocation of only those costs that are directly attributable to the Project.

106. The allocation process as described in the evidence before the Committee is too vague to enable the Committee to determine whether it is fair and reasonable and whether it results in the allocation of costs actually incurred and allowable under section 2.

107. In the result the Committee is not persuaded that Alberta Energy was wrong in disallowing the costs of the Treasurer Department and concludes that more and better information as to the actual activities of the various cost centres and a better justification of the allocation methodology is required before the costs can be treated as allowed costs under the Regulation.

108. Turning to the Procurement Department, in addition to disallowing the costs of support services for personnel in various cost centres which were acknowledged by the Department to be providing services to the Project, which costs were dealt with in paragraphs 90-92, Alberta Energy also disallowed the entirety of the costs claimed with respect to two cost centres – Business Services and Operations Excellence.
109. These services are described by Mr. Gillis in his affidavit\textsuperscript{60} and he states that those groups "perform work that is required within the Procurement Department as part of the support for Cold Lake"\textsuperscript{61}.

110. In the Committee’s view it is not the requirements of the Procurement Department which determine whether costs are directly attributable. It is the activities of the Project. The Committee agrees that the services of the two groups in issue may be useful for the Project and its owner (and even perhaps in the longer term the Crown) but there is no evidence that they are required in connection with any of the activities listed in section 2(e).

111. Turning to the Controller Department, Alberta Energy has only allowed costs based upon time sheets later created to reflect employee time specifically devoted to the Project and disallowed all other costs of the Controller Department allocated to the Project. It is not clear from the material provided which of the cost centres included within the Controller Department provided the time sheets. However, it is clear from the limited acceptance of time sheets that Alberta Energy accepts that work in one or more of the cost centres supports an activity listed in section 2(e).

112. While time sheets provide some documentation, they are no more than an individual’s recollection of time spent and are not inherently more reliable than an analysis by management of the work that has to be done for the Project. The issue is not whether individuals are recording time to the Project, but whether work is required for the Project. If work is required in relation to one of the activities listed in section 2(e), and the cost centre is providing the work, it is an allowed cost.

113. To determine that issue, time sheets may be useful but are not determinative. What is determinative is what the cost centres are in fact doing. Mr. Gillis describes what those centres are doing in his affidavit\textsuperscript{62}.

114. From those descriptions it appears that Operations Support (Cold Lake), Operations Support (Fixed Assets), and Operations Support (Project Accounting) are providing services that support activities listed in section 2(e) and that the allocation methodology is based on the work done for the Project as a percentage of the total group work. \textit{Prima facie} those costs appear to be allowed costs, and there is no contrary evidence.

\textsuperscript{60} Affidavit of Randy Gillis, paragraph 51(c) and (g)
\textsuperscript{61} Affidavit of Randy Gillis, paragraph 59
\textsuperscript{62} Affidavit of Randy Gillis, paragraph 45
115. With respect to Revenue and Royalty Accounting, Process and Controls, Financial Reporting, and Upstream Business Services Administration, the direct connection to the Project is not as clear. While those activities may be necessary for the Project as a part of the Imperial Oil Limited family, and for other corporate purposes, it is not readily apparent that they relate to the activities listed in section 2(e).

116. Turning to the Safety Health and Environment Department, in addition to the costs of support services for personnel for whom Alberta Energy accepted as allowed costs salaries, wages and benefits dealt with paragraphs 90-92 of this Report, Alberta Energy disallowed:
   (a) for 2001 and 2002, all of the costs allocated to the Industrial Hygiene Unit (notwithstanding that in the year 2003 and 2004 it accepted as allowed costs the salaries wages and benefits associated with Industrial Hygiene West, which was one of two cost centers created when Industrial Hygiene was split into two units);
   (b) all of the costs associated with the Business and Support cost centre; and
   (c) all of the costs associated with the Security Management cost centre.

117. Imperial provided evidence of the functions of those cost centres and method of allocating their costs to the Project63.

118. The Committee has reviewed the description of the functions of the cost centres and is satisfied that those functions are directly attributable to the activities of the Project.

