



**Date: January 1, 2009**

**INFORMATION LETTER #2009-01**

**SUBJECT: Net Profit Royalty Projects**

To: Industry Stakeholders

The net profit royalty for a producer with an interest in a net profit royalty project is comprised of:

- (a) a lower rate applied during the early years of project operation to allow for recovery of the producer's initial investment costs, and
- (b) a higher rate to be applied during the later years of project operation once payout of the producer's initial investment has been achieved.

This Information Letter illustrates the calculation of the major components of the Net Profit Royalty. This letter is for information purposes only, does not constitute legal advice and does not limit or vary anything in the Petroleum and Natural Gas Act, any regulation enacted under the authority of that Act, or any Order or other decision of the Administrator.

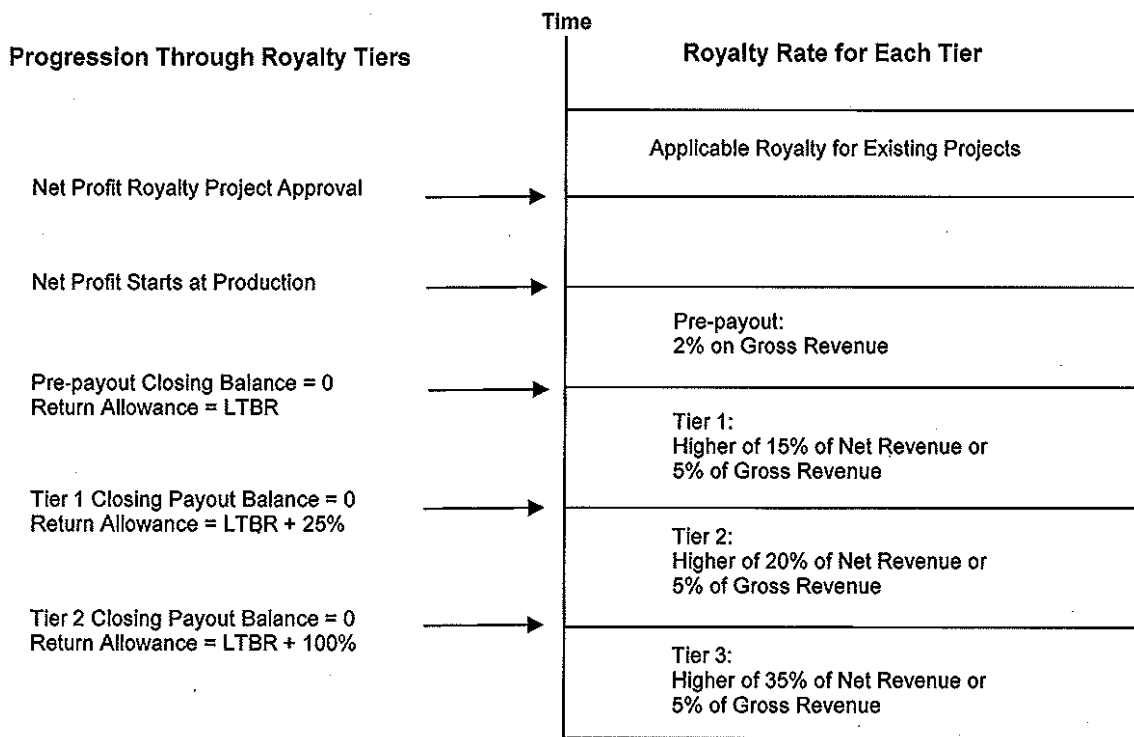
Any questions relating to the Net Profit Royalty can be directed to Ines Piccinino, Executive Director, Policy and Royalty Branch at (250) 356-9825.

**1. NET PROFIT ROYALTY PROJECT**

A net profit royalty project (project) is a three dimensional area of petroleum and natural gas subsurface rights that has been approved by the administrator to be a qualifying project under the Net Profit Royalty Regulation. An approved project must pay a net profit royalty as prescribed under the Net Profit Royalty Regulation on the production of oil, marketable gas and natural gas by-products produced from well events that have been completed within the project.

