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R. J. (Jack) Thrasher, Q.C.\*

Newfoundland Generic  
Royalty Regime

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*This paper reviews the regulations under the Newfoundland and Labrador Petroleum and Natural Gas Act governing the Newfoundland generic royalty regime. The author also points to some unresolved issues; in particular, he discusses transportation costs and the parameters of ministerial discretion.*

*Le présent article passe en revue les règlements pris sous le régime de la Petroleum and Natural Gas Act de Terre-Neuve et Labrodor, règlements qui s'appliquent au régime terre-neuvien de redevances. L'auteur souligne également certaines questions qui restent sans réponse. Il aborde en particulier la question des frais de transport et les paramètres de la discrétion du ministre.*

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\* Partner, Osler, Hoskin & Harcourt LLP. My thanks to Patrick Callaghan for his valuable research assistance, and to Peter Piliounis who reviewed some of the drafts and made some helpful suggestions.

### *Introduction*

- I. *Structure of Royalty*
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### *Introduction*

The lineage of the Newfoundland and Labrador generic royalty provisions is an interesting one. Other authors<sup>1</sup> have discussed the nature of the legal and fiscal authority exercised with respect to the area administered under the *Canada-Newfoundland and Labrador Atlantic Accord Implementation Act*<sup>2</sup> and its related mirror legislation in Newfoundland, the *Canada-Newfoundland and Labrador Atlantic Accord Implementation Newfound-*

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1. See A. Taylor and J. Dickey, "Regulatory regime: Canada-Newfoundland/Nova Scotia Offshore Petroleum Board Issues" (Spring 2001) 24 Dal. L.J. 51-86; R.E. Quesnel and R.J. Thrasher "East Coast Project Financing Issues" (2001) 24 Dal. L.J. 215; V. Penick, "Legal Framework in the Canadian Offshore" (2001) 24 Dal. L.J. 1; D. Black and F.V.W. Penick, "Survey of Legal Issues: Canada Offshore Oil and Gas Developments" (1991) 30 Alta. L. Rev. 178; R.G. Penney, "The Atlantic Accord: a model of cooperative federalism: a response to Paul Emond" (1986) 14 Resources 1-2; C.P. MacDonald and R.S.G. Thompson, "The Atlantic Accord: the politics of compromise" (1985) 24 Alta. L. Rev. 61-80; D.P. Emond, "A Critical evaluation of the Atlantic Accord" (1985) 12 Resources 4-6; R.M. Sinclair, "The Atlantic Accord: joint management of offshore oil and gas resources off Newfoundland and Labrador" (1985) 2 Bus. & L. 52-55.

2. S.C. 1987, c. 3 [*Newfoundland Accord Act (Canada)*].

*land and Labrador Act*.<sup>3</sup> This is an area subject to a joint management regime as opposed to one where a single government, as the undisputed owner of the resource, exercises authority. This paper attempts a general overview of the components of the generic regulations and raises, in that context, some points of interest to those dealing with the regulations.

The Hibernia Development Project, the first major development project in the offshore area subject to the *Accord Acts*, involved a written royalty agreement between the Hibernia Consortium and the province of Newfoundland and Labrador with incidental federal and provincial legislation.<sup>4</sup> Negotiations in connection with fiscal arrangements relating to the Terra Nova Development Project began in 1995. A letter of intent was executed between the Terra Nova Consortium and the province in August 1996, setting forth an agreement in principle between the parties with respect to certain matters including agreed elements of the project's fiscal regime.<sup>5</sup> Negotiations on a written royalty agreement between the Terra Nova Consortium and the province continued until August 2001, when the province indicated that it was going to legislate the terms of the royalty. In late 2001, the province prepared a set of draft regulations to deal with the Terra Nova Project on an interim basis and in April 2002, the province issued a set of draft regulations with respect to its proposed generic regime.<sup>6</sup> In July 2002, the province indicated that it intended to deal with the generic regime and the Terra Nova Project royalty as part of the same regulations.

Amendments to the province's *Petroleum and Natural Gas Act*<sup>7</sup> (the Act) were necessary to provide the statutory framework for the generic royalty regulations. The Act deals with royalties where the province has exclusive jurisdiction and areas subject to the joint management regime

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3. R.S.N.L. 1990, c. C-2 [*Newfoundland Accord Act (Newfoundland)*]. Together with the *Newfoundland Accord Act (Canada)* as the *Accord Acts*.

4. See for example, Division VI of the *Accord Act* and *The Oil Royalty Regulations*, Nfld. Reg. 264/90 which implemented a royalty of \$0.01 per barrel of oil under the *Petroleum and Natural Gas Act*, R.S.N.L. 1990, c. P-10. Regulation 264/90 was repealed by Consolidated Nfld. Reg. 22/96. The amendments to the Act necessary to authorize the Minister to enter into the written royalty agreement had been passed in 1986 (see S.N. 1986 Vol.I, c.40, s.25) but were not proclaimed until September 7, 1990. On the topic of written royalty agreements generally see A.T. Pettie "Are Royalty Agreements Required for Canada East Coast Offshore Oil and Gas?" (2001) 24 Dal. L.J. 151.

5. The process to develop the generic regulations had begun with a press release by the Province in June, 1996: Government of Newfoundland & Labrador, Statement, "Ministerial Statement – Royalty regime for development of petroleum resources" (13 June 1996), online: Government of Newfoundland & Labrador <<http://www.releases.gov.nl.ca/releases/1996/mines/en/0613n06.htm>>.

6. It is understood these were issued to a limited number of interested groups only.

7. *Petroleum and Natural Gas Act*, *supra* note 4.

under the *Accord Acts*. The unfortunate result is that some of the definitions and concepts in the Act do not agree entirely with those used in the *Newfoundland Accord Act (Newfoundland)*.<sup>8</sup>

The amendments to the Act were enacted in December 2001,<sup>9</sup> and dealt with a number of different subject areas, including:

- (a) reservation to the Province of a royalty share (royalty and interest, penalties and other amounts payable to the Province by an interest holder) on all petroleum recovered under a lease (defined as including a production license issued by the board under the Accord Act);
- (b) the ability of the Province to enter into an agreement with interest holders (the holder of a lease or a share in a lease as recorded in the appropriate registry) or other persons, including an agreement inconsistent with the regulations made under Part II of the Act that will prevail over those regulations where it is inconsistent;
- (c) the right of the Province to take royalty share in kind and to use facilities, assets and services for the handling, storage or transportation of petroleum produced under a lease from which it is taking royalty share in kind subject to payment for such use in accordance with regulations under Part II;
- (d) a lien in favour of the Province on all assets of a person owing royalty share, including assets held by a secured creditor of the person that, but for a security interest, would be assets of the person. The lien, which is described as “first and paramount,” attaches when the royalty share is due and payable and continues until paid or released by the Province. The Act gives the Provincial cabinet the authority to restrict the lien to certain assets or postpone, subordinate or release it, if the Province is satisfied that it has sufficient security for royalty share<sup>10</sup>;

8. *Supra* note 3. For example, the definition of “security interest” under the Act is different from the definition of “security interest” under section 102 of the *Newfoundland Accord Act (Newfoundland)* likewise the definitions of “interest holder” and “oil.” Part II of the Act refers to a royalty on “petroleum” but the Regulations refer throughout to “oil.” In the case of “security interest” the definition used in the Act is similar to the definition used in the *Income Tax Act*, R.S.C. 1985, (5<sup>th</sup> Supp.), c.1, s. 224 (1.3) and the province may wish to have the jurisprudence with respect to that definition apply to the definition under the Regulations.

9. S.N.L. 2001, c. 41.

10. Section 35(4) of the Act provides that the Minister may register a notice of the lien in a registry established under the Act, the *Registration of Deeds Act*, the *Personal Property Security Act* and the *Accord Acts* but that failure to register a notice in such a registry “shall not be necessary to perfect the lien.” Apart from the grammatical ambiguity, it is interesting to speculate on the “first and paramount” status of the lien under the *Newfoundland Accord Act (Newfoundland)*, particularly in relation to the operator’s lien recognized under section 112(5) of the *Newfoundland Accord Act (Newfoundland)*.

- (e) the liability for unpaid royalty share of a person or other persons (other than a trustee in bankruptcy) dealing with the assets of that person on behalf of creditors;
- (f) the right of the Minister (of Mines and Energy) to ignore artificial transactions or consider them to occur at fair market value, subject to arbitration (which is provided for under the regulations);
- (g) the authority to make regulations giving effect to the purposes of Part II of the Act<sup>11</sup>;
- (h) that regulations under section 39 of the Act may be made with retroactive effect;
- (i) directions of third party payments by the Minister;
- (j) requirements to file reports and returns as required under Part II and the regulations, subject to audit as established by regulation;
- (k) liability for royalty share being unaffected by an absent, incorrect or incomplete assessment and the validity of an assessment or reassessment despite an error, defect or omission in it, subject to appeal;
- (l) the adoption of sections 231 to 231.5 of the *Income Tax Act* (Canada) (dealing with audits and inspections, the provision of documents or information, search warrants, inquiries and copies and certification of documents), with required modifications, for the administration and enforcement of Part II of the Act;
- (m) fees, forms, penalties and offences under Part II; and

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11. These include regulations dealing with:

- (i) prescribing royalty on petroleum and its type, structure and amount;
- (ii) consolidating leases;
- (iii) allocating production, revenue, valuation of petroleum costs and other deductions between unitized leases;
- (iv) prescribing the rate, and determination, of interest on royalty share or its overpayment;
- (v) determining royalty share, its components (revenue, costs and other deductions) and their values;
- (vi) records and audits;
- (vii) the subordination, postponement and release of liens;
- (viii) the requirement for obtaining confirmation from the Minister of royalty share payable by a person;
- (ix) the assessment and reassessment of royalty share;
- (x) reports and returns;
- (xi) taking in kind of royalty share by the Provinces;
- (xii) the application of the rules of arbitration under the *Commercial Arbitration Act* (Canada) to matters arising under Part II of the Act;
- (xiii) penalties; and
- (xiv) generally to give effect to the purpose of Part II of the Act.

- (n) amendments to the *Crown Royalties Act* of the Province confirming that it does not apply to the Hibernia Development Royalty Agreement and petroleum defined in the Act.<sup>12</sup>

In addition to these amendments there is an agreement required between Canada and the province with respect to the collection and administration of the royalties, interest and penalties payable under section 97 of the *Newfoundland Accord Act (Canada)*. To date no such agreement has been concluded but it is understood that there are some interim arrangements in place pursuant to which payments are made to the federal authorities, who then remit the funds to the province under the *Newfoundland Accord Act (Canada)*.<sup>13</sup>

The first royalty regulations under section 39 of the Act were interim regulations with respect to the Terra Nova Project promulgated in December 2001, as Newfoundland and Labrador Regulation 84/01.<sup>14</sup> These regulations applied to all leases issued after April 1, 1990, and before November 30, 2001 (basically the Terra Nova production licences), and implemented a basic royalty (1-10 per cent of gross revenue depending on the aggregate volume of the interest holder's share of oil transferred at the loading point and whether simple payout had occurred) and an incremental royalty (in two tiers of 30 per cent and 12.5 per cent, respectively) on net revenue minus basic royalty and Tier I incremental royalty paid (in the case of Tier I) and on net revenue minus Tier II incremental royalty paid or, in a period where no Tier I royalty is paid, minus basic royalty paid (in the case of Tier II). These regulations also dealt with related concepts such as gross revenue, net revenue, gross sales revenue, allowed shrinkage, return allowance, payout levels, limitation of assets subject to the lien under the Act, reporting, and measurement standards.<sup>15</sup> The Terra Nova Project actually commenced production on January 20, 2002.<sup>16</sup>

The province indicated that this process of Act amendments, interim regulations and more detailed regulations was intended to permit a consultative process with interested parties.<sup>17</sup> The regulations implementing the

12. *Supra* note 4, s. 11.

