CAPLA Lunch'n Learn: Royalties
November 17, 2016

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and Kathy Luther – Manager, Land Compliance. PrairieSky Royalty Ltd.

PrairieSky Royalty Ltd.

IPO formed May 27, 2014:

- 5.2 million acres fee simple land
- 0.5 million acres GOR interest

Four major acquisitions:

- Range Royalty Ltd. (2014)
- Perpetual (2015)
- CNRL (2015)
- Pine Cliff (2016)

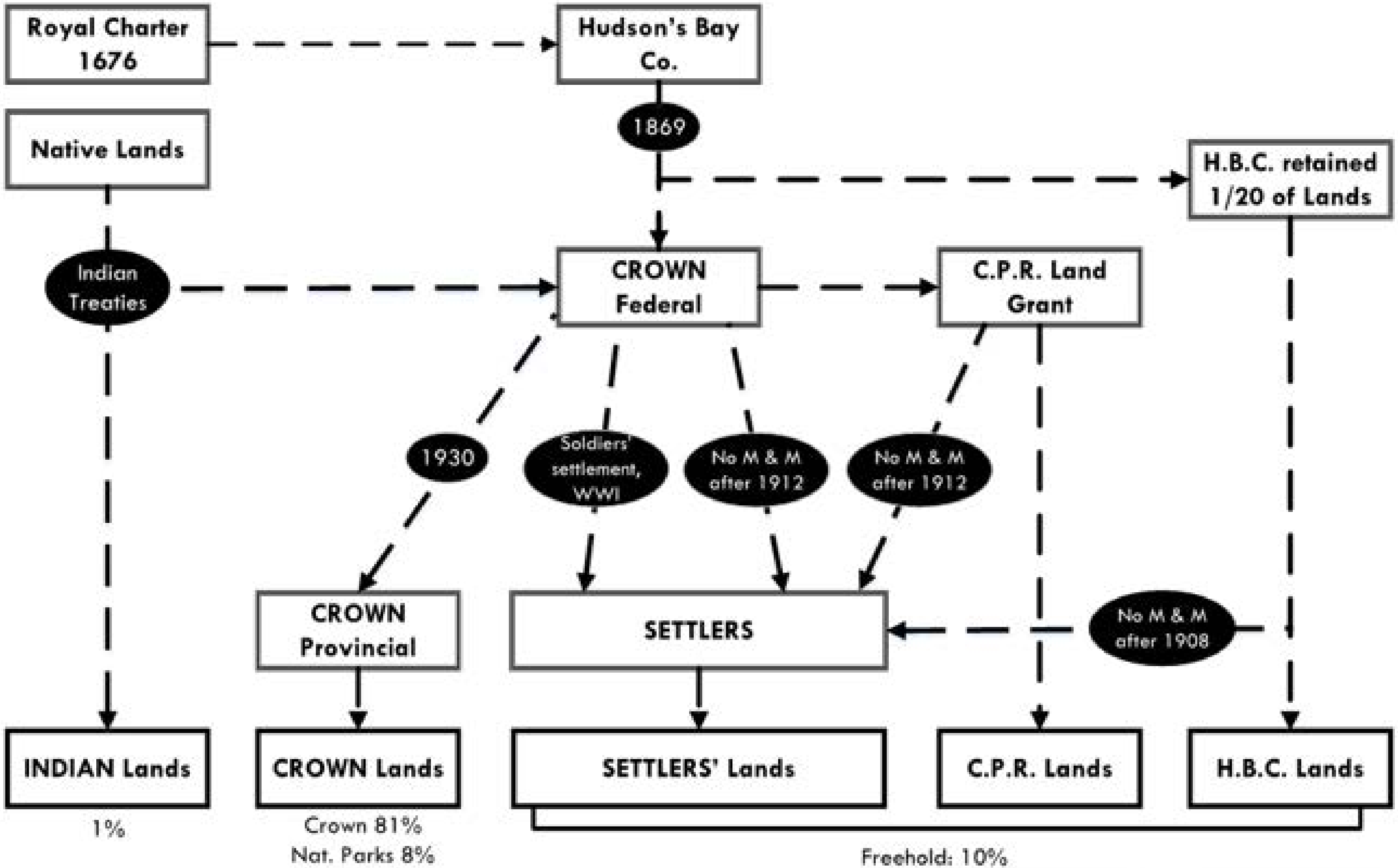
Current land base:

- 7.9 million acres fee simple land
- 6.9 million acres GOR interest
- ~345 Royalty Payors
- ~36,000 royalty wells
- > 300 Units

PrairieSky Model:

- acquire and manage fee title and royalty lands
- generate significant free cash flow through indirect third-party oil and gas exploration and development investments

Western Canada Land Holdings



GOR Interests
(Range, CNRL +others)

Encana Fee Lands

Range, CNRL + other Fee Lands

When Is Royalty An Interest in Land

- ‘Interest in land’ depends on two criteria:
  - Did the party creating the royalty have an interest in land (freeholder or lessee)?
  - Did the parties intend the royalty to be a grant of interest in land (i.e. right to take in kind) rather than a contractual right to a portion of the proceeds from the substances recovered from the land?
- These factors also contribute to what types of deductions may apply and at what point in place or time the royalty and deductions are determined.
  - **Interest in Land** – ownership share of production from the land (i.e. right to take in kind, so deductions typically for costs to handle production from or further downstream of wellhead)
  - **Not Interest in Land** – share of other party’s sales revenue/profit (deductions may be inclusive of costs/expenses to drill/produce)

Royalties and other Reserved Interests

- **Lessor Royalty (LOR)**
  - Reserved share of the minerals and/or a rent for the granting of a profit à prendre to the lessee and reverts back to lessor at expiry of the lease.
- **Overriding Royalty (ORR/ORRI)**
  - Grant or reservation out of the lessee's working interest entitling its owner to: (1) a percentage of the production or (2) a share of the **proceeds** from sale of production both free of drilling, completing, equipping and operating costs.
  - Gross Overriding Royalty (GOR)
    - Gross percentage share of the production/proceeds
  - Net Overriding Royalty (NOR/NRI)
    - A percentage of the WI share after netting out other specific interests/burdens (does not mean net of deductions)
- **Production Volume Royalty (PVR) or Volumetric Production Payment (VPP)**
  - Right to a receive a fixed production volume (over fixed time period) or to recover a certain cash amount from production proceeds
- **Net Profit Interest (NPI)**
  - Right to a percentage of the gross cash income from the sale of production less all expenses incurred to produce the income
- **Net Carried Interest (NCI)**
  - Basically an automatic "non-participation election" until recovery from revenues of 100% or more of costs and expenses