A producer may apply to the administrator for approval of a project in response to a Request For Applications (RFA) issued by the Ministry of Energy, Mines and Petroleum Resources (MEMPR). The producer's application provides the administrator with the project geographic area and details the producer's rights to specific geological horizons (formations) needed to make the project economically feasible.

**2. NET PROFIT ROYALTY PROJECT TIERS**

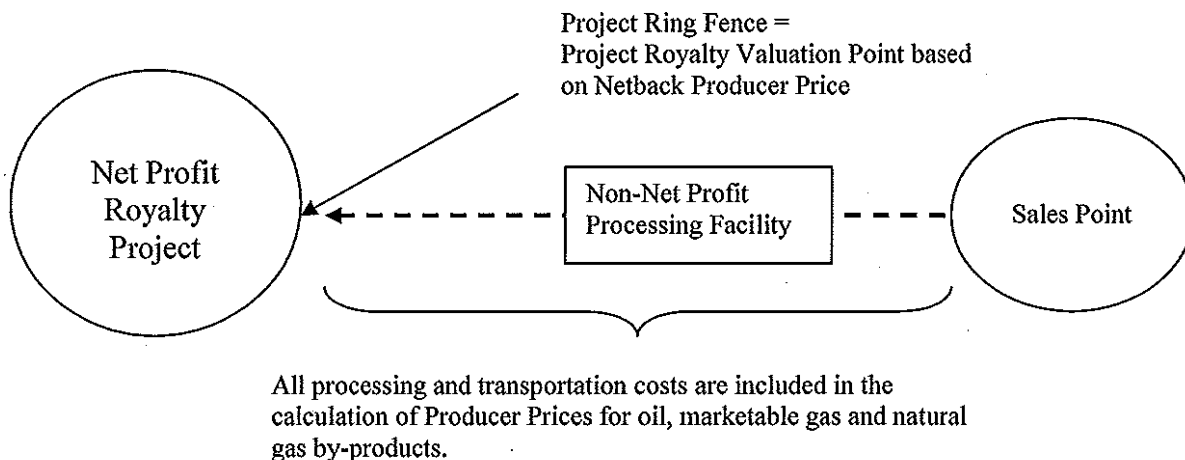


British Columbia's Net Profit Royalty consists of one pre-payout tier and three net profit tiers as shown in the diagram. Movement between the tiers (which determines royalty payable) is triggered when each tier's closing payout balance declines to zero. In the case of the Pre-payout Tier, movement to Tier 1 royalties is triggered after a maximum of 10 years after production start-up regardless of the balance in the pre-payout account.

**3. NET PROFIT ROYALTY PROJECT RING FENCE**

Each project will have a defined geographic ring fence and geological boundary. The extent of the project ring fence as it applies to pipelines and facilities used to transport and process hydrocarbons must be clearly established and identified at the time of the submission of the project to the RFA process. The final determination of the project ring fence will be made by MEMPR based on consideration of current policies regarding facilities, roads, plant and pipeline proliferation and other relevant policies.

The project ring fence identifies the two-dimensional surface representation of the project geographic area and is the point of royalty valuation for determining oil, marketable gas and by-product producer prices.



The project ring fence serves as a point of demarcation in terms of how costs are deducted in calculating a net profit royalty. Costs outside of the project ring fence are deductions included in the determination of producer prices used to calculate a producer's gross revenue for their interest in a project. Costs inside the project ring fence are included in the calculation of the producer's net revenue and payout balances used in determining the producer's royalty rate for their interest in the project.