13. *Supra* note 2, s. 97. Under s.98(3) of the *Newfoundland Accord Act (Canada)* the agreement is entered into by the Federal Minister, with the approval of the federal cabinet, with the Province and the CNOPB and section 98(5) suggests it is to be published in the Canada Gazette.

14. Nfld. Reg. 84/01 O.C. 2001 – 735 filed December 7, 2001, repealed by N.L.R. 71/03.

15. *Supra* note 4, ss. 7, 8, 12-16.

16. See Terra Nova Project, online: <<http://www.terranovaproject.com>>.

17. The Canadian Association of Petroleum Producers, for example, provided extensive comments on the Regulations.

generic regime in the province were promulgated as Newfoundland and Labrador Regulation 71/03 and were gazetted on July 18, 2003.<sup>18</sup> They generally apply to all leases issued after April 1, 1990 (which does not include the Hibernia production license, issued March 21, 1990) except for Part XIII which contains provisions particular to leases issued between April 30, 1990, and November 20, 2001 (the Terra Nova Project production licenses).

### I. *Structure of Royalty*

The regulations provide both a basic royalty and a two-tier incremental royalty payable separately by each interest holder in a lease.<sup>19</sup> The term “lease” is defined in Part II of the Act as including a production licence issued under the *Accord Acts*.<sup>20</sup> It is interesting to note that the term “interest holder” under the regulations has an additional meaning to that given the term in Part II of the Act. Under the regulations, where a lease has not been issued, it includes “the proponents of a project where the development plan has been approved by the board and the proponents will be applying for a lease.”<sup>21</sup> Again, this is a different meaning from that given to “interest owner” under the *Newfoundland Accord Act (Newfoundland)*.<sup>22</sup>

The minister also has the power to consolidate one or more leases for the purposes of the regulations.<sup>23</sup> Where an interest holder owes an amount to the province under the regulations, the minister may recover

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18. N.L.R. 71/03. The Regulations applied retroactively to December 31, 2001 and repealed N.L.R. 84/01 [Regulations].

19. The Regulations seem to recognize throughout the separate liability for royalty share of each interest-holder having a share in a lease – see esp. section 4(b). One of the concerns with respect to a production license issued to several interest holders that authorizes the CNOPB to cancel the production license where the interest holder has failed to meet the requirement under section 97(2) of the *Newfoundland Accord Act (Newfoundland)* to pay royalty, interest and penalties is the lack, under the *Accord Acts*, of any recognition of the separate nature of undivided interests and the concomitant recognition that default on royalty payments by one interest holder should not prejudice the interests of other interests. In Hibernia, this was dealt with by a joint Ministerial directive to the Board from the federal minister and the provincial minister under the *Accord Acts*.

20. The *Newfoundland Accord Act (Newfoundland)*, of course, contemplates several different interests, namely a former exploration agreement, former lease, former permit, former special renewal permit, an exploration license, a significant discovery licence, and a production license.

21. *Supra* note 18, s. 3(1)(k).

22. *Supra* note 3, s. 47: where “interest owner” is defined as “the interest holder who holds an interest or the group of interest holders who hold all of the shares in an interest.” Under the Act, s.30(1), an interest holder “with respect to a lease or a share in a lease, means the holder of the lease or that share as recorded in the appropriate registry for that lease or share.”

23. *Supra* note 18, s. 4(4). The Terra Nova Project, for example, involves three different production licenses (1002, 1003, and 1004) all issued by the CNOPB on August 20, 2001.



that amount by way of set-off against an amount the province owes to that interest holder.<sup>24</sup> This is a very broad right of set-off, unrestricted by the concepts developed by the courts in respect of legal and equitable set-off under the general law.<sup>25</sup>

Royalty is due on the last day of the month in which the royalty relates and is payable to the province in money or in kind at the option of the minister.<sup>26</sup> Royalty is normally calculated in respect of a "period" which is defined under the regulations as a calendar year. However, royalty calculations regarding a year in which payout occurs are broken down into two separate periods, one pre-payout and one post-payout.<sup>27</sup>

Royalty share paid by an interest holder is applied to amounts due to the province, in order of priority, as fees and expenses; penalties; interest; basic royalty and incremental royalty.<sup>28</sup>

### 1. *Basic Royalty*

The basic royalty payable by an interest holder for a month with respect to a lease is calculated by multiplying that month's sum of the gross revenue of an interest holder under the lease and the value of oil taken in kind by the province from that interest holder for that month by the applicable

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24. *Supra* note 18, s. 4(7).

25. Under the general law in Canada there are two requirements for legal set-off: (1) the cross-obligations which the set-off affects must be debts for liquidated sums, or money demands which can be ascertained with certainty (the "ascertainment" requirement); and (2) the cross-obligations must be between the same parties and in the same right (the "mutuality" requirement): *Telford v. Holt* (1987), 41 D.L.R. (4th) 385 at 393 (S.C.C.); *Agway Metals Inc. v. Dufferin Roofing Ltd.* (1991), 46 C.P.C. (2d) 133 at 136-137 (Ont. Gen. Div.); aff'd. (1994), 30 C.P.C. (3d) 295 (C.A.). The rules of ascertainment and mutuality do not apply with the same rigour to equitable set-off. In order for equitable set-off to apply, however, the claim of the defendant must be so closely bound up with the rights relied upon by the plaintiff that it would be unconscionable that the plaintiff should be allowed to proceed without the operation of set-off (*Telford, supra*, pp. 394, 401; *Agway Metals Inc.* (Gen. Div.), *supra*, pp. 136-137). The exact nature of the connection between the cross-claims required by this very broad test is not entirely clear. It appears, however, that equitable set-off operates wherever the cross-demands arise from the same contract or course of dealings between the parties and the court thinks it unfair that set-off should not apply: Judge & Grottenthaler, "Legal and Equitable Set-Offs" (1991), 70 Can. Bar Rev. 91 at 113-114, 120; *Eight Silver Maple Ltd. Partnership v. Bramalea Inc.* (1996), 39 C.B.R. (3d) 107 at 114-116 (Ont. Gen. Div.).

26. *Supra* note 18, ss. 5(1) and 4(1).

27. *Supra* note 18, s. 3(1)(n).

28. *Supra* note 18, s. 5(2).

basic royalty rate in effect under Part XIII or Part XIV of the regulations.<sup>29</sup> Part XIII deals with the calculations and rates for the Terra Nova Project (as well as other specific changes to the generic regime for the Terra Nova Project). Part XIV deals with calculations and rates for leases issued after November 30, 2001 — i.e., the leases other than those in respect of the Terra Nova Project that are subject to the generic regime.

## 2. *Gross Revenue*

The monthly gross revenue for an interest holder in a lease is its gross sales revenue in the lease less the eligible transportation costs under Part XI.<sup>30</sup>

## 3. *Gross Sales Revenue*

The monthly gross sales revenue of an interest holder in a lease is its revenue from sales and deemed sales of oil produced under the lease less any revenue in that month that was included in gross sales revenue under the lease in a previous month.<sup>31</sup> Under the deemed sales concept, oil transferred to an interest holder at the loading point (the final point of measurement of the production facilities prior to the loading of oil for transportation) to the end of a month that has not been sold is deemed sold at the end of that month unless it is oil in inventory transferred to the interest holder at the loading point within ninety-one days before the end of the month for which the royalty is calculated, or allowed shrinkage.<sup>32</sup>

There is significant storage capacity at the production facilities under each of the existing production facilities in the Newfoundland offshore area: the gravity-based structure (GBS) in the case of Hibernia, and the

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29. *Supra* note 18, s. 6. For the Terra Nova Project (see section 73(1)) this is, not surprisingly, the same rate as under the interim regulations applicable to that project (see note 14). For other leases subject to the generic regime the rate is from 1 per cent to 7.5 per cent depending on the cumulative oil transferred at the loading point for that interest holder: see section 90(1) of the Regulations. Hibernia involves, in addition to the one cent per barrel royalty imposed under the Act (*supra* note 4) a gross royalty varying from a rate of 1 per cent to 5 per cent (indexed to reduce the rate if the price of oil falls below a certain level) payable from the commencement of production and varying depending on the time interval from the commencement of production or whether net royalty payout had occurred, a net royalty (against which gross royalty paid is credited) from the month in which net royalty payout occurred equal to 30 per cent of net transfer revenue, and a supplementary royalty (against which gross royalty paid is credited) from the month in which supplementary royalty payout occurred equal to 12.5 per cent of net transfer revenue.

30. *Supra* note 18, s. 7(1).

31. *Supra* note 18, s. 7(2).

32. *Supra* note 18, s.7(4). There is no guidance in the Regulations or the Act as to what “oil in inventory” means other than the general rule in section 3(4) that accounting terms and practices have the meaning assigned to them in accordance with Canadian GAAP and good petroleum industry practices.

floating production and storage vessel (FPSO) in the case of Terra Nova. The deemed sales occur under the regulations as the oil is taken by an individual interest holder “lifting” its entitlement under the relevant lifting agreement and loading it to a shuttle tanker for transportation to transshipment facilities or market.<sup>33</sup> Deemed sales for a month is the quantity of oil deemed sold multiplied by the applicable price for that month, determined by the minister under section 7(9) for the generic regime and determined under section 81(1) for the Terra Nova Project.<sup>34</sup>

#### 4. *Allowed Shrinkage*

Allowed shrinkage is defined as the reduction in the volume of oil incidental to its transportation from the loading point under a lease directly to an entry valve at a trans-shipment facility in the province (currently the Newfoundland Transshipment Limited facility at Whiffen Head) or other initial discharge point for that oil.<sup>35</sup> Allowed shrinkage is capped at the lesser of actual shrinkage and 0.2 per cent of the bill of lading net standard volume quantity of oil loaded at the loading point.<sup>36</sup>

#### 5. *Eligible Transportation Costs*

Part XI of the regulations dealing with eligible transportation costs appears to be an interim provision that provides for transportation costs to be whatever the minister determines them to be. An estimate of the eligible transportation costs for an interest holder for a period, after consultation with the interest holder, is determined by the minister and the minister notifies the interest holder of the determination before the beginning of the period. The minister will provide the interest holder with determination of the eligible transportation costs for the period before the interest holder is required to file its annual reconciliation for that period under section 32 of the regulations.<sup>37</sup>

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33. Such lifting arrangements typically deal with the batching of production by allocating each interest holder be petroleum produced during a specific period, with the length and frequency of the intervals allotted to individual interest holders determined by the relative size of their working interest. See the discussion in R.E. Quesnel and R.J. Thrasher, “East Coast Project Financing Issues” (2001) 24 Dal. L.J. 215 at 244-245.

34. *Supra* note 18, s. 7(6).

35. *Supra* note 18, s. 8(1).

36. If the measurement facilities and practices at the loading point and the discharge point do not comply with section 18 of the Regulations (in accordance with the legislation, regulations and rules administered by the CNOPB or measurement and device standards established by the Minister after consultation with the interest holders) there is no allowed shrinkage.

37. *Supra* note 18, ss. 70(1) and (3).