Royalty Products and Oil & Gas Production

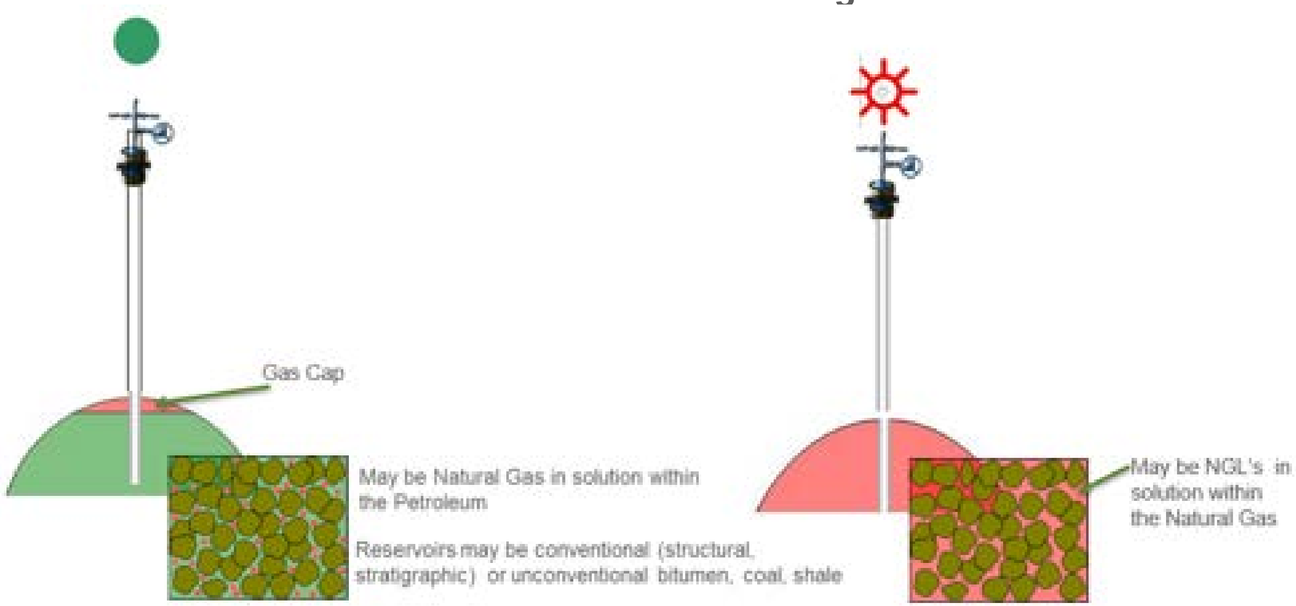
- Throughout history, Leases have used a number of terms to define lease substances which affect royalties and deduction calculations:
  - Petroleum vs. Crude Oil, Natural Gas vs. Condensate vs. Natural gasoline, Plant Products vs. Natural Gas Liquids vs. Solution Gas, NG vs. Coal Bed Methane etc.

OIL WELL

- Well flowing or pumping liquid Petroleum
- May produce Solution Gas
- Solution Gas may contain Natural Gas Liquids

GAS WELL

- Well flowing Natural Gas and suspended gaseous liquids
- Natural Gas may be “Dry” with no NGL’s, or “WET GAS” with NGL’s
- **There is little or no oil produced with the natural gas**



Natural Gas and Natural Gas Liquids

- Natural Gas includes NGL's which include Field Condensate (products are distinguished in royalty treatment)
- Amount of NGL's depends how NG was generated - thermogenic vs biogenic
- Source material, migration, trapping history also affect final composition
- Field Condensate is produced at the wellsite when temp of NG drops below HC dew point and heavier **HC's condense** to liquid
- Ethane, Propane, Butane, additional Pentanes Plus are removed by Gas Plants (otherwise they stay in the NG and add to it's heating value – but NG must meet pipeline specifications)

"Wet" Natural Gas						
"Dry" Natural Gas	Natural Gas Liquids (NGL's) - dissolved in NG					
Methane	Ethane	Propane	Butane	Pentane		
C1	C2	C3	C4	C5	C6	C7+
CH_4	C_2H_6	C_3H_8	C_4H_{10}	C_5H_{12}	C_6H_{14}	
Lighter Hydrocarbons	Products removed by Gas Plants			Condensate (C5+) - wellsite separation		

Sulphur?

Heavier Hydrocarbons

Liquid Petroleum - comprised of

Paraffin, Naphthene, Aromatic and Asphaltic hydrocarbon molecules

Condensate, Pentanes+ and Plant Products

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Condensate

- Removed from gas at the well site
- heavier hydrocarbons naturally condense into a liquid at a well site separator
- similar to how steam condenses into water
- Condensate has the same molecular composition as Pentanes+ which is produced at a NGL Fractionation Facility
- The term "condensate" describes the method of extraction from the gas – wellsite simple separation

Condensate – "Also Known As"

- Field Condensate
- Crude Naphtha
- Natural Gasoline
- Liquid Hydrocarbons Other than Oil (C5+)
- Must be Extracted through **Simple Separation**