**4. CALCULATION OF GROSS REVENUE AND NET REVENUE**

**4.1 Gross Revenue**

Gross revenue is a monthly calculation for each producer's interest in a project and is equal to the greater of zero and the sum of:

- (a) sales value amounts received by the producer from sales of marketable gas, natural gas by-products and oil produced from the project;
- (b) any proceeds received under an insurance policy related to the operations of the project other than loss of revenue insurance;
- (c) any consideration received from technology developed in the project, the costs of which have been included as an allowed cost in the calculation of the net profit royalty or opening and closing payout balances;
- (d) a grant, subsidy or other form of assistance received from a government, municipality or other public body.

For the purpose of determining sales values under 4.1(a) above for sales of marketable gas, natural gas by-products and oil, sales values are calculated by multiplying the sales volume by the applicable producer price.

#### **4.2 Marketable Gas Producer Price**

For the purpose of determining gross revenue for sales of marketable gas, the Ministry of Energy Mines and Petroleum Resources will calculate a monthly producer price for each producer with a reporting interest in a project. The procedures used to calculate the monthly producer price are documented in the Pricing Order of the Administrator. The monthly producer price will be equal to the actual consideration received or receivable by the producer for their interest in the project, with the following deductions allowed back to the royalty valuation point (project ring fence).

- A gas cost allowance (GCA) where a producer with an interest in a project has either transported or processed their natural gas on a producer owned gathering system, at a producer owned plant and/or producer owned sales line that is located outside the project ring fence. A producer must apply to the royalty collector (the collector) for an approved annual GCA rate to be eligible for a GCA to be deducted in the determination of their marketable gas producer price.
- Custom processing and transportation, including
  - Arm's length transportation charges for transporting marketable gas on a residue gas transmission system that is outside the project ring fence,
  - Arm's length processing fees where the natural gas has been processed at a natural gas processing plant or a portion of a natural gas processing plant that is outside the project ring fence and is owned by an unrelated party who is not a producer of natural gas at the plant in which the gas is processed,
  - Arm's length gathering per unit charges where the natural gas has been delivered to a natural gas processing plant through a gathering line owned by a third party who is not a producer of natural gas at the natural gas processing plant in which the natural gas is processed,

Natural gas sales will be subject to the posted minimum price (PMP) at the royalty valuation point (project ring fence) when determining gross revenue.

**4.3 Oil and Natural Gas By-Product Producer Price Calculations**

For the purpose of determining gross revenue for sales of oil and natural gas byproducts, the oil and natural gas by-product producer price calculations will be based on the actual selling price at the point of sale, with deductions for all costs of transportation and processing netted back to the royalty valuation point (Project ring fence). Note that processing and transportation costs deducted in calculating the producer price for marketable gas cannot also be deducted in calculating the producer price for oil and natural gas by-products and must relate to infrastructure outside the project ring fence. Examples of eligible processing cost deductions are oil treating and natural gas by-product stabilization and fractionation.

**4.4 Net Revenue**

Net Revenue is a monthly calculation for each producer with an interest in a project and is equal to gross revenue less the following amounts:

- (a) allowed capital costs multiplied by 1.01,
- (b) allowed operating costs multiplied by 1.10, and
- (c) an amount equal to the greater of zero and the opening net allowed cost balance,
- (d) an amount of allowed capital costs and allowed operating costs designated by the producer under section 10(3) of the Net Profit Royalty Regulation to be deducted from the producer's reclamation and remediation cost bank.

**5. CALCULATION OF NET ALLOWED COST**

Each producer with an interest in a project calculates a monthly net allowed cost amount that is used in determining the producer's monthly return on investment amount and a producer's opening and closing payout balances. The formula for calculating the monthly net allowed cost amount follows:

- (a) First Calendar Month Subsequent to the Project Approval Month (Month 1)

$$\begin{array}{rcl} \text{Net} & & \text{Allowed Historical Costs} \\ \text{Allowed Costs} = & + & \text{Allowed Capital Costs x 1.01} \\ & + & \text{Allowed Operating Costs x 1.10} \\ & - & \text{Gross Revenue} \end{array}$$