There may well be more detailed regulations dealing with eligible transportation costs before other projects subject to the generic regime go into production. There will be a number of issues to resolve, depending on the form the regulations take. The Hibernia Royalty Agreement adopted a cost of service approach. The province will undoubtedly seek adequate rules to avoid double-counting and allocations of transportation and trans-shipment costs between projects subject to different royalty rates that might prejudice their royalty take. In contrast, interest holders will want assurance that money spent on transportation and trans-shipment costs and charges is reflected in the appropriate deductions for royalty purposes and that the regulations recognize the limits on information available to interest holders and respect the separate entities involved in the provision of trans-shipment and transportation services in the offshore area.

The current transportation and trans-shipment arrangements in the Grand Banks area involve transportation by a fleet of specially designed shuttle tankers and a trans-shipment terminal at Whiffen Head in Newfoundland owned by Newfoundland Transshipment Ltd. (NTL). NTL is in turn owned, directly or indirectly, by affiliates of Chevron Canada Resources Limited, ExxonMobil Oil Canada Ltd., IMTT-NTL Ltd., Petro-Canada, Norsk Hydro Canada Oil & Gas Inc., Murphy Atlantic Offshore Oil Company Ltd., and Husky Oil Operations Ltd.. NTL has contracted an international terminal operator, International Matex Tank Terminals, to manage and operate the terminal.

The NTL facility has heated crude oil storage tanks and a berth that can accommodate 35,000 to 150,000 deadweight-ton tankers, as well as separate facilities to load and unload vessels carrying oil from the oil-producing projects in the region (such as Hibernia and Terra Nova) to markets in Canada, the United States, and other parts of the world.<sup>38</sup>

The shuttle tankers take delivery of oil from Hibernia and Terra Nova and either deliver the crude directly to market or to the trans-shipment facility at Whiffen Head for storage and trans-shipment. Crude oil delivered to Whiffen Head is subsequently transported to market by second leg tankers in the world fleet.

The estimated eligible transportation costs for a month for an interest holder in a lease are the estimated eligible transportation costs for the interest holder for the period determined by the minister multiplied by

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38. See the discussion of the NTL terminal in R.E. Quesnel and R.J. Thrasher, *supra* note 33 at 223-224.

the ratio of barrels of oil produced under the lease in the month to the expected amount of oil to be produced under the lease in the period by that interest holder.<sup>39</sup> Before the interest holder is required to file its annual reconciliation (not later than 120 days from the end of the period), the minister must provide the interest holder with the minister's determination of the eligible transportation costs for the period, which is allocated on a monthly basis by the ratio of actual barrels of oil produced in the month to the actual amount of oil produced in the period by the interest holder under the lease.

Interest holders, project operators, tanker administrators and trans-shipment facility administrators must provide the minister with the information and access to records necessary to calculate estimated and actual eligible transportation costs. There may be some challenges in working this out in practice. Any dispute with respect to the calculation or eligibility of an eligible transportation cost is subject to arbitration under the regulations (see section 49(b)).<sup>40</sup>

#### 6. *Simple Payout*

Simple payout for an interest holder under a lease (which affects the basic royalty rate applicable) occurs when the sum of the cumulative (i.e., for the current month and all prior months) gross revenue and incidental revenue exceeds the sum of the cumulative eligible pre-development costs, eligible capital costs, eligible operating costs, and basic royalty paid (excluding basic royalty paid in kind) for that interest holder.<sup>41</sup>

#### 7. *Incidental Revenue*

Incidental revenue is consideration received or deemed to be received or declared by the interest holder or the project operator on behalf of the interest holder from:

- (a) sale, lease, licence or other disposal or use of lease assets or technology under the lease where the costs were royalty costs under the lease;
- (b) proceeds received under insurance policies whose premiums were included as a royalty cost;

39. *Supra* note 18, s. 70(3).

40. *Supra* note 18, s. 49(b). For example, a "tanker administrator" is defined under the Regulations as a person designated by interest holders to act as the administrator for the transportation activities of that tanker. It is not inconceivable that there may be tankers used in the offshore area that have no such person, at least not one designated by interest holders.

41. *Supra* note 18, s. 9(1).

- (c) amounts required to be included as incidental revenue under section 59;
- (d) amounts required to be included as incidental revenue under Part VII; and
- (e) other revenue received on account of the lease that the minister may reasonably declare to be incidental revenue.<sup>42</sup>

Decommissioning revenue (defined in section 67 of the regulations as “revenue received or deemed to be received by the interest holder or project operator on behalf of the interest holders in [a] lease in accordance with a decommissioning plan”) is neither incidental revenue nor revenue that arises in relation to a transaction entered into to hedge price risk with respect to a commodity or money.<sup>43</sup>

Where a cost in respect of a service or asset is allocated under the regulations, the same relative allocation is applied to incidental revenue in respect of the service or asset.<sup>44</sup> Any dispute with respect to incidental revenue or the calculation or inclusion of incidental revenue or tanker incidental revenue is subject to arbitration under the regulations.<sup>45</sup>

### 8. *Incremental Royalty*

Beginning with the month in which its Tier I payout occurs, an interest holder becomes liable to Tier I incremental royalty which is calculated on the interest holder’s net revenue under the lease, cumulative from the start of the period to the end of that month, multiplied by the applicable Tier I royalty rate in Part XIII (30 per cent) or Part XIV (20 per cent) less the cumulative basic royalty paid by the interest holder under the lease for the period to the end of the previous month (to the extent that it is less than or equal to the cumulative net revenue multiplied by the applicable Tier I rate) and less the cumulative Tier I incremental royalty paid under the lease for the period to the end of the previous month.<sup>46</sup>

Tier I payout occurs when the cumulative gross revenue and incidental revenue equals the sum of cumulative eligible pre-development costs, eligible capital costs, eligible operating costs, Tier I return allowance, and basic royalty paid, excluding basic royalty paid in kind.<sup>47</sup>

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42. *Supra* note 18, s. 69(1).

43. *Supra* note 18, ss. 69(2), (3).

44. *Supra* note 18, s. 69(4).

45. *Supra* note 18, ss. 49(b), (c).

46. *Supra* note 18, s. 10(2).

47. *Supra* note 18, s. 10(3).

Tier II payout for an interest holder occurs when, for the first time, the sum of gross revenue and incidental revenue equals the sum of the cumulative eligible costs, Tier II return allowance, basic royalty paid (excluding basic royalty paid in kind) and incremental royalty paid (excluding incremental royalty paid in kind).<sup>48</sup>

Beginning with the month in which its Tier II payout occurs, an interest holder becomes liable to Tier II incremental royalty which is calculated on the interest holder's net revenue under the lease cumulative from the start of the period to the end of that month, multiplied by the applicable Tier II incremental royalty rate in Part XIII (12.5 per cent) or Part XIV (10 per cent) less the cumulative Tier II incremental royalty paid to the end of the previous month.<sup>49</sup>

### 9. Return Allowance

Tier I return allowance for an interest holder for each month after the commencement date is the product of the Tier I return allowance factor (determined in accordance with Part XIII (section 75(1)) or Part XIV (section 92(1)) multiplied by the amount by which the sum of the interest holder's cumulative eligible predevelopment, capital and operating costs, basic royalty paid (excluding basic royalty paid in kind) and Tier I return allowance to the end of the previous month exceeds the sum of cumulative gross revenue and incidental revenue.<sup>50</sup>

The Tier II return allowance for an interest holder for each month after the commencement date, until the month in which Tier II payout occurs, is the product of the Tier II return allowance factor (determined in accordance with Part XIII (section 75(2)) or Part XIV (section 92(2)) multiplied by the amount by which the sum of the interest holder's cumulative eligible predevelopment, capital and operating costs, basic royalty paid (excluding basic royalty paid in kind), incremental royalty paid (excluding incremental royalty paid in kind), and Tier II return allowance to the end of the previous month exceeds the sum of the interest holder's cumulative gross revenue and incidental revenue.<sup>51</sup>

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48. *Supra* note 18, s. 10(3).

49. *Supra* note 18, ss. 11(1), (2).

50. *Supra* note 18, s.10(4). The Terra Nova Project is also entitled to an additional Tier I return allowance under section 80(1) from August 1997 to January 1998.

51. *Supra* note 18, s. 11(4). Again, the Terra Nova Project is entitled to an additional Tier II return allowance under section 80(2) from August 1997 to January 1998.

### 10. *Suspension of Return Allowance*

The minister may suspend the calculation of Tier I and Tier II return allowance before production start up if substantially all the design, construction, and drilling work under the lease has ceased or the interest holders have stopped making the necessary expenditures and effort required to reach production start up.<sup>52</sup> The minister may also suspend this calculation after production start up where there is no activity under the lease or no production of oil for a period of sixty days or when a force majeure event causing or resulting in the cessation of production has occurred and is continuing.<sup>53</sup> A dispute with respect to the Minister's application of the return allowance suspension provision is subject to arbitration under the regulations.<sup>54</sup>

### 11. *Net Revenue*

Net revenue for an interest holder in a lease for a month is the amount by which the sum of gross revenue, incidental revenue, and the value of oil taken in kind exceeds the sum of eligible capital costs and eligible operating costs for that interest holder.<sup>55</sup> If, in a period after Tier I payout, the sum of the interest holder's gross revenue, incidental revenue, value of oil taken in kind by the minister for the period (for a lease subject to the generic regime, the volume of oil taken in kind multiplied by the price determined by the minister under section 7(9) and for the Terra Nova Project, the volume of oil taken in kind multiplied by the price determined under section 81(1) for the month the oil was taken in kind) is exceeded by the sum of the interest holder's eligible capital costs and eligible operating costs, the excess is carried forward as a deduction against net revenue in the next period.<sup>56</sup>

### 12. *Sale of Oil*

For the purposes of section 7(4) (deemed sales), oil taken under a lease that is transferred at the loading point is considered to be sold by the inter-

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52. *Supra* note 18, s. 13(1)(a).

53. *Supra* note 18, s. 13(1)(b). "Force majeure" is defined rather narrowly under section 3(6) as the initial occurrence and period of duration of one or more events specified in the definition (i.e. no general category of event beyond the reasonable control of the party) including "another event in the nature of" the previously specified events. Lack of finances or change in the economic circumstances of the interest holder or project operator is not a force majeure event. It is interesting to speculate how far the phrase "in the nature of" can go in expanding beyond the previously specified events. On "force majeure" generally see J.R. Paulus and D.J. Meeuwig, "Force Majeure – Beyond Boilerplate" (1999) 37(2) *Alta. L. Rev.* 302.

54. *Supra* note 18, s. 49(f).

55. *Supra* note 18, s. 12(1).

56. *Supra* note 18, s. 12(2).



est holder on a first-in, first-out basis.<sup>57</sup> Where oil that was deemed sold under section 7(4) is actually sold, gross revenue for that month is adjusted to reflect the difference between the actual sale value of the oil and the value previously determined under section 7(4).<sup>58</sup> Oil is considered to have been sold, for the purpose of calculating royalty share, at the earlier of the time when title to the oil passes to an arm's length purchaser, the oil enters the entry valve of a refinery or a consuming facility, or the interest holder or an affiliate of that interest holder has received payment for the oil.<sup>59</sup>

### 13. *Price of Oil*

For the purposes of section 7(6) (deemed sales), section 7(b) (non-arm's length), section 23(3)(g) (calculation of volume to be taken in kind), section 24(1) (adjustment of volume taken in kind), and section 24(2) (payment for excess volumes taken in kind), the minister is to determine a monthly price for oil in the month, based upon the fair market value for oil during that month.<sup>60</sup> For the Terra Nova Project, Part XIII contains a specific set of provisions for determining the sale price.<sup>61</sup> For non-arm's length transactions it is a reference price applicable to that oil, as determined on a monthly basis by a reference price committee in accordance with section 82 of the regulations. For arm's length transactions it is the actual sales price except when, after twelve months of production, it is outside a band 1.25 per cent above and below the reference price in which case it is the applicable limit of the band. If, at the end of a calendar year,

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57. *Supra* note 18, s. 7(5).