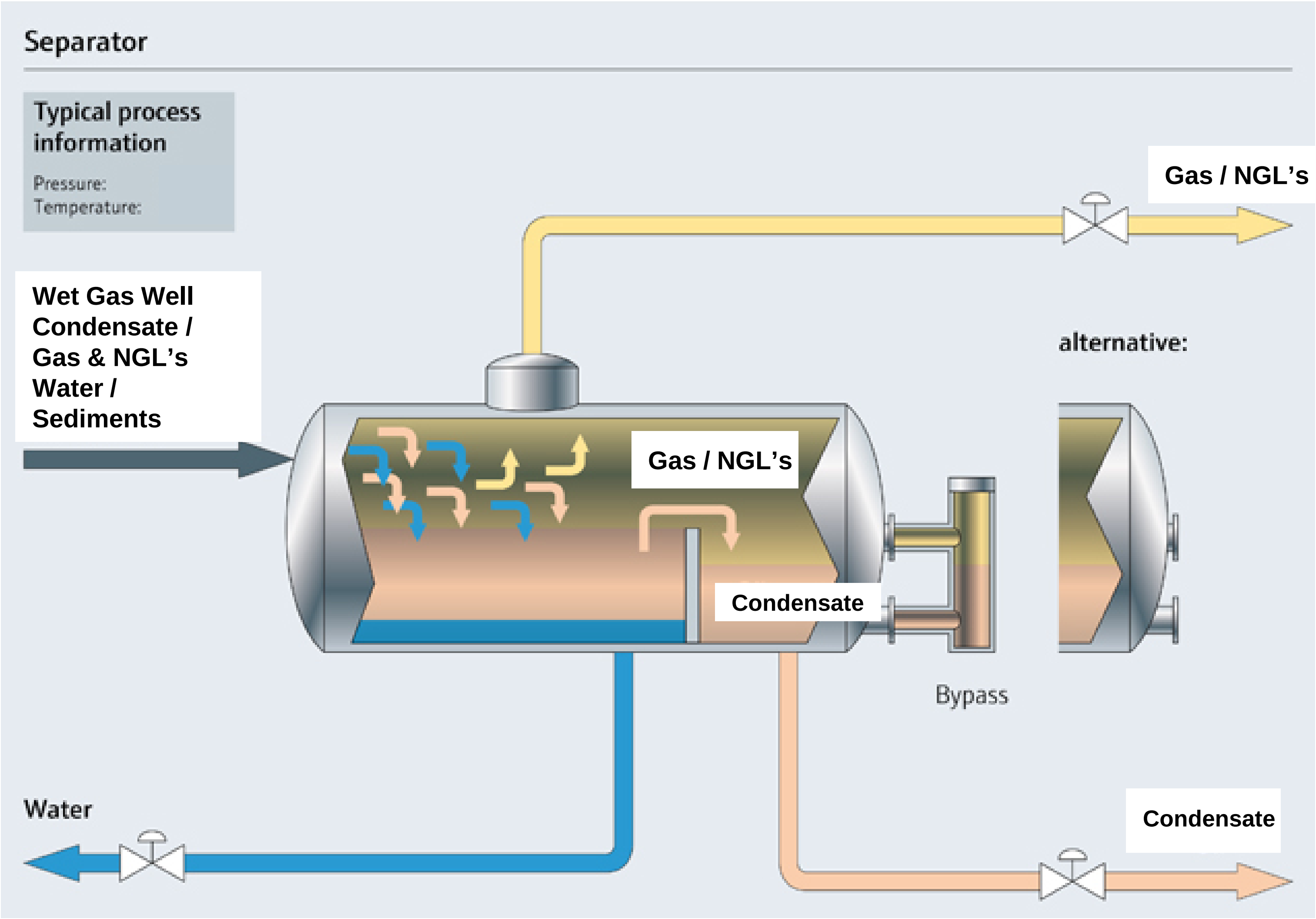
Pentanes+ "Also Known As"

- Crude Naphtha
- Natural Gasoline
- Liquid Hydrocarbons Other than Oil (C5+)
- Must be Extracted **at a Gas Processing Plant or a NGL Extraction Plant**

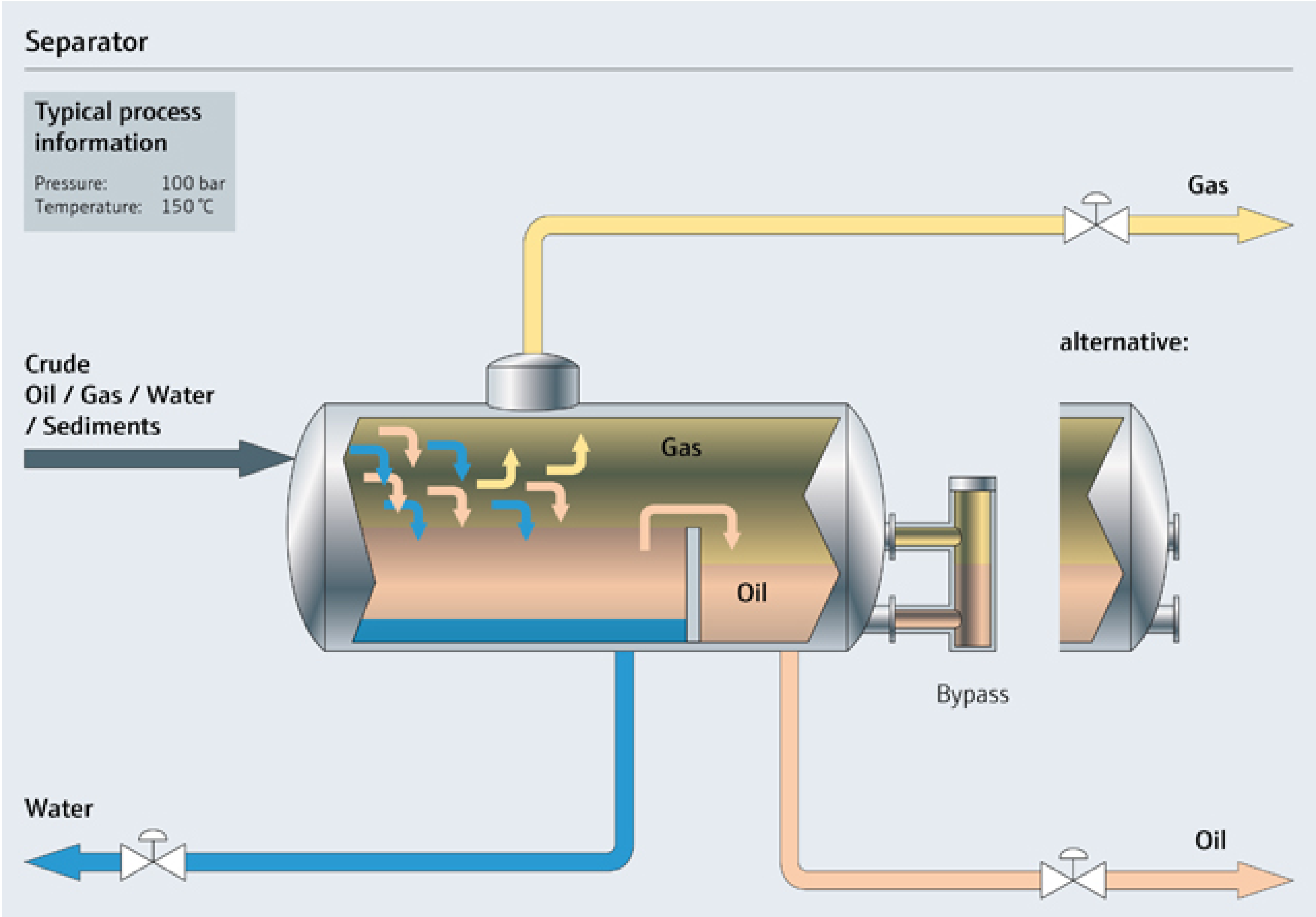
Plant Products "Also Known As"