119. The Committee also notes that no specific complaint was raised about the method of allocation by Alberta Energy, which simply disallowed the costs because they were allocated. The allocation methods described appear to be reasonable and in the absence of the identification of specific concerns, the Committee has no basis to question the methodology used to allocate the Safety Health and Environment Department costs to the Project.

120. Finally turning to the Human Resources Department, the only costs that Alberta Energy allowed were, for the years 2001 and 2002, all Payroll Administration costs and for 2003 and 2004, only the salaries, wages and benefits for personnel in the Payroll Administration cost centre.

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63 Affidavit of Randy Gillis, paragraphs 31 and 32
121. All other costs were disallowed including all costs of the Diversity and Recruitment, Benefits, Policy & Annuitant, UBS Human Resources, Executive Development & Compensation, Downstream and Corporate Advisory Services, Advertising, Marketing, Mocan, Management and HR Recruitment and Projects. The costs were disallowed on the basis that such costs were not directly attributable to the Project.

122. Imperial provided evidence respecting the functions carried out by those cost centres and the method of allocating costs from those cost centers to the Project\textsuperscript{64} and asserted that those functions were "\textit{essential to the proper and effective staffing of the Cold Lake Project operations}"\textsuperscript{65} and consequently are directly attributable to the project.

123. The Committee has reviewed the description of the cost centres provided by Imperial and is satisfied, subject to the exceptions noted in the next paragraph, that the cost centres in the Human Resources Department for which costs have been disallowed provide functions which are required for the Project and the methodology used to allocate those costs is reasonable for the purpose of ensuring that only costs directly attributable to the Project are allocated to the Project.

124. However, the Committee is not satisfied that sufficient information has been provided to conclude that the functions in the Downstream and Corporate Advisory cost centre, the Projects cost centre and the Management and HR Recruitment cost centre are functions that meet the "\textit{incurred for test}" or that the allocation methodology for those cost centers allocates only costs that are "\textit{directly attributable}" to the Project.

The Committee recommends as follows

1. The costs of providing support services to persons who have been accepted by Alberta Energy as providing services to the Project and whose salaries, wages and benefits have been determined to be allowed costs be treated as allowed costs for the purpose of the royalty regime.

2. Costs notionally but not actually allocated to cost centres which have been disallowed by Alberta Energy be allowed to the extent that the total costs allocated do not include any costs for cost centres or activities which are not related to the Project.

3. Unless further detailed information satisfactory to Alberta Energy is provided with respect to how all of the functions included within the cost centres in the Treasurer

\textsuperscript{64} Affidavit of Randy Gillis, paragraphs 39 and 40
\textsuperscript{65} Affidavit of Randy Gillis, paragraph 41
Department for which recovery is claimed relate to the activities set out in section 2(e) of Schedule 1, that no Treasurer Department costs should be allowed, and further recommends that the allocation methodology utilized by Imperial be rejected on the grounds that it does not provide a reliable basis for determining costs directly attributable to the Project.

4. The costs of the Business Services and Operations Excellence cost centres of the Procurement department be disallowed.

5. The costs of Operations Support (Cold Lake), Operations Support (Fixed Assets), and Operations Support (Project Accounting) allocated to the Project be treated as allowed costs.

6. Unless further detailed information satisfactory to Alberta Energy is provided with respect to how all of the functions included within the Revenue and Royalty Accounting, Process and Controls, Financial Reporting, and Upstream Business Services Administration cost centres of the Controller Department for which recovery is claimed relate to the activities set out in section 2(e) of Schedule 1, that no such costs should be allowed.

7. All of the costs claimed with respect to the Safety Health and Environment Department be treated as allowed costs.

8. The costs claimed with respect to the Diversity and Recruitment, Benefits, Policy & Annuity, UBS Human Resources, and Advertising, Marketing & Mocan cost centres of the Human Resources Department be treated as allowed costs.