58. *Supra* note 18, s. 7(7).

59. *Supra* note 18, s. 7(8).

60. *Supra* note 18, s. 7(9). Although there is a final offer selection arbitration process to determine the sales price of oil for royalty purposes (see section 51(2)) it is not as clear that a dispute as to the Minister's determination of the monthly price for oil, based on the fair market value for oil during that month, is subject to arbitration although presumably it could be raised in the arbitration of a dispute as to the assessment or reassessment of royalty share under section 49(a) or as to the fair market value of a price under section 49(e). The term "fair market value" has been given different interpretations. It has been described as "the price that a seller is willing to accept and a buyer is willing to pay on the open market and in an arm's length transaction; the point at which supply and demand intersect," *Black's Law Dictionary*, 7<sup>th</sup> ed., s.v. "fair market value." See also *Re: Leiser; Forman & Fowkles vs. M.N.R.* (1937) 2 WWR 428 (BCCA). cf. *M.N.R. v. Northwood Country Club* (1989) 89 D.T.C. 173 and 176 (T.C.C.) cited in D.A. Dukelow and B. Nuse, *The Dictionary of Canadian Law*, 2<sup>nd</sup> ed. (Scarborough, Ont: Carswell, 1995) at 432.

61. *Supra* note 18, ss.81, 82, 83. The Hibernia Royalty Agreement requires that the sale price of oil, for royalty purposes, reflect fair market value at the sale point taking into account factors relevant to the nature, time and context of the sale. An interest holder is required to report its actual sales price on a monthly basis and the province can redetermine or recalculate the royalty share if it believes that sale price does not reflect such fair market value with the interest holder having the right to have the fair market value determined by arbitration.

the reference price committee is of the opinion (determined on a majority basis) that the percentages used to establish the band result in an unsuitable valuation of arm's length sales of oil it may change these percentages as it considers necessary.<sup>62</sup> An interest holder in the Terra Nova Project, under section 83(1), can elect that the reference price applies to all arm's length sales but must still report monthly the actual sales price of oil its sells during the month.

## II. Administration and General Accounting

### 1. Ministerial Discretion

Under the regulations, there are many instances where the minister can make determinations or impose requirements on interest holders for the purpose of implementing and administering the regulations. In some instances, there is a requirement in the regulations that the minister act reasonably or be otherwise subject to an objective standard.<sup>63</sup> In other instances the minister's determination will be subject to arbitration.<sup>64</sup> In still other cases, the minister is to make the determination in accordance with good industry practices or some similar benchmark.<sup>65</sup>

In cases where the determination is not subject to an objective standard or arbitration there may well be concerns on the part of interest holders at the unilateral nature of the process. There have been suggestions in the past by representatives of governments in Canada that the Crown is always reasonable. Unfortunately, the jurisprudence appears to give little assistance in grounding that characteristic.

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62. *Supra* note 18, s. 82(3).

63. *Supra* note 18, ss. 21(3), 26(2), 41(1), 62(3) and 69(e). These are some instances where the Minister is required to do something that is reasonable (give notice or reasonably declare something, for example) and other cases the Minister must form an opinion as to whether something is reasonable. The latter may be a more difficult standard to question.

64. *Supra* note 18, s. 49(2).

65. See for example the general requirement that all accounting terms and practices referred to in the Regulations, unless otherwise expressed, have the meaning assigned to them that is in accordance with Canadian GAAP and good petroleum industry practices (section 3(4)); the requirement that the approval by the Minister of adjustments to the quantity or value of commingled oil, for the purpose of calculating royalty share, be based upon industry practices (section 19(2)), the requirement that the measurement of the use of a service or asset for the purpose of allocating costs between leases, where it is not customarily based upon volume of oil dealt with or days, is to be according to industry practice (section 59(2)(c)); and whether an asset, with respect to which a cost to be allocated between leases, is a capital asset is to be as defined by Canadian GAAP and good petroleum industry practices (section 59(3)).

## 2. *Consistent Treatment*

The Hibernia Royalty Agreement contained provisions requiring consistent treatment of interest holders in similar circumstances. The regulations contain no such requirement. Where a legislative provision can be interpreted to give the Crown (in this case, the province) some discretion in its application, the duty on the Crown to exercise the discretion in a similar manner in similar circumstances is not as clear or comprehensive as one might think it should be. Indeed, it may be that the duty is only breached where the Crown has engaged in differential treatment that amounted to an abuse of discretion. This could lead to significantly different results for different interest holders in similar circumstances.

## 3. *Double Counting*

A cost that has been claimed, deducted or included by an interest holder in a lease in the calculation of royalty share cannot be claimed, deducted or included by that or any other interest holder in calculating royalty share under that or any other lease.<sup>66</sup> This rule takes priority over any other section of the regulations.<sup>67</sup> It will be interesting to see how this rule is applied in practice and, in particular, if it is applied so as to permit the sharing of costs by interest holders that is clearly acknowledged by other parts of the regulations (notably section 59(1)).

## 4. *Arm's Length and Fair Market Value*

The arm's length rules under the regulations with respect to costs or revenue adopt the meaning of "arm's length" in section 251 of the *Income Tax Act* (Canada).<sup>68</sup> The general rule is that a cost for a transaction, or a series of transactions that are not at arm's length, is valued at the lesser of the payment made for the transaction, in cash or in kind, or the fair market value. Revenue from transactions that are not at arm's length is valued at the greater of the payment received by or on behalf of the interest holder for the transaction, in cash or in kind, or the fair market value. Except with respect to the value on the sale of oil, "fair market value" is the value based on the transactions occurring in comparable open markets among persons

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66. *Supra* note 18, section 15(1).

67. *Supra* note 18, s. 15(2).

68. *Supra* note 8. See s. 16(2) of the Regulations. The Terra Nova Project has a set of *de minimus* exceptions to the arm's length rules in section 77 of the Regulations for transactions whose costs fall below the values specified (which are indexed).

who are not affiliated.<sup>69</sup> A dispute with respect to whether or not persons are in fact dealing at arm's length and a dispute over the fair market value of a cost, expense, price, proceed of disposition or other amount receivable or payable is subject to arbitration under the regulations.<sup>70</sup>

In addition, the regulations set out several circumstances which are not considered to be arm's length transactions under the regulations, namely:

- (a) a transaction involving only two or more interest holders or their affiliates in a lease;
- (b) where the consideration is other than cash;
- (c) where the contract price is not the only consideration;
- (d) where the terms of a transaction are materially affected by a commercial relationship, other than that created by the transaction, among any of the parties to the transaction or anyone not otherwise at arm's length with them;
- (f) a transaction involving two or more leases controlled in fact by the same interest holder, or a group of common interest holders in each lease, including their affiliates;
- (g) a transaction between an interest holder in a lease and a corporation in which one or more interest holders in the lease have a controlling interest; and
- (h) other circumstances the Minister determines not to be at arm's length.<sup>71</sup>

Where a sale of oil relates to a transaction or series of transactions that are not at arm's length, for the purpose of calculating royalty share payable, the sale price is valued at the higher of the actual price received for the oil and the price that the minister determines in accordance with section 7(9).<sup>72</sup>

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69. *Supra* note 18, s.16(2)(b). It is not clear what "comparable open markets" means in this context although the same term is used in the Alberta Oil Sands Royalty Regulations under the *Mines and Minerals Act*, Alta. Reg. 185/97, s. 9. If it is comparable to the market in which the transaction to be valued occurred that may leave a relatively narrow field of inquiry. It is interesting to speculate as to what criteria will be applied under the Regulations to establish the "fair market value" of a good or service for which there is no competitive market. If there is no competitive market for a particular asset, courts have been willing to use other criteria to establish the "fair market value" of the asset: *Smith v. Minister of National Revenue*, [1951] 1 D.L.R. 162 at 165 (S.C.C.). Unfortunately, the courts have only developed such criteria for establishing the "fair market value" of specific types of assets, such as shares and real property, and these would not be applicable to the goods and services with which the Regulations are concerned.

70. *Supra* note 18, ss. 49(i), (e). On arm's length generally see B. Hansen, "Factual Non-Arm's Length Relationships In Canadian Business Statutes" (1978) 2 Can. Bus. L. J. 278 and more recently, in the income tax context, see E.P. Moskowitz, "Dealing at Arm's Length: A Question of Fact" (1987) 39 Can. Tax Found., 33:1 and S. Eng., "The Arm's Length Rules" (1988) Can. Tax Found. 13:1.

71. *Supra* note 18, s. 16(3).

72. *Supra* note 18, s. 17.

### 5. *Measurement and Standards*

Section 18 of the regulations deals with the measurement of, and devices used to measure, oil and petroleum substances and requires that these be in accordance with the legislation, regulations and rules administered by the Canada Newfoundland Offshore Petroleum Board (the CNOBP). Subsection 18(2) allows the minister to establish measurement and device standards after consultation with the interest holders for the purposes of the Regulations. With respect to the Terra Nova Project, measurement and device standards had been negotiated between the Province and the Terra Nova Consortium and approved by the CNOBP and have been applicable since the project began production in January 2002. There has been a comprehensive set of measurement and standards provisions circulated for discussion and industry comment by the CNOBP.

### 6. *Commingling*

Where oil from a lease is commingled with oil from another lease at any time before its final sale, adjustments to the quantity or valuation of the commingled oil, for the purposes of calculating royalty share payable, must be approved by the minister.<sup>73</sup> If the minister is not satisfied with that calculation, the minister can determine the adjustments to quantity or valuation for the purposes of the Regulations subject to arbitration.<sup>74</sup> The approval by the minister is to be based upon industry practice with respect to the adjustments to the quantity or valuation of commingled oil.<sup>75</sup> There are currently two producing fields in the offshore area with different qualities of crude and it is understood that the current practice is to keep them separate in the tankers and NTL storage tanks. In areas of the industry (such as pipelines, tankers, and storage facilities) where commingling does occur, the practice adopted for adjustments is generally based on some process (independent or otherwise) to analyze sales of the constituent elements to determine market differences and then apply the result on a volume basis.

### 7. *Lien*

The Act (as noted above) contains lien provisions in favour of the province for amounts owing in respect of royalty share. Under section 20(1) of the regulations, the assets of an interest holder that are subject to the lien established under the Act are restricted to:

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73. *Supra* note 18, s. 19(1).

74. *Supra* note 18, ss. 19(1) and 49(n).

75. *Supra* note 18, s. 19(2).

- (a) its undivided share of all oil produced from the lease;
- (b) its undivided interest in the lease, all rights derived under the lease or resulting from its issue, and in all agreements between the interest holders in the lease respecting the development, production and transportation of oil under the lease;
- (c) all money and proceeds that may at any time be due, owing or payable to the interest holder with respect to:
  - (i) its share in all oil and in all agreements in effect or entered into by it that relates to the sale, use or disposition of its share of oil produced from the lease, and
  - (ii) the sale, assignment other than by way of security, transfer or disposition, in whole or in part of the share of the interest holder in the lease, including all book debts, accounts receivable, instruments, judgements, securities and choses in actions arising from the sale or disposition of that oil or its share in the lease; and
- (d) records with respect to the assets referred to in paragraphs (a) through (c) including those pertaining to the sale of oil under the interest holder's lease.