- means all products removed from the Natural Gas at a Gas Processing Plant
- It's the equivalent NGL's + Sulphur
- Ethane, Propane, Butane, Pentanes and Sulphur

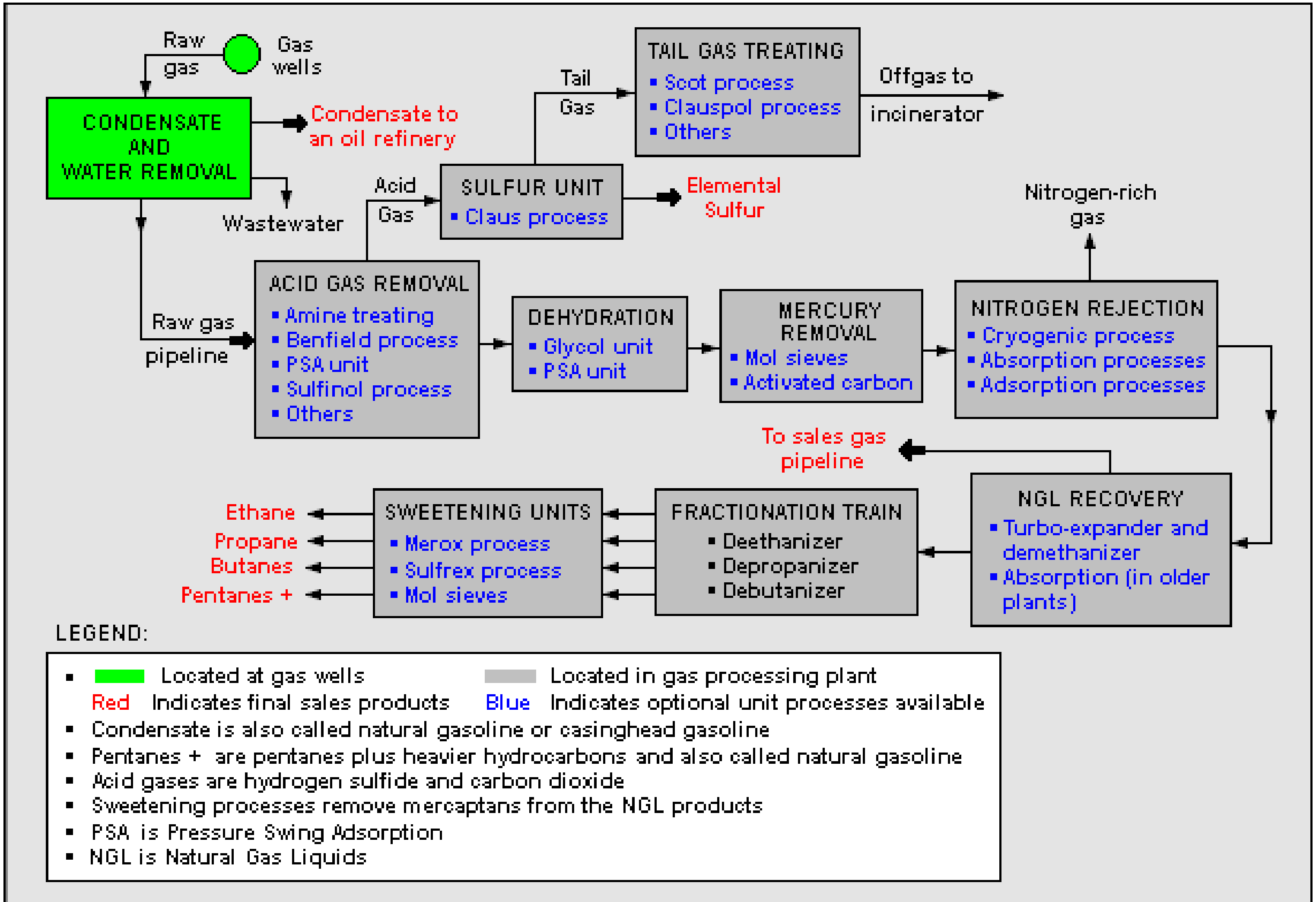
Wet Gas Well
Wellsite Separator



Oil Well
Wellsite Separator



A Schematic flow diagram of a typical large natural gas processing plant



(PD) Diagram: Milton Beychok

A schematic flow diagram of a typical large natural gas processing plant

Natural Gas vs. Oil Ownership

Petroleum – also otherwise known as crude oil (inclusive of Heavy Oil and Bitumen), means a mixture mainly of hydrocarbons heavier than pentanes that are in a liquid state at both the prevailing reservoir conditions and at surface conditions, which are not derived from but may be found in association with Natural Gas or Solution Gas in the reservoir and which may contain sulphur compounds.

Heavy Oil - means Petroleum that has a relative density greater than ten degrees (10°) and less than or equal to twenty-two decimal three degrees (22.3°) API.

Bitumen - also known as tar sands or oil sands, means Petroleum that is a naturally occurring solid or semi-solid hydrocarbon having a relative density less than ten degrees (10°) API and a viscosity greater than ten thousand (10,000) centipoises, measured at the original reservoir temperature and at atmospheric pressure on a gas-free basis, that will not flow to a well in its natural state.

