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Payout under Alberta's Oil Sands Royalty Regulationv

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Case Commented On: *Fort Hills Energy Corporation v Alberta (Minister of Energy)*, 2018 ABQB 905

A year ago, ABlawg posted a case comment on a dispute related to the determination of payout with respect to the Hibernia project on the East Coast. That case, *Newfoundland and Labrador v ExxonMobil Canada Properties*, 2017 NLDT(G) 147, 2017 CanLII 56724 (NL SCTD), involved an arbitration followed by an unsuccessful application by the Province of Newfoundland and Labrador to have the court overturn the arbitral award. *Fort Hills*, perhaps more conventionally, involves the definition of payout under the terms of Alberta's *Oil Sands Royalty Regulation, 2009*, Alta Reg 223/2008, (*OSRR*). In this case the matter arises as an application for judicial review with respect to the Minister's decision on one element of the payout account for the Fort Hills Oil Sand Project (FHOS Project), namely a category of expenses referred to as 'prior net cumulative balance' (PNCB). The differences between the parties were massive. Suncor had originally claimed a PNCB of $1,898,205,145; the minister allowed a PNCB of a little more than $33 million, and a further review and audit reduced this to $NIL. Definitely worth fighting about!

Payout refers to the time at which a proponent or working interest owner reaches the point in the life of a project when it can be said to have recovered all of its project related costs and expenses out of the sale of production. The definition of allowable costs and expenses is crucial. The broader the definition of allowable expenses the longer it will take to reach payout (all other things being equal). In royalty schemes payout typically triggers a move to a more aggressive royalty take by a government or private party. Thus, the concept is closely associated with risk sharing between the working interest owner and the royalty owner (typically also the owner of the resource *in situ*). The basic idea of a two (or more) step royalty system is that the resource owner shares in the commercial risk by taking a low gross royalty while the working interest owner is still recovering the costs of its investment. Once those costs are recovered (payout), the royalty becomes more aggressive whether structured as a share of net profits or as a higher gross royalty (or some combination).

There is no agreed or industry standard definition of payout. It must be defined either through a private agreement or, in the case of a Crown royalty system, through statute, regulations and guidelines. Since 'payout' is a project specific concept, it is necessary to define or ring-fence the project for the purposes of calculating payout. Accordingly, s.10(1) of the *OSRR* contemplates that the lessees of the oil sands project may apply for approval of a Project. The application must address numerous issues including a description of project operations and a proposed effective date for the Project as well as "a proposed calculation" of PNCB for the Project. Section 11 of the Regulations indicates the Minister may by order "approve a Project" and directs the Minster in doing so to take into a consideration a non-exhaustive list of factors including whether the project will generate net revenues and achieve payout. If the Minster decides to approve a project the Minister must (section 11(4)) establish a PNCB for the Project and the Project's effective date.

Section 15(2) of the Regulations instructs the Minister as to how s/he must determine the PNCB. At the relevant time the *OSSR* provided that the Minister must take into consideration the following:

> (a) the costs of the Project or of the expansion, respectively, incurred during the period of 3 years preceding the effective date of the Project or expansion;
>
> (b) the costs of the Project or of the expansion, respectively, incurred during the period comprising the whole or the portion of the 4th and 5th years preceding the effective date of the Project or expansion, as the case may be, during which the obtaining of the approval of the Regulator under the *Oil Sands Conservation Act* for a scheme or operation included in whole or in part in the Project or expansion subsequent to the 4th year preceding the effective date or the Project or expansion, as the case may be, was diligently pursued;
>
> (c) the costs of the tangible assets of the Project or of the expansion, respectively, incurred prior to the periods referred to in clauses (a) and (b), to the extent the Minister is satisfied that the use of the assets in relation to the Project after the effective date of the Project or expansion, as the case may be, will clearly result in significant savings of costs to the Project;
>
> (d) [omitted]
>
> (Emphasis added)

In addition to this "inclusion" list, section 11(3) directs the Minister to

> … take into consideration at least the following with respect to amounts to be excluded in determining the prior net cumulative balance:
>
> (a) the costs referred to in subsection (2)(a), (b) and (c),
>
>> (i) incurred during any portion of the periods referred to in those clauses when development of oil sands in the development area of the Project or the area and strata to be added to the development area by virtue of the Project expansion, as the case may be, was, in the Minister's opinion, substantially suspended or abandoned, …
>>
>> [(ii) and (iii) omitted;]
>
> (Emphasis added)

It bears emphasising that the "project approval" contemplated under the *OSRR* is purely for the purposes of the royalty regulations and it should not be confused with the scheme approval for an oil sands project under the terms of the *Oil Sands Conservation Act*, RSA 2000, c O-7, (*OSCA*).

Under section 10 of the *OSCA* no person shall commence or continue an oil sands scheme or operation without the approval of the Alberta Energy Regulator (AER). The AER may approve the scheme or operation if it considers the scheme to be in the public interest and only with the prior approval of the Lieutenant Governor in Council.

The AER approval under the *OSCA* invariably pre-dates the application for project approval for royalty purposes and in some cases by some years. This case was no exception. The FHOS project obtained its initial *OSCA* Approval in 2002 with subsequent amendments in 2005 and 2009. The project application for royalty purposes was not filed until November 30, 2011 seeking an effective date of November 1, 2011 and a PNCB as noted above of $1,898, 205,145. The Ministerial Order approving the project for royalty purposes was issued on August 31, 2012. It accepted the proposed effective date but established a PNCB of only $33,024,321 – subject to further audit. Following that audit, Alberta Energy restated the PNCB to $ NIL. Alberta Energy provided Suncor with a draft of the audit and the opportunity for objections and follow up meetings. Alberta Energy provided Suncor with its final decision on March 17 and Suncor filed its application for judicial review on September 19, 2015.