9. Unless further detailed information satisfactory to Alberta Energy is provided with respect to how all of the functions included within the Downstream and Corporate Advisory cost centre, the Projects cost centre and the Management and HR Recruitment cost centre of the Human Resources Department for which recovery is claimed relate to the activities set out in section 2(e) of Schedule 1 and which demonstrates that the allocation methodology allocates only costs directly attributable to the Project, all costs of those cost centres be disallowed.

V. OTHER COSTS

125. Alberta Energy disallowed the certain other costs claimed by Imperial as allowed costs, namely:
(a) EUB administration and orphan well levies;
(b) costs related to certain employee recognition events and service awards; and
(c) costs of membership in the Lakeland Industry and Community Association.
126. With respect to the EUB Administration Fees and Orphan Well Levies, Imperial’s position is that “the fees and levies are imposed based upon IOR’s Cold Lake Project licenses and wells and are therefore just as ‘directly attributable to the Project’ and just as necessary to maintain the licenses which allow IOR to ‘recover oil sands’ as are the guideline examples of costs which are allowed”\(^{66}\).

127. The rationale advanced by Imperial is that the fees are calculated by reference to the Project, and that failure to pay them can result in suspension or cancellation of approvals and permits.

128. The Committee is not satisfied that these fees meet the criteria set out in section 2(e) of Schedule 1. They are not incurred to obtain project approval so are not within the class of fees and expenses found by the Suncor Committee to qualify as allowed costs.

129. Further, the fact that the level of the fee is calculated by reference to the operations of the payer does not make the fee one incurred to carry out the Project’s activities or directly attributable to the Project.

130. The Committee is of the view, having reviewed Exhibits 41 and 43 to Mr. Walker’s affidavit, that these fees are administrative fees attributable to being in business, represents its share of the costs of the regulatory system, and are not directly attributable to any project.

131. With respect to the employee recognition and service award costs the Committee is of the view that these costs were exactly the kind of costs that the Suncor Committee found recoverable in its report.

132. With respect to the Lakeland membership, the material provided in the supplementary affidavit of Ian Walker makes it clear that the membership in that organization is a condition of the Amending Approval dated July 30, 2004\(^{67}\) and prior to that time could reasonably be viewed as an expectation of the EUB\(^{68}\).

133. The Committee is of the view that these costs are allowed costs in accordance with the principles set out in the Suncor Committee Report. The Committee notes that

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\(^{66}\) Imperial submission, paragraph 201
\(^{67}\) Exhibit A
\(^{68}\) Exhibits 47 and 48 to Affidavit of Ian Walker, November 25, 2011
Alberta Energy acknowledged at the hearing that the costs of environmental monitoring by Lakeland which were paid by Imperial were allowed costs.

The Committee recommends that the EUB administration fees and orphan wells levy be disallowed.

The Committee recommends that employee recognition and service awards and costs of membership in the Lakeland Industry and Community Association be treated as allowed costs.

VI. CONCLUSION

134. In conclusion the Committee makes the following recommendations to the Minister:

(a) The Committee recommends that the amount for marketing services for the sale of blended bitumen and the purchase of diluent, whether the sales or purchases are with affiliated or non-affiliated entities be accepted as an allowed cost of the Project.

(b) The Committee recommends that the allowed cost of diluents for the project be calculated on the basis of the total cost of natural gas condensate diluent, plus the total cost of Pembina 3-28 and manufactured diluent, calculated in accordance with the definition of “cost of diluent” in the regulation, in any month where any of the three diluents are delivered to the Project, and that for the purpose of determining the weighted average cost of Pembina 3-28, and manufactured diluent, the equalization scales contained in The Equalization Procedures Guide be utilized. With respect to Pembina 3-28, the Committee recommends that the crude oil equalization scale be utilized.

(c) The Committee recommends that to the extent that such information has not been kept or provided to Alberta Energy, Imperial be required to keep and provide to Alberta Energy appropriate records of purchases from affiliates which specifically identifies the price, its method of calculation, and the timing of purchase, together with information respecting the market circumstances at the time of purchase, including the price and availability of natural gas condensate.