Solution Gas - means a mixture of primarily ethane and methane that exists in a gaseous state in solution with Petroleum at the prevailing reservoir conditions and is gaseous at surface conditions, and which may be contaminated with sulphur compounds and mixed with other heavier hydrocarbons that are also in a gaseous state in solution with the Petroleum within the reservoir.

Natural Gas – means a mixture of primarily methane and ethane that is not Solution Gas and that is in a gaseous state at both the prevailing reservoir conditions and at surface conditions, and which may be contaminated with sulphur compounds and mixed with other heavier hydrocarbons that are also in a gaseous state in solution with the Petroleum within the reservoir.

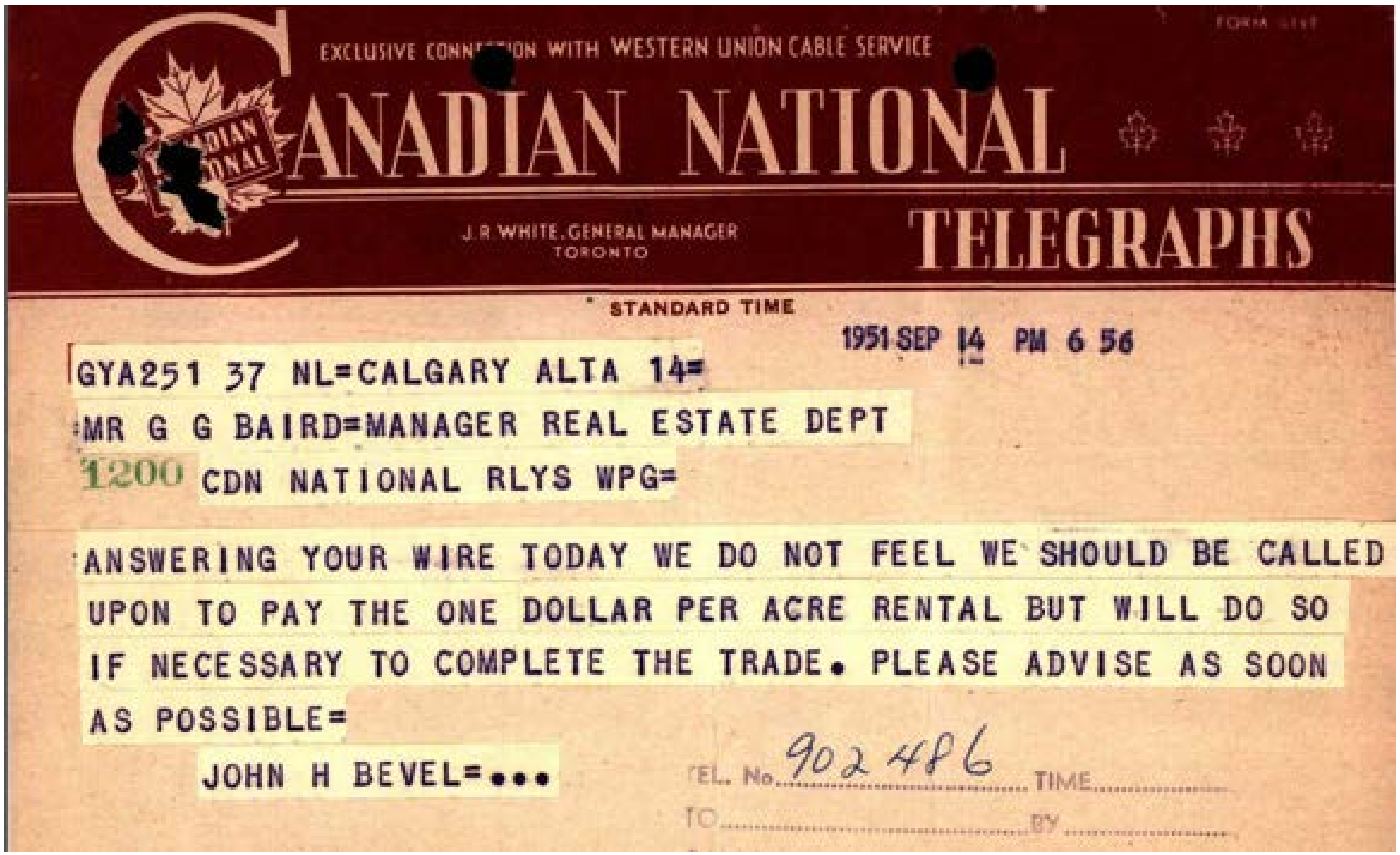
Natural Gas Liquids (NGL's) - means those heavier hydrocarbon components recovered or recoverable from Natural Gas or Solution Gas as a liquid through extraction and separation from the gas stream at a processing, extraction or fractionation facility, including, but not limited to, ethane, propane, butanes and pentanes plus.

Field Condensate – means a mixture of primarily pentanes and heavier hydrocarbons that are in a gaseous state dissolved with Natural Gas or Solution Gas at their virgin reservoir conditions and condense from a vapor to a liquid upon certain changes to temperature or pressure in the reservoir or at surface and are extracted or separated from the Natural Gas or Solution Gas prior to the gas stream entering a processing, extraction or fractionation facility

Coal Bed Methane or CBM - means Natural Gas that is contained in a Coal deposit.

Royalties – “A Creature of Contract”

- Parties are free and clear to enter into any arrangement; therefore, **“what does the contract say?”**



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ANSWERING YOUR WIRE TODAY WE DO NOT FEEL WE SHOULD BE CALLED UPON TO PAY THE ONE DOLLAR PER ACRE RENTAL BUT WILL DO SO IF NECESSARY TO COMPLETE THE TRADE. PLEASE ADVISE AS SOON AS POSSIBLE=

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TO BY

"What Does The Contract Say?"

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- Royalties may be payable on products that are not owned by the Lessor.
- Quieting Title.

The Gulf Oil are willing to contribute an additional 1¼% royalty, and the C.P.R. are prepared to contribute 1¼% of their 12½% royalty, in order to obtain this lease and to permit the Gulf to proceed immediately with their drilling operations. It may be years before the question is decided as to whether petroleum includes natural gas. There is every likelihood that it will go to the Privy Council, and this may take several years. In the meantime, the Gulf are prohibited from drilling on these three quarter sections, and it is in order to avoid this delay that they are prepared to pay this royalty of 2½%. It is not to be paid just so long as gas is considered to be no part of petroleum according to the present Court ruling, but is to continue as compensation for their being permitted to get on the land now, in view of their producing wells immediately alongside.