Assets other than those specified in section 20(1) of the Regulations are released from the lien established under the Act.<sup>76</sup>

The regulations also contain provisions restricting the exercise of rights by the minister with respect to the lien.<sup>77</sup> If an interest holder is in default of its obligations to pay royalty share, the minister must give notice to all the interest holders in the relevant lease and not exercise any rights under the lien until at least five days after the notice (at least sixty days in the case of the exercise of the lien in respect of the interest holder's interest in the lease, agreements between the interest holders in the lease relating to the development, production and transportation of oil under the lease, or proceeds of its disposition, or records subject to the lien).<sup>78</sup> These restrictions do not apply and any notice period ceases where an interest holder breaches an obligation to assist the minister in taking in kind.<sup>79</sup> This

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76. *Supra* note 18, s. 20(2). The Regulations also provide (section 20(7)) that Part V of the Newfoundland *Personal Property Security Act*, S.N.L. 1998, c. P-7.1 applies to the lien established under the Act, with the necessary changes.

77. *Supra* note 18, ss. 20(3), 20(4), 72(2).

78. *Supra* note 18, ss. 20(3), 20(4).

79. *Supra* note 18, s.20(5). The Terra Nova Project, under Part XIII of the Regulations (see section 72(2)) has a slightly different set of restrictions, in that the Minister, with respect to the interest holder's interest in the lease, agreements relating to the development, production or transportation of oil under the lease and the records subject to the lien, cannot act for 180 days after the notice of default has been given, subject to the same provisions for ending the notice period.

“collective” responsibility is found in other parts of the regulations as well.<sup>80</sup>

### III. *Taking In Kind*

#### 1. *Right to Take In Kind*

The regulations contain detailed provisions with respect to the taking in kind of royalty share by the province. Royalty share can be taken in kind by the minister, and the minister can stop taking in kind, granted at least six months written notice is given to the interest holder.<sup>81</sup> Taking in kind begins on the first day of a month and ends on the last day of a month.<sup>82</sup> Where the minister has given notice of taking in kind, after consultation with the interest holder, the minister must give reasonable notice to the interest holder of the time, manner, location, and volume of the delivery of oil taken in kind.<sup>83</sup>

Where the minister intends to take in kind from an interest holder that is in default of its royalty share payment obligations, the minimum notice period for taking in kind and specifying time, manner, location, and volume for delivery is five days.<sup>84</sup>

Where notice of taking in kind has been given to a defaulting interest holder, the minister may give notice to another interest holder in the lease or, with respect to storage of oil, another person, requiring the other interest holder or person:

- (a) to store on behalf of and make available to the Crown oil stored by the interest holder or person on behalf of the defaulting interest holder;
- (b) when storage space is available and the Crown is not otherwise in a position to take delivery of oil scheduled to be delivered to the defaulting interest holder, to store that oil on behalf of the Crown;
- (c) not to allow delivery of oil to the defaulting interest holder or another person claiming through that defaulting interest holder;
- (d) not to interfere with scheduled rights of the defaulting interest holder to take delivery of oil where the Crown requires those rights in order to take in kind notwithstanding that these rights may have been

80. *Supra* note 18, s. 28(6).

81. *Supra* note 18, s. 21(1). The Hibernia Royalty Agreement also has extensive taking in kind provisions.

82. See generally *supra* note 4, s. 34 for the Province’s right to take royalty share in kind.

83. *Supra* note 18, s. 21(3).

84. *Supra* note 18, s. 22(1).

- directly or indirectly affected by the default of the defaulting interest holder; and
- (e) to generally co-operate in the provision of lifting scheduling, transportation scheduling and delivery plans of the defaulting interest holder.<sup>85</sup>

Where an interest holder breaches an obligation to assist the minister in taking in kind, any notice requirements for the minister's exercise of rights under the province's lien for royalty share no longer apply.<sup>86</sup>

Subsection 23(1) provides for the calculation of the volumes the province is entitled to take in kind with respect to royalty shares before an interest holder obtains Tier I payout. Subsection 23(2) deals with the calculation after the interest holder has obtained Tier I payout. Where the province is taking in kind all calculations made under section 23 are made as if there has been no shrinkage in transit.<sup>87</sup> Except in cases where the interest holder is in default of its royalty share obligations, an interest holder is to provide monthly estimates to the province of the volume of oil the province will be entitled to take in kind in the succeeding month and if it does not, or the minister does not agree with the estimates, the minister may make the estimates.<sup>88</sup>

Section 26 provides that where notice has been given, the province may take in kind oil produced under the lease that is owned by, owing or deliverable to the interest holder, or for which the interest holder has receipt or possession of bills of lading or other evidence of entitlement. The oil may be taken in kind wherever it is located, including oil located in tankers or in a trans-shipment facility. The minister must give reasonable notice to the interest holder of the time, manner, and volume of the delivery of oil taken in kind. The minister must also consult with all affected interest holders with respect to the delivery of oil taken in kind in order to facilitate its orderly transfer without significant disruption to their activities under

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85. *Supra* note 18, s. 22(6). These broad powers with respect to "other persons" raise some interesting questions as to existing contractual obligations.

86. *Supra* note 18, s. 20(5).

87. *Supra* note 18, s. 23(4). The volumes can be adjusted if an amount is determined to be owing to the Province as a result of an assessment, reassessment, or arbitration or annual reconciliation (section 24(1)). If there is an excess volume that has been taken at the point the province stopped taking in kind, the province can return the excess or, at the Minister's option, pay a money equivalent of its value (section 24(2)).

88. *Supra* note 18, s. 22(5), 25(1), (2).



the lease. Even though the minister is taking in kind from less than all of them, section 28(6) of the regulations requires that all interest holders in the lease must facilitate and assist the minister in taking in kind.

A third party from whom an interest holder is entitled to receive oil that the province is taking in kind must deliver to the province the volumes requested by notice from the minister and is not liable to the interest holder from whom the minister is taking in kind.<sup>89</sup> If the province is required to compensate another person for a payment owed by the interest holder from whom the province is taking in kind, the province can make the payment and add it to royalty share payable.<sup>90</sup>

The minister can take delivery of oil in kind at the loading point, where title to the oil passes to an arm's length purchaser, where oil enters the entry valve of a refinery or consuming facility or at a trans-shipment facility.<sup>91</sup> Delivery to the minister is complete when the oil is delivered to a facility as directed by the minister or the province takes possession. Oil remains at the risk of the interest holders until delivery as requested by the minister (section 29(1)).

If the minister requires access to a trans-shipment facility or tanker for the storage or transport of oil taken in kind that access must be given on terms customary for access by either the interest holder from whom the royalty share is being taken in kind or the trans-shipment facility or tanker upon notice by the minister.<sup>92</sup> If an interest holder provides storage and transportation to the minister for oil taken in kind, the minister must pay that interest holder for it at the rates determined under Part XI rather than at fair market value or actual cost.<sup>93</sup>

An interest holder may request in writing that the minister commence negotiations with respect to a lifting agreement for royalty share taken in kind.<sup>94</sup> The requirement for a provincial lifting agreement is obvious where the interest holders themselves have lifting arrangements in place. Within three months of the request, the minister and the interest holders in the lease must begin negotiations with respect to the lifting agreement, which contains the terms and conditions for the delivery to the province of oil including those specified in section 29(3).<sup>95</sup>

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89. *Supra* note 18, s. 26(3), (5).

90. *Supra* note 18, s. 26(4).

91. *Supra* note 18, s. 28(1).

92. *Supra* note 18, s. 29(2).

93. *Supra* note 18, s. 29(3). Part XI at the present time has only a general description of a process to determine eligible transportation costs, as described above.

94. *Supra* note 18, s. 30(1).

95. *Supra* note 18, s. 30(2).

If a lifting agreement cannot be concluded within twelve months after the request, the minister or another party to the negotiations may refer the matter to binding arbitration.<sup>96</sup> Where the minister has received a request and a lifting agreement is not in place but its negotiation has commenced and resolution of some of its terms have not occurred, the minister or an interest holder may refer those terms to arbitration at any time before the taking of royalty share in kind.<sup>97</sup> Both types of arbitration are to be final offer selection or “baseball” arbitration — i.e., choosing either the position of the minister or the interest holder made in a specific offer of settlement before the matter is referred to arbitration, as presented to the arbitrators before the hearing.<sup>98</sup>

#### IV. *Reporting and Assessments*

##### 1. *Reporting and Reconciliations*

Reporting is on a monthly basis with a certified annual reconciliation to be filed by an interest holder not more than 120 days after the end of each period together with other information sufficient for the minister to determine royalty share under the Act and the regulations.<sup>99</sup>

The interest holders in a lease must cause the project operator to provide to the minister, not more than 120 days after the end of each period, a report on the royalty costs paid by the project operator on their behalf for that period.<sup>100</sup> Similar reports are required from a tanker administrator and trans-shipment facility administrator where interest holders in a lease share in the use of transportation assets.<sup>101</sup> These reports must be accompanied by the report of an independent auditor that they have been prepared and the costs reported in compliance with the Act, the regulations and any agreements made under the Act.<sup>102</sup>

##### 2. *Advance Rulings*

Section 34 provides for advance rulings by the minister for an interest holder in a lease, or an instrument related to exploration or development preliminary to a lease, with respect to any matter relating to the calcula-

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96. *Supra* note 18, s. 30(4).

97. *Supra* note 18, s. 30(5).

98. *Supra* note 18, s. 30(6).

99. *Supra* note 18, s. 31, s. 32(1).

100. *Supra* note 18, s. 33(1).

101. *Supra* note 18, s. 3(2).

102. *Supra* note 18, s. 33(3).

tion and payment of royalty share. The minister may rule or decline to do so. A ruling made is final and binding subject to the terms and conditions the minister includes in it.<sup>103</sup> A person may withdraw an application for a ruling at any time before the minister makes the ruling.<sup>104</sup>

### 3. *Assessment*

Upon receipt of an annual reconciliation the minister assesses the royalty share payable for each month in the period and delivers that assessment to the interest holder no more than sixty days after receiving the annual reconciliation.<sup>105</sup> The assessment is to include an assessment of basic royalty, incremental royalty, gross revenue, net revenue, simple payout, Tier I payout, Tier II payout, and cumulative production of that interest holder as well as interest or penalties payable with respect to each month of the period.<sup>106</sup> The Minister has up to 120 days after the expiration of the audit period to issue a reassessment.<sup>107</sup> A dispute with respect to the assessment or reassessment of royalty share is subject to arbitration under the regulations.<sup>108</sup>

### 4. *Reassessments and Objections*

The minister may revoke, amend or revise an assessment or reassessment at any time before 120 days after the expiration of the audit.<sup>109</sup>

An interest holder may, by written notice to the minister, object to an assessment or reassessment within ninety days of receiving it.<sup>110</sup> The notice of objection must clearly identify the matter objected to, setting out the reasons for the objection, all the relevant facts, and the desired remedy. The minister must review a notice of objection, may request further particulars be provided and must give a reply in writing to the objecting person confirming, amending or rescinding part or all of the matter objected to in the same manner for giving a notice of assessment or reassessment.<sup>111</sup>

### 5. *Annual Forecasts*

Not fewer than thirty days before the beginning of a period, an interest holder is to submit to the minister, in the required form, an annual forecast

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103. *Supra* note 18, s. 34(4).

104. *Supra* note 18, s. 34(5).

105. *Supra* note 18, s. 35(1).

106. *Supra* note 18, s. 35(2).