(b) Any Other Calendar Month After the Project Application Month

$$\begin{array}{rcl} \text{Net} & & \text{Allowed Capital Costs x 1.01} \\ \text{Allowed Costs} = & + & \text{Allowed Operating Costs x 1.10} \\ & - & \text{Gross Revenue} \end{array}$$

### **5.1 Inclusion of Allowed Historical Costs in Net Allowed Cost**

Historical costs for an approved project that are incurred within five years prior to the calendar month in which the proposal was submitted to the MEMPR RFA process may be allowed provided they meet the eligibility principles for allowed costs (see Net Profit Allowable Cost Order of the Administrator 2008 - 02). In addition, the following two allowable cost amounts may be included in the determination of allowed historical costs even though the cost was incurred prior to five years preceding the calendar month that the project was submitted to the MEMPR RFA process:

- a) costs for directly attributable seismic information used in the development of the project, and
- b) any allowed capital cost or allowed operating cost that is approved by the administrator due to the cost not being incurred within the five year period as a result of force majeure.

A proponent may apply to the administrator to convert a successful pilot project to a net profit royalty project and, if approved, will include all allowed capital costs and allowed operating costs in their calculation of allowed historical cost as long as the above eligibility rules are met.

## **6. CALCULATION OF RETURN ON INVESTMENT**

The calculation of the monthly return on investment amount is based on the average net allowed cost balance for the producer's interest in a project for the calendar month, the long term bond rate percentage (LTBR%) and the return allowance percentage for the applicable tier that the return on investment is being calculated for. A return on investment is only calculated for a month subsequent to the project approval month and where net profit well events in the project have produced marketable gas for sale. (i.e. No return on investment amount for historical cost periods)

The formula for calculating the monthly return on investment follows:

$$\text{Return on Investment} = \text{Average Net Allowed Cost Balance} \times (\text{LTBR} \% + \text{Return Allowance} \%) / 12$$

Where,

- Average Net Allowed Cost Balance is the sum of the opening net allowed cost balance and the closing net allowed cost balance divided by two;

- LTBR % is the percentage published by the Bank of Canada for the Government of Canada 10-year benchmark bond yield for the calendar month in which the monthly return on investment is being calculated;
- Return Allowance % is equal to:
  - (i) zero %, for the pre-payout tier,
  - (ii) 25%, for tier 1, and
  - (iii) 100%, for tier 2.

## **7. OPENING AND CLOSING PAYOUT BALANCES**

The opening and closing payout balance calculations are the basis for determining the tier (e.g. Pre-payout tier, tier 1, tier 2 or tier 3) and hence which royalty rate a producer must use in calculating net profit royalty. The opening and closing payout balances are calculated each month by adding the amount of net allowed cost and return on investment to the opening payout balance to calculate the closing payout balance for each applicable tier. A producer's interest in a project will move from one tier to another once their closing payout balance for a tier becomes negative, meaning that the producer at this point has recovered both their costs and return on investment.

## **8. ROYALTY RATES**

### **8.1 Pre-payout Tier Royalty Rates**

The royalty rate in the Pre-payout Tier is 2% of Gross Revenue.

An approved project will stay in the pre-payout tier until payout is achieved, or for a maximum of 10 years, commencing from the first month subsequent to the project approval month where the project produced marketable products for sale, whichever occurs first.

Exceptions to the 10-year maximum time limit may be granted in specific cases upon application to the administrator when an event occurs causing a material negative impact or delay to the project.

### **8.2 Tiers 1, Tier 2 and Tier 3 Royalty Rates**

The tier 1, tier 2 and tier 3 royalty rates are as follows:

- a) Tier 1, greater of 15% of net revenue and 5% of gross revenue.
- b) Tier 2, greater of 20% of net revenue and 5% of gross revenue.
- c) Tier 3, greater of 35% of net revenue and 5% of gross revenue.

Once a producer's interest in a project progresses to a tier, the producer's interest in the project will stay in that tier until either the cessation of the project or the producer's interest in the project progresses to the next tier. Once a project has progressed to tier 3, it remains in tier 3 until cessation of the project.