Allowable Royalty Deductions

“Current Market Value” and related allowable deductions depends on “Point of Determination” -- so what costs can actually be deducted?

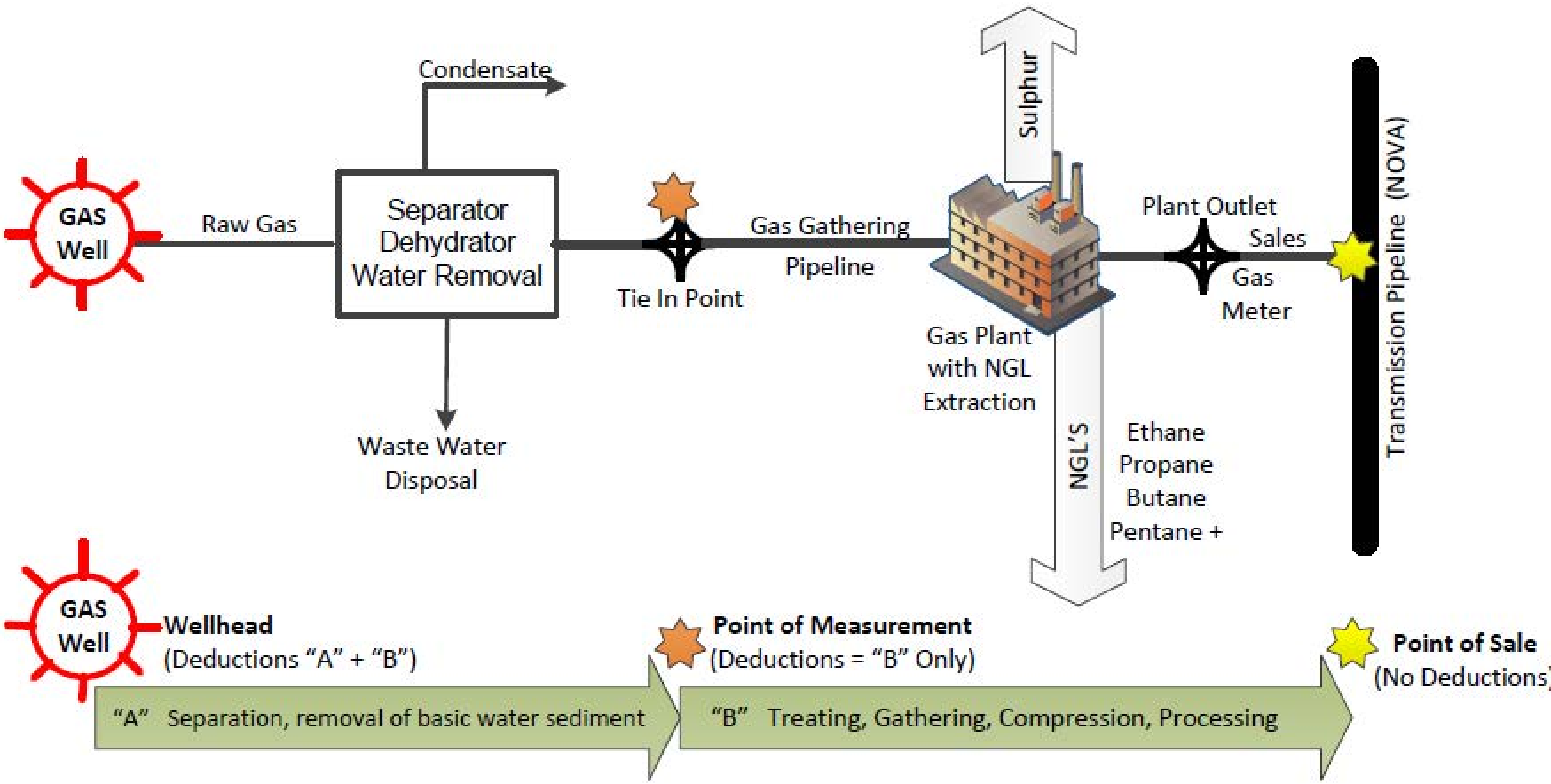
- PSK Guidelines – are posted on our website under Lease Compliance