107. *Supra* note 18, s. 35(3).

108. *Supra* note 18, s. 49(g).

109. *Supra* note 18, s. 35(5).

110. *Supra* note 18, s. 35(7).

111. *Supra* note 18, s. 35(9).

of estimated royalty costs, transportation costs, and production for the subsequent period and an estimate of when simple payout, Tier I payout, and Tier II payout is expected to occur.<sup>112</sup> Payout estimates would require the use of predictions as to future oil prices, which may be a difficult matter for an interest owner.

## V. *Records and Audit*

### 1. *Records*

Subsection 39(1) of the regulations requires that either one of an interest holder, project operator, transshipment facility administrator or tanker administrator maintain in the province records detailing eligible costs, decommissioning costs, incidental revenue, production, and inventory.<sup>113</sup>

An interest holder must maintain in Canada records required to determine the calculation of basic royalty, incremental royalty, simple payout, Tier I payout, and Tier II payout.<sup>114</sup> Records required to be maintained under the regulations are not to be destroyed before the expiration of the audit period without the prior written approval of the minister and may not be destroyed where the minister or another person referred to in section 39(1) is aware that an allegation of fraud, gross negligence or wilful and deliberate misconduct has been made.<sup>115</sup> Records required under the Act or regulations that are stored electronically must be provided to the minister in a form that is readable and usable for the purpose of an audit.<sup>116</sup>

### 2. *Successors*

Where a transfer of an interest in a lease is to occur, the transferor must, before the transfer, give written notice to the minister of the transfer stating its effective date, the identity of the transferee and the exact portions

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112. *Supra* note 18, s. 36(1).

113. Where a person is required to maintain records under section 39(1) and those records are maintained outside Newfoundland and Labrador, the interest holder to whom the records relate shall in addition to a penalty payable under the Act or the Regulations, for the purpose of an audit under the Regulations, reimburse the Minister for all reasonable expenditures necessary for or incidental to examination of those records or provide access to those records in Newfoundland and Labrador within the time specified by the Minister.

114. *Supra* note 18, s. 39(2).

115. *Supra* note 18, s. 39(6). Presumably, there will be some communication on this point between the person who is aware of this and the person required to maintain the records, although the Regulations are silent on how that will occur. It is a gap that should be addressed.

116. *Supra* note 18, s. 43(1). There is also a further requirement in section 44(2) that an interest holder co-operate with an employee of the department in translating electronic records into a readable format.

of the transferor's interest to be retained by the transferor and transferred to the transferee.<sup>117</sup> There is also an interesting requirement in section 40(14) of the Regulations that an interest holder give reasonable notice to the minister of a change of name, amalgamation or other change "that involves the interest holder's position in a lease" but is not a transfer.

Within thirty days of the minister's receipt of a notice of transfer, the minister must notify the transferor and the transferee of the royalty share payable by the transferor to the effective date of the transfer<sup>118</sup> and is to notify the parties in writing when it is paid.<sup>119</sup>

The transferor is liable for all royalty on an interest in a lease to be transferred until and including the effective date of the transfer.<sup>120</sup> The transferor and the transferee are jointly and severally liable for royalty share payable identified by the minister in their notice as of the effective date of the transfer until it is paid.<sup>121</sup> The transferee is liable for royalty on the transferred interest after the effective date of the transfer.<sup>122</sup> The consideration paid for the transfer of an interest in a lease is not a royalty cost of the transferee or incidental revenue to the transferor.<sup>123</sup>

### 3. *Audit and Audit Periods*

The basic audit period with respect to royalty share payable or an eligible cost under the Act and regulations is five years following the period in which it is reported.<sup>124</sup> If, before the expiration of the audit period, the minister requests that a person provide records to the minister and that person has access to or can reasonably obtain access to the required records, until those records are provided in satisfaction of the minister's request, the time in which the audit must be undertaken is not considered to pass, the audit period cannot expire and there is no prejudice to the minister and the audit due to the passage of time.<sup>125</sup>

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117. *Supra* note 18, ss. 40(1), (2). This section applies to a transfer of an interest by a receiver, liquidator, administrator, executor or other like person, other than a trustee in bankruptcy: see section 40(11). There may be some confidentiality and other legal requirements (securities law and stock exchange rules, for example) to be considered in connection with this notice requirement.

118. *Supra* note 18, s. 40(3).

119. *Supra* note 18, s. 40(3).

120. *Supra* note 18, s. 40(4).

121. *Supra* note 18, s. 40(5). It will be interesting to see how potential transferees receive this joint and several liability.

122. *Supra* note 18, s. 40(6).

123. *Supra* note 18, s. 40(9).

124. *Supra* note 18, s. 45(1).

125. *Supra* note 18, s. 45(2).

Disputes with respect to the provision of records and the extension of an audit period for failure to provide records are subject to arbitration under the regulations.<sup>126</sup> In addition, there is no limitation for an audit period where there has been fraud, gross negligence or wilful and deliberate misconduct with respect to the reporting or calculation of royalty share.<sup>127</sup>

#### 4. *Enforcement*

Section 41 of the regulations gives the minister or a person authorized by the minister broad powers of access for audit and inspection purposes. Section 42 gives broad powers of entry, search and seizure to the minister, upon a warrant issued by a provincial court judge. The minister can act where the minister believes on reasonable grounds that an interest holder, project operator, tanker administrator or trans-shipment facility administrator (note the breadth of the net cast here) is not providing information or access in accordance with the Act and the regulations. The provincial court judge, before issuing the warrant, must be satisfied upon oath or affirmation that there are reasonable grounds for believing that there is in premises or property of the person against whom entry is sought anything that will give evidence of a contravention of the Act or regulations or of a failure to provide information or access in accordance with the Act and regulations.<sup>128</sup>

#### 5. *Crown Liability*

Subsection 46(1) of the regulations (which comes under the title “Indemnity” although it does not seem to contain any sort of indemnity) provides that the minister or other person authorized under the Act or the regulations is not personally liable for anything done or omitted to be done in the performance of duties under the Act or the Regulations. Provisions that relieve Crown servants from liability for acts done in good faith in the intended execution of their duties will ordinarily also protect the Crown from liability. The general rule regarding vicarious liability is that liability of the servant (the minister or authorized person in this case) is a precondition of vicarious liability of the master (the province, in this case).

Subsection 46(2) of the regulations provides that

Notwithstanding subsection 5(4) of the *Proceedings Against the Crown Act*...the liability of the Crown with respect to anything done or omitted

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126. *Supra* note 18, s. 49(h).

127. *Supra* note 18, s. 45(3).

128. *Supra* note 18, s. 42.

to be done by the Minister or other authorized person is the same as if subsection (1) were not in force.<sup>129</sup>

There is an apparent conflict between section 46(2) of the regulations and section 5(4) of the Newfoundland *Proceedings Against the Crown Act*<sup>130</sup> which provides that:

An enactment that negatives or limits the amount of the liability of an officer of the Crown in respect of a tort committed by that officer or limits the time within which an action may be taken against that officer, in the case of proceedings against the Crown under this Act in respect of a tort committed by that officer, applies in relation to the Crown as it would have applied in relation to that officer if the proceedings against the Crown had been proceedings against that officer.<sup>131</sup>

Section 28 of the *Proceedings Against the Crown Act* provides that: "Except as otherwise provided in this Act, where this Act conflicts with another Act, this Act prevails."<sup>132</sup>

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129. *Supra* note 18, s. 46(2).

130. R.S.N.L. 1990, c. P-26.

131. *Ibid.*, s. 5(4).

132. *Ibid.*, s. 28. There may be some question as to whether section 46 of the Regulations is authorized by the Act. While section 39 of the Act includes a long list of matters in respect of which regulations may be made (see note 11) there may be an issue as to whether any of them authorizes a regulation of this sort. If section 46(2) of the Regulations is authorized under the Act, there is a question as to how the apparent conflict between section 46(2) of the Regulations and section 5(4) of the *Proceedings Against the Crown Act*, *supra* note 131, would be resolved. There are at least two distinct approaches to the resolution of conflicts between regulations and so-called 'co-ordinate legislation' (i.e. a statute other than the statute under which the regulation was promulgated, but of the same jurisdiction). J.M. Keyes, *Executive Legislation*, (Toronto: Butterworths, 1992) at 206-207; Holland & McGowan, *Delegated Legislation In Canada*, (Toronto: Carswell, 1989) at 189-191). One view is that any conflict between a regulation and co-ordinate legislation must be resolved in favour of the co-ordinate legislation, because a statute is a superior instrument to a regulation. Holland & McGowan, *supra*, p. 190; *Re Assessor of City of Edmonton and J.J.C. Holdings Ltd.* (1984), 12 D.L.R. (4<sup>th</sup>) 380 at 384-385 (Alta. C.A.). Under this approach, s.5(4) of the *Proceedings Against the Crown Act* would take priority over section 46(2) of the Regulations. Another view is that a conflict between a regulation and co-ordinate legislation should be resolved on the same principles as a conflict between two statutes of the same jurisdiction. On this view, if a regulation is in accordance with its authorizing legislation, it is part of that legislation for purposes of the analysis: Keyes, *supra*, p. 206; *Association des Gens de L'Air du Quebec Inc. v. Lang* (1978), 89 D.L.R. (3<sup>rd</sup>) 495 (Fed. C.A.). Under this approach, section 46(2) of the Regulations would have effect despite the apparent conflict with section 5(4) of the *Proceedings Against the Crown Act*, since the principles governing conflicts between co-ordinate statutes provide that the more specific instrument should be given priority over the more general. Keyes, *supra*, p. 207; *Re Mahlberg and Ferguson* (1983), 44 O.R. (2<sup>nd</sup>) 239 at 244 (Div. Ct.). The resolution of the conflict between section 46(2) of the Regulations and section 5(4) of the *Proceedings Against the Crown Act* depends upon which of the two contending approaches to resolving such conflicts is adopted. As a result, there is a possibility that section 46(2) of the Regulations would have no effect because of its inconsistency with section 5(4) of the *Proceedings Against the Crown Act*.

## 6. Confidentiality

Section 47 deals with the information obtained by or on behalf of the minister for the purposes of the Act and the regulations. Like a parallel provision in the *Income Tax Act* of Newfoundland,<sup>133</sup> it provides that a person who, while employed in the administration of the Act and the regulations:

- (a) knowingly communicates or knowingly allows to be communicated to a person not legally entitled to information, information obtained by or on behalf of the minister for the purpose of the Act and regulations;
- (b) knowingly allows a person not legally entitled to do so, to inspect or have access to a book, record, writing, return or other document obtained by or on behalf of the Minister for the purposes of the Act and these Regulations; or
- (c) knowingly uses, other than in the course of his or her duties in connection with the administration or enforcement of the Act or these regulations, information obtained by or on behalf of the minister for the purpose of the Act or these regulations is guilty of an offence and liable on summary conviction to a fine not exceeding \$5,000 or imprisonment for a term not exceeding 12 months or to both.<sup>134</sup>

The provision does not apply to the communication of information between the Minister and any of the Minister of Finance and Treasury Board, the Minister of Natural Resources for Canada and the Board.<sup>135</sup>

There is an interesting issue with respect to the confidentiality of information required to be provided under the Act and Regulations and the relationship of the Act and Regulations to the Province's Access to Information legislation. With respect to the latter, there are two levels of concern — the existing statute and the as yet unproclaimed *Access to Information and Protection of Privacy Act*.<sup>136</sup>

In Alberta, section 50(1) of the *Mines and Minerals Act*<sup>137</sup> is similar in scope to section 47 of the Regulations. The Alberta provision states that a person is not legally entitled to a record, return or information for the purposes of such provision simply because of a right of access to it under

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133. S.N.L. 2000, c. I-1.1.