The 2012 decision reduced claimed eligible amounts as follows (at para 48):

- Costs incurred more than five years before the effective date in the amount of $91,311,040 were disallowed because they could not be eligible under section 15(2)(a) or (b) and they could not be eligible under paragraph (c) because they did not pertain to tangible assets.
- Costs incurred in the fourth and fifth years prior to the effective date in the amount of $859,267,048.00 were disallowed because they did not meet the test specified in section 15(2)(b) because they were not incurred as part of diligently pursuing approval of the scheme under the *OSCA*. They could not be because the main scheme approval had been obtained much, much earlier in 2002.
- Costs incurred in the three years prior to the effective date in the amount of $846,568,278.00 were disallowed under section 15(3)(a)(i) on the basis that the FHOS project was "substantially suspended" during this period.
- Costs incurred in the three years prior to the effective date in the amount of $68,034,457.00 were disallowed under section 15(3)(a)(iii) on the basis that they represent payment of cancellation fees to third parties.

The 2015 audit decision both confirmed and further reduced claimed eligible amounts during the three years preceding the effective date on the basis that the project was substantially suspended and in some cases on the alternative basis that the costs incurred were associated with the cancellation of contracts (at para 49).

The judgment deals separately with costs incurred between November 1, 2006 and November 1, 2008 (i.e. in years four and five prior to the effective date) and costs incurred between November 1, 2008 and November 1, 2011 (i.e. during the three years immediately prior to the effective date). The principal issue with respect to years four and five related to the amendments to the Project's *OSCA* approvals. The principal issue with respect to the immediately preceding three years was on the question of "substantially suspended".

Both parties agreed that the standard of review was reasonableness with respect to both of these issues (at para 52).

Costs incurred between November 1, 2006 and November 1, 2008 (i.e. in years four and five prior to the effective date)

It will be recalled that the FHOS project obtained its initial *OSCA* Approval in 2002 with subsequent amendments in 2005 and 2009. While the Department took the position that the only *OSCA* Approval that mattered for the purpose of section 15(2)(b) of the *OSRR* was the 2002 Approval, Fort Hills was of the view that costs could be eligible if they were incurred in years four and five so long as it was engaged in the diligent pursuit of the 2009 amendment. The Department's principal reason for concluding that costs associated with the 2009 amendment should be excluded was based on the proposition that these amendments were minor and not material to the preparation of the royalty project application (at para 95). In effect, a project should not be allowed to game the need for an amendment, however insignificant, to qualify all sorts of additional PNCB costs (at para 112). Fort Hills noted that the Regulation did not distinguish between major and minor Approvals and further pointed to "Alberta Oil Sands Royalty Guideline: Principles and Procedures" (Edmonton: Alberta Energy, October 2012) which contemplated the eligibility of PNCB costs associated with amendments to approvals (at paras 101 and 102).

Justice Yamauchi concluded the Minister's decision fell within a range of possible, acceptable outcomes which are defensible in respect of facts and law (at para 118).

Costs incurred between November 1, 2008 and November 1, 2011 (i.e. during the three years immediately prior to the effective date)

As noted above, the principal issue for this three-year period was, at paragraph 124, "whether Alberta Energy was reasonable in its conclusion that the Project was substantially suspended during the relevant time" bearing in mind that the Regulations (section 15(3)(a)) refer to a project that was "*in the Minister's opinion*, substantially suspended …." (emphasis added). The Regulation does not offer a definition of suspension or substantial suspension.

Justice Yamauchi concluded that the Minister's conclusion was unreasonable. The corporate records of the FHOS Project made it clear that the working interest owners never suspended the Project. They may have gone slow with the project and delayed investments, cancelled contracts and postponed the ultimate decision to sanction the project, but they did not suspend the project. The Minister's decision to find that the project was substantially suspended in light of this and in light of evidence of continuing investments was unreasonable (at paras 186 - 188):

> We must remember that the whole idea behind these provisions is to ensure that a developer is entitled to recover its costs of developing an oil sands project before it is required to pay an enhanced royalty to the Crown. *OSRR* '09 is, however, structured in such a way to ensure that developers are encouraged to develop the oil sands project in a timely manner, and to ensure that the Crown is not required to bear costs that do not advance the oil sands project. Taking a "pragmatic and

> functional" approach, this Court is of the view that what the Operator was doing in the case at bar during the 3-year period was advancing the FHOS Project.
>
> Thus, the Decision under *OSRR* '09 s 15(3)(a)(i) was unreasonable. The Operator provided Alberta Energy with ample evidence to show that the FHOS Project development had advanced throughout November of 2008 through October of 2011, and with commercially reasonable information to explain why certain other FHOS Project activities, such as construction, had slowed during that period….
>
> … this Court finds that it was unreasonable for the Minister, through Alberta Energy, to find that the FHOS Project was substantially suspended during the entire 3-year period. There might have been short periods of time during which the FHOS Project was "suspended," but Alberta Energy has not identified those particular times (and its reasons), nor whether those suspensions were "substantial." It simply held that there was "substantial suspension" during the entire 3-year period.

As a result, Justice Keith Yamauchi quashed the Minister's decision with respect to the Three-Year Costs and remitted it to the Minister for a proper redetermination.

This post may be cited as: Nigel Bankes, "Payout under Alberta's Oil Sands Royalty Regulation" (November 20, 2018), online: ABlawg, http://ablawg.ca/wp-content/uploads/2018/11/Blog_NB_Payout_Under_Alberta_November2018.pdf

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