Deductions or No Deductions

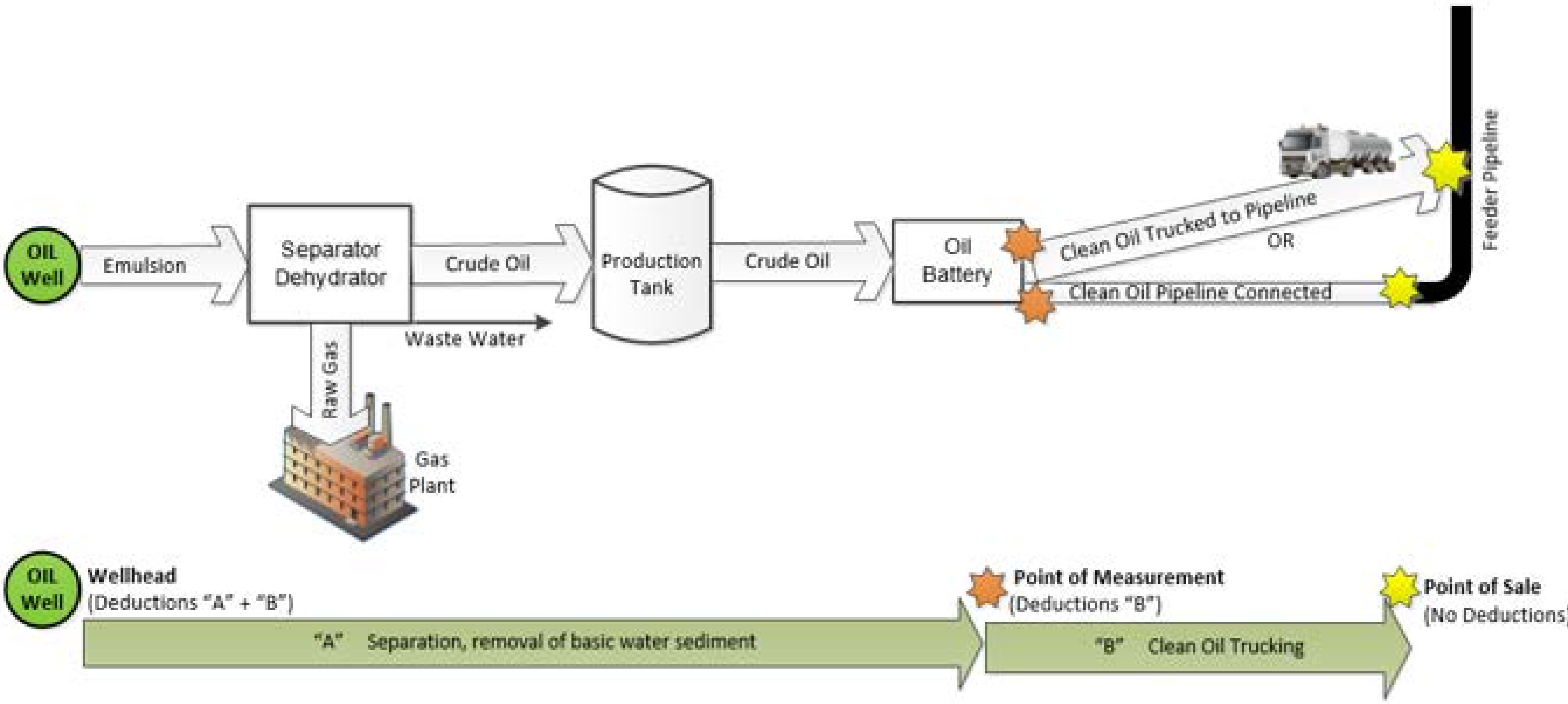
- Royalty Determination Point – means where “possession” of the royalty share is determined and therefore proportionate share of costs borne beyond that point.
  - typically at Point of Measurement
    (i.e. inlet meter of gathering system for gas or outlet of production tanks for oil)
  - sometimes at the Wellhead
  - Words like “current market value at ….”

- Current Market Value at Point of Sale = No Deductions
  - Unless specific deductions are otherwise allowed in the agreement

Typical Wet Gas Well Flow



Typical Oil Well Flow



Deduction language over time – Freehold Leases

- 1950's and 60's vintage lease
- Point of Measurement

(C) "Point of measurement" with respect to:
(i) crude petroleum oil and other liquid hydrocarbons which are recovered by simple separation means the production tanks of the Lessee to which any well on the leased area is connected;
(ii) plant products and natural gas means the point of connection with the gas gathering system to which the well is connected.

ROYALTY PAYABLE BY LESSEE

4. The Lessee shall pay to the Lessor a gross royalty as hereinafter specified on any of the following substances produced, saved and marketed from the leased area, namely:
(A) On crude petroleum oil and other liquid hydrocarbons — Twelve and one-half per cent (12½%) of the current market value at the point of measurement of the said substances;
(B) On natural gas — Twelve and one-half per cent (12½%) of the current market value at the point of measurement of the gas marketed, or, if the same be treated in a plant, of the residue gas marketed therefrom; PROVIDED HOWEVER, that the minimum amount of royalty shall be three-quarters of a cent (¾¢) per thousand cubic feet of natural gas marketed;

- Key words are:
  - Other liquid hydrocarbons…recovered by simple separation means Condensate.
  - Plant Products means NGL's (including Sulphur) that are recovered from Wet Gas Well through a Gas Processing Plant.
  - Residue Gas means residual gas remaining after NGL's have been removed at a Gas Processing Plant.
  - Current Market Value at the Point of Measurement means the sales price less the actual costs incurred from Point of Measurement to the Sales Point.
  - Point of Measurement:
    a) For Oil and Condensate it is at the outlet of the storage production tanks – clean oil trucking is allowed.
    b) For Natural Gas & NGL's it is at tie-in to the gathering system – gathering, compression and processing are allowed.

Deduction language over time – Freehold Leases

- 1950's and 60's vintage lease
- Point of Measurement

(c) "Point of measurement" with respect to:

(i) crude petroleum oil and crude naphtha means the production tanks of the Lessee to which any well on the said lands is connected;

(ii) plant products and natural gas means the point of connection with the gas gathering system connected to the well.

(d) "Crude naphtha" shall be deemed to include condensate or other liquid hydrocarbons which exist underground in gaseous conditions and which are condensed to liquid form in ordinary producing operations as distinguished from natural gasoline and liquefied petroleum gases which are the product of some plant or treating process.

- Crude Naphtha means Condensate
- Natural Gasoline means Pentanes+ that are produced at a gas plant
- Liquefied Petroleum Gases means NGL's (Ethane, Propane, Butanes, Pentanes) extracted at a plant
- Plant Products means NGL's and Sulphur extracted at a plant.

Deduction language over time – Freehold Leases

- 1950’s & 60’s vintage lease
- Time and Place of Production

ROYALTY PAYABLE BY LESSEE

11. The Lessee will pay to the Lessor (in addition to the rental hereinbefore reserved) a royalty in cash of twelve and one-half percent (12½%) of the current market value at the time and place of production of the leased substances won, saved and/or sold from the leased area, except such as may be used for drilling and production purposes thereon, and the amount of such royalty shall be payable monthly at the office of the Department of Natural Resources of the Lessor at Calgary, such payments to be made on the fifteenth day of the month next following the month for which the said royalty is payable after commercial production is obtained from any quarter section of the leased area, the portion of the current yearly or half-yearly cash rental applicable to such quarter section being the rate of One Dollar ($1.00) per acre shall, if paid, be credited on the royalty payable hereunder in respect of each quarter section of land from which such production is obtained. In determining the place of production each quarter section of the leased area shall be deemed to be a separate unit.

- **Time and Place of Production = Point of Measurement**
- This interpretation has been confirmed by Canadian case law – Amerada Minerals Corporation v. Mesa Petroleum (N.A.) Co.
- The Court concluded “time and place of production” is the point where crude oil and natural gas are separated and each separate product can be measured, its value can be tested and where it can be effectively stored and used.
- The Court stated that the place of production is NOT the place at which actual severance from the ground takes place (i.e. is not the wellhead).