134. *Supra* note 18, s. 47.

135. *Supra* note 18, s. 47(2).

136. S.N.L. 2002, c. A-1.1 [AIPPA].

137. R.S.A. 2000, c. M-17, s. 50(1).



the Alberta *Freedom of Information and Protection of Privacy Act*.<sup>138</sup> With respect to any record, returns, or information obtained under the *Mines and Minerals Act*<sup>139</sup> that would reveal geological or geophysical work, section 50(1) prevails despite the FIPPA for a period of fifteen years following the end of the year in which it was obtained. For information on a royalty return, account, invoice or statement obtained for the purpose of royalty determination under the *Mines and Minerals Act*, section 50(1) prevails despite the Alberta FIPPA for a period of five years following the end of the year to which the information relates.

Apart from section 47 of the Regulations and a provision that requires an arbitrator to keep confidential all information received from an interest holder or the minister unless otherwise ordered by a court (see section 52), there is no confidentiality provision in the Act or regulations. If the AIPPA comes into force in its current form and there is a provision in the regulations at that time providing that such records, returns, documents, and information are to be kept in confidence the materials should be protected from disclosure under the AIPPA for two years after it comes into force (see sections 6(3) and (4)(a) of the AIPPA). If a regulation is promulgated under paragraph 73(g) of the AIPPA indicating that the confidentiality provisions in the regulations prevail over disclosure requirements under the AIPPA, the confidentiality provisions under the regulations could continue to prevail even after the two year period. The exemptions from disclosure under the AIPPA may apply in any event, but the better solution would be to deal with the issue as Alberta has.

## VI. *Dispute Resolution*

### 1. *Arbitration Code*

Part VI of the Regulations adopts the Arbitration Code set out in the federal *Commercial Arbitration Act*<sup>140</sup> except to the extent varied under subsection 48(2). Subsection 48(2) stipulates specific procedures with respect to an arbitration conducted under the regulations including making the applicable court the Trial Division of the Supreme Court of Newfoundland and

138. R.S.A. 2000, c. F-25 [FIPPA].

139. *Supra* note 137.

140. R.S.C. 1985, (2<sup>nd</sup> Supp.), c.17; see L. Biukovic, "Impact of the Adoption of the Model Law in Canada: Creating a New Environment for International Arbitration" (1998) 30 Can. Bus. L. J. 376; D.R. Haigh, A. Kunetski and C.M. Antony "International Commercial Arbitration and The Canadian Experience" (1995) 34:1 Alta. L. Rev. 137.

Labrador, the rules of law applicable to an arbitrated dispute the laws of the province, and requiring that the arbitration be carried out in St. John's or another place in the province agreeable to the parties to the arbitration.

The *Commercial Arbitration Act* adopts the United Nations Commission on International Trade Law (UNCITRAL) rules<sup>141</sup> and has been used in the offshore area before under the Hibernia Royalty Agreement.

## 2. *Matters Subject to Arbitration*

Section 49 lists matters that may be submitted to arbitration. It contains a list of specific types of disputes. There is no general ability to arbitrate any dispute under the Act and regulations.

An interesting issue under the regulations is the scope within which an arbitrator could redetermine any matter which had already been determined by the minister since the wording in the regulations gives the minister significant discretion to determine certain matters. One would hope that the arbitrator would be able to take a fresh look at the subject of the minister's determination or assessment.

## 3. *Procedures*

Section 50 provides for the procedures by which a reference to arbitration may occur. Arbitration of issues relating to the sales price of oil for royalty purposes are to be on a final offer selection basis.<sup>142</sup> An arbitrator must keep confidential all information received from an interest holder or the minister in the course of the arbitration, unless otherwise ordered by a court to make that information available.<sup>143</sup>

## 4. *Independent Expert*

For the Terra Nova Project, a dispute between the minister and the interest holder with respect to whether an eligible cost should be an eligible capital cost or an eligible operating cost may, before it is submitted to arbitration, be sent to an independent expert (a public accountant with a substantial presence in Newfoundland and Labrador, on whose selection the parties must agree).

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141. *UNCITRAL Arbitration Rules*, GA Res. 31/98, UN GAOR, 31<sup>st</sup> Sess., Supp. No. 17, UN Doc. A/31/17, (1976).

142. *Supra* note 18, s. 51(2).

143. *Supra* note 18, s. 52

## VII. *Decommissioning*

Part VII of the Regulations deals with decommissioning — activities associated with the termination of the production of oil under a lease and the reversion of project lands related to that lease or to their state before concluding the matters specified in sections 53(a) to (e). Costs to abandon wells that are not incurred with respect to a decommissioning plan but otherwise meet all other capital cost criteria under the regulations are treated as eligible capital costs under section 65(3).

### 1. *Plan*

An interest holder or a project operator on behalf of all interest holders must submit a decommissioning proposal to the Minister not less than one year before the decommissioning of the production activities under a lease.<sup>144</sup> The Minister must approve or reject the decommissioning proposal not more than sixty days after receiving it. An approved decommissioning proposal becomes the decommissioning plan for the lease. The Minister must approve the decommissioning proposal submitted under section 54(1) where it meets all requirements with respect to abandoning the activities under the lease imposed as a result of law, rule, regulation, permit, license, order or other directive of the Province or Canada or an agency of them.<sup>145</sup>

### 2. *Changes*

If there is a material change (an increase of 10 per cent or more) in the nature or amount of an estimate contained in a decommissioning plan or a material change (six months or more) in the date of substantial completion under the plan, the interest holder or project operator who submitted the plan must immediately submit an amendment to the plan to the minister.<sup>146</sup>

### 3. *Carry-back Statements*

An interest holder or project operator acting for all interest holders must give notice to the minister of the substantial completion of the decommissioning.<sup>147</sup> Where the minister confirms that substantial completion has occurred, the interest holder or project operator submits to the minister

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144. *Supra* note 18, s. 54(1).

145. *Supra* note 18, s. 54(3).

146. *Supra* note 18, ss. 54(4), (5).

147. *Supra* note 18, s. 55(1).

a decommissioning carry-back statement, which contains the interest holder's working interest share of the total decommissioning costs and decommissioning revenues and the result of subtracting the costs from the revenues.<sup>148</sup> If decommissioning revenues exceed decommissioning costs, the excess is incidental revenue for the period in which the initial carry-back statement is prepared. If decommissioning costs exceed decommissioning revenues, the resulting net decommissioning costs are used to reduce net revenue to zero for the period in which the initial carry-back statement is prepared. Any excess of net decommissioning costs over that required to reduce net revenue to zero for that period is carried back to the previous period to reduce net revenue for that period to zero. This process continues for each preceding period until all net decommissioning costs have been applied.<sup>149</sup>

Where decommissioning revenue is received more than one year before the beginning of the period in which substantial completion of the decommissioning is expected to occur, it must be included as incidental revenue when received by the interest holder.<sup>150</sup>

#### 4. *Verification*

The decommissioning carry-back statement must be accompanied by an independent auditor's report verifying that decommissioning costs and decommissioning revenues comply with the regulations.<sup>151</sup>

Where the application of net decommissioning costs to net revenue results in an amount owed by the Crown to the interest holder with respect to the recalculation of royalty share, it is due and payable thirty days after the minister has received the decommissioning carry-back statement. If the minister is satisfied that activities under the decommissioning plan have been substantially completed, interest is paid by the Crown with respect to the amount determined to be owing to the interest holder under the section from the date the amount is payable by the Crown until it is paid.<sup>152</sup>

#### 5. *Additional Costs*

Where an interest holder incurs additional decommissioning costs after the period in which substantial completion of the decommissioning has occurred, the interest holder may submit to the minister a supplemen-

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148. *Supra* note 18, s. 55(2).

149. *Supra* note 18, s. 55(7). Where an adjustment is made to net revenue for a period in which net decommissioning costs are applied incremental royalty for that period is recalculated to take into account the deduction of net decommissioning costs: see s. 55(10).

150. *Supra* note 18, s. 55(9).

151. *Supra* note 18, s. 55(8).

152. *Supra* note 18, s. 56(1).

tal decommissioning carry-back statement for each period in which those additional costs were incurred and Part VII applies to that statement.<sup>153</sup>

### 6. *Disputes*

Disputes with respect to ministerial approval of a decommissioning plan, compliance with a decommissioning plan and confirmation by the minister of substantial completion are all subject to arbitration under the regulations.<sup>154</sup>

## VIII. *Costs — General Requirements, Disallowance, and Rules*

### 1. *Eligible Costs — General Requirements*

Part X of the regulations deals with eligible costs. Under section 63 of the regulations, a cost qualifies as an eligible pre-development cost, an eligible capital cost, an eligible operating cost (all of which, together with net decommissioning costs, are sometimes referred to as a “royalty cost”) or a decommissioning cost under a lease only to the extent that:

- (a) it is a cash payment;
- (b) it is directly attributable to exploration, development, production or decommissioning activities under the lease or was incurred to market oil produced under a lease and complies with section 68(1)(f) of the regulations;
- (c) it is reasonable in relation to the circumstances under which it is incurred;
- (d) it is not a cost under another lease within Newfoundland and Labrador;
- (e) with the exception of marketing costs, and insurance costs approved by the minister under this section, it is a cost that was incurred by the project operator and shared by all interest holders in the lease in proportion to their working interest share in the lease; and
- (f) it meets all other requirements of these regulations.<sup>155</sup>

These are the general requirements of any cost to qualify. If a cost meets these general requirements and otherwise fits the definitions of one of

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153. *Supra* note 18, s. 57.

154. *Supra* note 18, s. 49(j).

155. *Supra* note 18, s. 63.

the “royalty costs” under the regulations it is an eligible cost unless expressly disallowed by the regulations. A dispute with respect to the calculation or eligibility of a royalty cost is subject to arbitration under the regulations.<sup>156</sup>

## 2. *Insurance Costs*

Insurance costs are approved by the minister based on the minister’s assessment of the fair market value of those costs (which is subject to arbitration).<sup>157</sup> Marketing costs and approved insurance costs with respect to a lease will qualify as eligible costs if they are incurred in whole or in part by a partner of the interest holder in a partnership (in which all partners are affiliates of each other) established for the purposes of exploration, development and production of oil under the lease.<sup>158</sup>

## 3. *Decommissioning Costs*

Section 67 deals with decommissioning costs (costs under a decommissioning plan that otherwise satisfy the requirements of the regulations) which are grossed up by 1 per cent.

## 4. *Eligible Pre-Development Costs*

Section 64 deals with pre-development costs (costs incurred before the commencement date or after the commencement date for the purpose of exploration of project lands). The interest holder must apply to the minister for certification of pre-development costs.<sup>159</sup> Subsection 64(3) determines eligible pre-development costs by a formula. The minister has authority to approve amounts as pre-development costs in addition to what is calculated under the formula.<sup>160</sup> The minister also has a general power to determine the allocation among interest holders of certified eligible pre-development costs. In addition, the minister may approve any cost that meets all the criteria of sections 63(1)(a) to (d) to be a pre-development cost if the minister is satisfied that the sharing of costs on other than a

156. *Supra* note 18, s. 49(b).

157. *Supra* note 18, s. 63(2).

158. *Supra* note 18, s. 63(3). Under paragraph 3(1)(b) “affiliate” has the same meaning as the words “affiliated persons” in section 251.1 of the *Income Tax Act*, *supra* note 8.