(d) The Committee recommends that the costs of providing support services to persons who have been accepted by Alberta Energy as providing services to the
Project and whose salaries, wages and benefits have been determined to be allowed costs be treated as allowed costs for the purpose of the royalty regime.

(e) The Committee recommends that costs notionally but not actually allocated to cost centres which have been disallowed by Alberta Energy be allowed to the extent that the total costs allocated do not include any costs for cost centres or activities which are not related to the Project.

(f) The Committee recommends that unless further detailed information satisfactory to Alberta Energy is provided with respect to how all of the functions included within the cost centres in the Treasurer Department for which recovery is claimed relate to the activities set out in section 2(e) of Schedule 1, that no Treasurer Department costs should be allowed, and further recommends that the allocation methodology utilized by Imperial be rejected on the grounds that it does not provide a reliable basis for determining costs directly attributable to the Project.

(g) The Committee recommends the costs of the Business Services and Operations Excellence cost centres of the Procurement Department be disallowed.

(h) The Committee recommends that the costs of Operations Support (Cold Lake), Operations Support (Fixed Assets), and Operations Support (Project Accounting) allocated to the Project be treated as allowed costs.

(i) The Committee recommends that unless further detailed information satisfactory to Alberta Energy is provided with respect to how all of the functions included within the Revenue and Royalty Accounting, Process and Controls, Financial Reporting, and Upstream Business Services Administration cost centres of the Controller Department for which recovery is claimed relate to the activities set out in section 2(e) of Schedule 1, that no such costs should be allowed.

(j) The Committee recommends that all of the costs claimed with respect to the Safety Health and Environment Department be treated as allowed costs.

(k) The Committee recommends that the costs claimed with respect to the Diversity and Recruitment, Benefits, Policy & Annuitant, UBS Human Resources, and Advertising, Marketing, and Mocan cost centres of the Human Resources Department be treated as allowed costs.

(l) The Committee recommends that unless further detailed information satisfactory to Alberta Energy is provided with respect to how all of the functions included within the Downstream and Corporate Advisory cost centre, the Projects cost centre and the Management and HR Recruitment cost centre of the Human Resources Department for which recovery is claimed relate to the activities set out in section 2(e) of Schedule 1 and which demonstrates that the allocation methodology allocates only costs directly attributable to the Project, all costs of those cost centres be disallowed.
(m) The Committee recommends that the EUB administration fees and orphan wells levy be disallowed.

(n) The Committee recommends that employee recognition and service awards and costs of membership in the Lakeland Industry and Community Association be treated as allowed costs.

All of which is respectfully submitted this 30th day of March, 2012.

Phyllis Smith, Q.C. Chair

Peter Taschuk, Q.C.

James McCartney
methodology allocates only costs directly attributable to the Project, all costs of those cost centres be disallowed.

(m) The Committee recommends that the EUB administration fees and orphan wells levy be disallowed.

(n) The Committee recommends that employee recognition and service awards and costs of membership in the Lakeland Industry and Community Association be treated as allowed costs.

All of which is respectfully submitted this ____ day of __________, 2012.

Phyllis Smith, Q.C. Chair

Peter Taschuk, Q.C.

James McCartney
(m) The Committee recommends that the EUB administration fees and orphan wells levy be disallowed.

(n) The Committee recommends that employee recognition and service awards and costs of membership in the Lakeland Industry and Community Association be treated as allowed costs.

All of which is respectfully submitted this _____day of __________, 2012.

______________________________
Phyllis Smith, Q.C. Chair

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Peter Taschuk, Q.C.

______________________________
James McCartney
GOVERNMENT OF ALBERTA

DEPARTMENT OF ENERGY

MINISTERIAL ORDER 97/2012

I, KEN HUGHES, Minister of Energy, pursuant to section 10(2) of the Oil Sands Dispute Resolution Regulation (AR 247/2007), section 35 of the Oil Sands Royalty Regulation, 1997 (185/97) and sections 8(3) and 39 of the Mines and Minerals Act, R.S.A. 2000, c. M-17, make the Order in the attached Appendix, being the Imperial Oil Sands Dispute Review Committee Decision Order.