159. *Supra* note 18, s. 64(2). The commencement date is determined by the Minister under section 14 of the Regulations after consulting with the interest holders in a lease or, where a lease has not been issued, a project where a development plan has been approved by the CNOPB and the interest holders will be applying for a lease. A dispute with respect to costs included in certified predevelopment costs is subject to arbitration under the Regulations (see section 49(b)). The Terra Nova Project has some separate rules on eligible pre-development costs. See section 79 of the Regulations.

160. *Supra* note 18, s. 64(6).

working interest basis is appropriate in the circumstances.<sup>161</sup>

### 5. *Eligible Capital Costs*

Eligible capital costs are costs incurred after the commencement date, where it:

- (a) is not a pre-development cost, an eligible operating cost or a cost incurred in compliance with a decommissioning plan; and
- (b) is incurred after the commencement date; or notwithstanding paragraphs (a) and (b);
- (c) is a cost that qualifies as an eligible operating cost but was incurred before production start-up.<sup>162</sup>

Eligible capital costs that are not overhead, marketing costs or costs for a funded reserve eligible under section 61 are grossed up by 1 per cent.<sup>163</sup>

### 6. *Eligible Operating Costs*

To qualify as eligible operating costs, costs must meet certain requirements. These costs must not be pre-development costs, a cost incurred in compliance with a decommissioning plan or an eligible capital cost; they must be incurred after production start-up; must meet all other criteria of the regulations; and would be classified as an operating cost in accordance with Canadian generally accepted accounting principles.<sup>164</sup> Eligible operating costs which are not overhead, marketing costs or costs for a funded reserve eligible under section 61 are grossed up by 10 per cent.<sup>165</sup>

### 7. *Disallowed Costs*

Section 68 contains extensive rules with respect to the disallowance of costs. Of particular interest is the exclusion of overhead of an interest holder, the project operator, tanker administrator or trans-shipment facility administrator or an affiliate of any one of them unless it was incurred before the commencement date and is approved by the minister or was incurred for an office located in the province or for a person working

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161. *Supra* note 18, ss. 64(7), 63(4).

162. *Supra* note 18, s. 66(2).

163. *Supra* note 18, s. 66(1).

164. *Supra* note 18, s. 65(2).

165. *Supra* note 18, s. 65(1)(b).

in the province.<sup>166</sup> Marketing costs are also excluded except those incurred within the province and directly attributable to the office or employees of the interest holder for the purpose of marketing that interest holder's share of production obtained under the lease.<sup>167</sup> Costs incurred by an interest holder for the use of trans-shipment facilities not located within the province are also disqualified unless approved by the minister.<sup>168</sup> Research and development costs are excluded except those:

- (a) necessary for the purpose of exploration, development, production or decommissioning in respect of the lease;
- (b) not charged to or credited against another royalty regime; and
- (c) for activity substantially performed within the Province or the Offshore Area.<sup>169</sup>

Unless approved by the minister, a cost will not qualify as a royalty cost if it is a charge (not all directly related to a third party charge) from another lease in the province, in which the interest holder holds an ownership interest, that does not come under the regulations.<sup>170</sup> This appears to be a general prohibition against charges between projects, again presumably motivated by the province's concern that costs from projects outside the regulations (and having lower royalty rates) may be off-loaded to projects subject to the regulations with higher royalty rates, to the fiscal prejudice of the province.

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166. *Supra* note 18, s. 68(1)(b). "Overhead" is defined in section 3(1)(f) as "the general corporate and administrative costs incurred for an organization, employees and facilities" including those specified in the definition. The Terra Nova Project has a set of specific rules disallowing certain overhead costs incurred by an alliance member: see section 85(1), (4). One of the concerns about the "overhead" exclusion is the risk of extending it to the "overhead" portion of legitimate third party charges. Mark-up of the charges of a third party by an interest holder, project operator, a tanker administrator or trans-shipment facility administrator is also disallowed: section 68(1)(g).

167. *Supra* note 18, s. 68(1)(f).

168. *Supra* note 18, s. 68(1)(q). Direct costs of purchasing, leasing or renting land or a building not in the Province or the Offshore Area are also disallowed: section 68(1)(o).

169. *Supra* note 18, s. 68(1)(r). Interest and other financing charges are disallowed (section 68(1)(a)) as are payments on account of an overriding royalty, a net profits interest, a carried interest or other similar interest (section 68(1)(d)), and costs or payments in relation to transactions entered into to hedge price risk with respect to a commodity or money (section 68(1)(u)). Costs in the nature of reservoir risk amounts (under section 3(1)(u)) - these are basically amounts an interest owner pays to another person that otherwise qualify as a royalty cost and are computed based on the amount or volume of production under a lease) are allowed if approved by the Minister (section 68(1)(s)). Costs resulting from wilful and deliberate misconduct or gross negligence of management or supervisory personnel are disallowed (section 68(1)(j)). Costs to purchase an interest in a transportation or trans-shipment asset previously used in the Offshore Area are also disallowed (section 68(1)(e)).

170. *Supra* note 18, s. 68(2).



### 8. *Prepayment*

Under section 58(1) of the regulations, the eligible amount of a cost that includes prepayment with respect to goods and services allocated within the month is the portion of the cost relating to goods and services that is consumed within a year of the prepayment and the remaining portion of the cost is allocated to the months in which the goods and services are actually consumed or used.

Subsection 58(2) provides that subsection 58(1) does not apply to a progress payment, deposit or prepayment on a capital asset or materials to construct a capital asset if paid under an agreement between a person dealing at arm's length with the interest holder and the interest holder or the project operator. There is no similar exception for such payments in respect of other assets or contracts for services; the distinction seems somewhat artificial and the exception is sensible in these other cases as well. For the Terra Nova Project, section 85(3) of the regulations excludes the application of section 58(1) to a cost incurred to purchase commercially justifiable inventory that is justifiable solely on the basis of the business purpose of the arrangement to provide goods or services without regard to the impact on royalty share. One would have thought that such an approach might have been compelling enough to find its way into the generic regime, as well.

### 9. *Allocation*

With the exception of marketing and insurance costs dealt with under paragraph 63(1)(e), the maximum portion of a cost incurred by or on behalf of an interest holder that may be a royalty cost is the amount allocated to the interest holder according to its working interest share in the lease at the time the cost was incurred.<sup>171</sup>

Subsection 59(2) provides a process for allocating costs between leases. In areas where it makes good economic sense to share costs between projects (in some cases, such as emergency response systems, it may be mandated by the regulator) the province has a concern with respect to how those costs are allocated for royalty purposes between different projects subject to different royalty rates. Under the regulations, if the capacity and usage of the services or asset to which the cost relates is customarily measured by the volume of oil, the cost is allocated on a volume basis. If it is customarily measured by days it is allocated on a daily basis. If neither, it is measured according to industry practice for the measure-

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171. *Supra* note 18, s. 59(1).

ments of the services.

If the cost is with respect to a capital asset as defined by Canadian generally accepted accounting principles and good petroleum industry practices, it is allocated in accordance with the percentage of expected use of the asset over the expected life of the lease. A dispute with respect to the allocation of a cost is subject to arbitration under the regulations.<sup>172</sup>

#### 10. *Dispositions*

The cost of an asset disposed of within one year of its acquisition is not a royalty cost and the proceeds of disposition are not incidental revenue or a reduction in royalty cost unless the asset disposed of has served its useful life or purpose within the lease at the time of its disposition.<sup>173</sup> An asset is deemed disposed of where it is no longer available for use under the lease or there is no longer a use for that asset under the lease.<sup>174</sup> The proceeds of disposition of an asset or incidental revenue is the fair market value of the asset at the time of the disposition.<sup>175</sup>

#### 11. *Reserves*

Payments into reserve funds only qualify as eligible costs where the requirements of section 61(1) are met. The reserve must be a funded reserve and required by law or other directive of the Province, Canada or the CNOPB, the obligation for it must be imposed upon an interest holder with respect to its interest in a lease or upon the resource project operator with respect to a lease and access to the fund cannot be controlled by the interest holder, the project operator or a tanker or trans-shipment facility administrator.<sup>176</sup> Funds cannot be withdrawn from the reserve except as allowed by law or other directive or by the terms and conditions establishing the reserve.<sup>177</sup>

Payments to reserve funds for costs resulting from damage to the environment cannot qualify as an eligible cost unless payment out of that fund at a later date can exceed the amount of the interest holder's payment at the end of the fund plus interest on the amount paid in.<sup>178</sup> The Minister may consent to payments to a reserve fund being eligible costs

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172. *Supra* note 18, s. 49(d).

173. *Supra* note 18, s. 60(1).

174. *Supra* note 18, s. 60(2).

175. *Supra* note 18, s. 60(4).

176. *Supra* note 18, s. 61(1).

177. *Supra* note 18, s. 61(1)(f).

178. *Supra* note 18, s. 61(3).

even though they do not qualify under sections 61(1) through 61(3).<sup>179</sup> If a payment into a reserve fund qualifies as an eligible cost, payments made out of or amounts returned from the reserve fund that are not applied for the purpose for which the reserve fund is established are incidental revenue or tanker incidental revenue.<sup>180</sup>

### IX. *Interest*

Under Part IX of the regulations, interest is payable in respect of all amounts payable under the regulations from the date the amount was due until the date of receipt of payment at an annual rate equal to the Bank of Canada business prime rate plus two percent, compounded and payable monthly.<sup>181</sup> Interest is not payable where an interest holder has underpaid royalty share if the minister is satisfied that the discrepancy results from the use of transportation costs that, in the opinion of the minister, are reasonably estimated eligible transportation costs of the interest holder.<sup>182</sup> In addition, interest is not payable where an interest holder has overpaid royalty share if the discrepancy resulted from the use of estimated transportation costs of the interest holder in the lease.<sup>183</sup> An interest holder can apply to the minister to waive interest on outstanding royalty share.<sup>184</sup>

### X. *Penalties*

If a person fails to file with the minister a statement or report under the Act or the regulations the minister may order the person to pay a penalty of not more than \$2,000 for each month that it is not filed.<sup>185</sup> A violation of the requirement to maintain records under section 39 (except for records on marketing costs and insurance costs) can result in a penalty of \$5,000 per month in which the records are not maintained as required.<sup>186</sup>

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179. *Supra* note 18, s. 61(4).

180. *Supra* note 18, s. 61(5).

181. *Supra* note 18, s. 62(1).

182. *Supra* note 18, s. 62(3).

183. *Supra* note 18, s. 62(7).

184. *Supra* note 18, s. 62(6).

185. *Supra* note 18, s. 74(1).

186. *Supra* note 18, s. 74(2).

### *Conclusion*

The Regulations represent another step in the province's efforts to foster the development of its petroleum resources while at the same time taking its fair share of the resource as the joint administrator of it under the *Accord Acts*. The province has had experience with the Hibernia Royalty Agreement and the negotiations of the written Terra Nova Royalty Agreement, and the benefits of the experiences of other jurisdictions. There are a number of issues not dealt with, or not dealt with in detail, in the regulations that will need to be considered in the future, particularly with respect to transportation costs. There are a number of provisions in the regulations, such as the lien provisions, the taking-in-kind provisions, the successor provisions, and the allocation of costs provisions, that will need to be tested in practice to confirm their practicality and effectiveness. Provisions with respect to the exercise of discretion by the province or the minister will also need to be tested to see whether they will be administered in the fair and impartial way that one would expect, or whether they involve so much discretion and so much variation in results in practice that the attendant uncertainty prejudices the attractiveness of the offshore area from the standpoint of future investment.