DATED the 31 day of October, 2012.

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Minister of Energy
APPENDIX

IMPERIAL OIL SANDS DISPUTE REVIEW COMMITTEE DECISION ORDER

1. The recommendations in paragraph 134 of the Imperial Oil Sands Dispute Review Committee (the “Committee”), established by Ministerial Order 84/2011 pursuant to the Oil Sands Dispute Resolution Regulation to hear matters in dispute under the Oil Sands Royalty Regulation, 1997 between the Department of Energy (the “Department”) and Imperial Oil Resources (“Imperial”) concerning the Department’s royalty audit assessments for the Imperial Cold Lake Production Project approved pursuant to Project Approval Order No. OSR037 (production years 2001, 2002, 2003 & 2004), as provided in the Committee’s report dated March 30, 2012 (the “Report”) are accepted, unless otherwise varied or rejected herein.

2. The recommendations regarding diluent costs are varied:

2.1 by adding the following after paragraph 134(a):

(a.1) If evidence, satisfactory to Alberta Energy, of sufficient third party transactions exists involving either Pembina 3-28 light crude oil or Strathcona manufactured diluents for a similar purpose and at similar times, that information shall be utilized for the determination of fair market value of the diluents from affiliates.

2.2 by repealing paragraph 134(b) and substituting the following:

(b) The Committee recommends that the “cost of diluent” for the project be calculated in accordance with the definition in the Regulation and includes the cost of natural gas condensate diluent purchased from third parties; plus the cost of Pembina 3-28 light crude oil; plus the cost of Strathcona manufactured diluent in any month where any of the three diluents are delivered to the Project; plus any adjustments shown on invoices provided by Imperial, such adjustments being calculated in accordance with the condensate equalization scales contained in the Equalization Procedures Guide; plus applicable tariffs. Where there is an absence of satisfactory evidence of sufficient third party transactions for Pembina 3-28 light crude oil, the published par price of light or non-heavy oil will be utilized for determining the cost of Pembina 3-28 light crude oil. Where there is an absence of satisfactory evidence of sufficient third party transactions for Strathcona manufactured diluent, the posted Enbridge condensate allowance price will be utilized to determine the cost of Strathcona manufactured diluent.
3. The recommendations regarding head office costs are varied in paragraph 134(d) by adding ", subject to the regulation," after "The Committee recommends that".

4. Further to paragraphs 134(f), (i) and (l) of the Report, Imperial shall submit any detailed information within 60 days of the date of this Order, or such other period of time as agreed to by the parties.

5. The Department shall review any detailed information submitted by Imperial under paragraph 4 of this Appendix and issue a decision to Imperial and the Department’s Director of Dispute Resolution with respect to each cost centre or allocation methodology, as the case may be, described in paragraphs 134(f), (i) and (l) of the Report within 120 days of the date of this Order, or such other period of time as agreed to by the parties.

6. If Imperial does not submit the detailed information referred to in paragraph 4 of this Appendix within the stated or agreed to period of time, the Department shall disallow the costs or reject the allocation methodologies, as the case may be, described in paragraphs 134(f), (i) and (l).

7. Imperial may appeal a decision made by the Department under paragraph 5 of this Appendix to the Director of Dispute Resolution. The appeal must be made in writing and received by the Director of Dispute Resolution within 7 days of the date of the decision.

8. The Director of Dispute Resolution, upon receiving an appeal request under paragraph 7 of this Appendix, shall conduct the appeal and make a final decision within 45 days of receiving the request, or such other period of time as agreed to by the parties.

9. Further to the Committee’s Report, the Department shall issue guidelines on support services provided through a central business model for which the costs may or may not be considered an allowed cost under the Oil Sands Royalty Regulation, 1997.

10. At the conclusion of an appeal, if any, conducted under paragraph 8 of this Appendix, the Department shall make recalculation under section 39(2) of the Mines and Minerals Act in respect to cost decisions made under this Appendix, as applicable.

11. Cost decisions made under this Appendix are final and may not be further appealed.