Deduction language over time – Freehold Leases

- 1990's
- Clean Oil Trucking Only

5. **Royalties:**

a. The Lessee shall pay to the Lessor royalties in cash in respect of:

(i) solution gas and related or associated materials and substances, whether hydrocarbon or not (hereinafter collectively referred to as "gas"), a royalty of **Twenty** Percent (20%); and

(ii) leased substances exclusive of gas but including condensate (such leased substances hereinafter referred to in this clause and clauses 6 and 7 as "petroleum" or "crude oil"), a royalty of **Twenty** Percent (20%),

of the greater of the actual price received (including payments received from any source whatsoever in respect thereof) or the current market value of such substances or any of them, at the time and place of sale in respect of such substances produced, saved and marketed from the demised estate or at the time such substances are used in respect of such substances used for purposes other than operations to produce leased substances from the demised estate, all without deduction, except for reasonable clean oil trucking fees for petroleum, if applicable.

- **Reasonable** Clean Oil Trucking = Actual costs incurred for transporting the oil to market, after removal of basic sediment and water. Does not include trucking of emulsion.
- Solution Gas & NGL's = No Deductions

Deduction language over time – Freehold Leases

- Post 2000's
- No Deductions

5. ROYALTY AND TAKING IN KIND

C. no deductions are permitted from the Royalty payable under this Lease.

Royalty Definitions

"Current Market Value" means, at the Royalty Determination Point,

"Royalty Determination Point" means for:

(a) PETROLEUM and FIELD CONDENSATE,

(i) where the Royalty is not taken in kind, the point where product enters a feeder pipeline at the inlet to the Lease Automated Custody Transfer (LACT) meter or, in the case where the product is sold directly at a terminal, the inlet meter of the terminal, or

- Oil = No Deductions

Deduction language over time – CAPL Leases

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- 1988 CAPL Petroleum and Natural Gas Lease

4. ROYALTIES

(a) The Lessee shall pay to the Lessor a royalty in an amount equal to the current market value at the wellhead as and when produced of .... percent (...............................%) of all the leased substances produced, saved and sold, or used by the Lessee for a purpose other than that described in subclause (b) hereof, from the said lands; provided that in no event shall the current market value be deemed to be in excess of the value actually received by the Lessee pursuant to a bona fide, arm's length sale or transaction. The royalty as determined under this clause shall be payable on or before the 15th day of the second month following the month in which the leased substances, with respect to which the royalty is payable, were produced, saved and sold, or used by the Lessee for a purpose other than that described in subclause (b). No royalty shall be payable to the Lessor with respect to any substance injected into and recovered from the said lands, other than leased substances originally produced from the said lands for which a royalty has not been paid or payable. The Lessor shall bear its reasonable proportion of any expense incurred by the Lessee for separating, treating, processing and transportation to the point of sale beyond the point of measurement.

(b) Notwithstanding anything to the contrary herein contained or implied, the Lessee shall be entitled to use such part of the production of leased substances from the said lands as reasonably may be required and used by the Lessee in its operations hereunder on the said lands, the pooled lands or the unitized lands and the Lessor shall not be entitled to any royalty with respect to leased substances so used.

(c) The Lessor agrees that the royalty reserved and payable hereunder in respect of the leased substances shall be inclusive of any prior disposition of any royalty or other interest in the leased substances, and agrees to make all payments required by any such disposition out of the royalty received hereunder and to indemnify and save the Lessee harmless from its failure to do so; provided, however, that the Lessee may elect by notice in writing to the Lessor to make such payments on behalf of the Lessor and shall have the right to deduct any such payments made from the royalty, rental and suspended well payments otherwise payable to the Lessor.

(d) The Lessee shall make available to the Lessor during normal business hours at the Lessee's address for notice, the Lessee's records relating to the leased substances produced from or allocated to the said lands.

- 'current market value at the wellhead' vs. 'cost beyond 'point of measurement'.
- 'separating' = separation at a processing plant (not wellsite separation)

- Gas Deductions = gathering, compression, processing and transportation

Deduction language over time – CAPL Leases

- 1991 CAPL Petroleum and Natural Gas Lease

4. ROYALTIES

(a) The Lessee shall pay the Lessor a royalty in an amount equal to the current market value at the wellhead as and when produced of ....

percent (.................%) of all the leased substances produced, saved and sold, or used by the Lessee for a purpose other than that described in subclause (b) hereof, from the said lands; provided that in computing the current market value at the wellhead of all the leased substances produced, saved and sold, or used by the Lessee for a purpose other than that described in subclause (b) hereof, the Lessee may deduct any reasonable expense incurred by the Lessee (including a reasonable rate of return on investment) for separating, treating, processing, compressing and transporting the leased substances to the point of sale beyond the wellhead or, if the leased substances are not sold by the Lessee in an arm's length transaction, to the first point where the leased substances are used by the Lessee for a purpose other than that described in

subclause (b) hereof; provided further, however, that the royalty payable to the Lessor hereunder shall not be less than ....percent (.................%) of the royalty that would have been payable to the Lessor if no such expenses had been incurred by the Lessee. In no event shall the current market value be deemed to be in excess of the value actually received by the Lessee pursuant to a bona fide, arm's length sale or transaction. The royalty as determined under this clause shall be payable on or before the 15th day of the second month following the month in which the leased substances, with respect to which the royalty is payable, were produced, saved and

- \- concept of a rate of return on capital is introduced
  \- wellsite separation is allowed

- 1999 CAPL Petroleum and Natural Gas Lease

4. ROYALTY

(a) Subject to Subclause (c) of this Clause, the Lessee shall pay to the Lessor a royalty (the "Royalty") in an amount equal to the current market value at the wellhead of.......................................% of the Leased Substances sold from the Lands, or used by the Lessee for a purpose other than that described in Subclause (d) of this Clause. In computing the current market value at the wellhead, the Lessee may deduct any reasonable expense incurred by the Lessee (including a reasonable rate of return on investment) for water disposal and for separating, treating, processing, compressing and transporting Leased Substances beyond the wellhead, provided that the Royalty shall not be less than .... percent of the Royalty that would have been payable to the Lessor if no such expenses had been incurred by the Lessee.

(b) The Royalty shall be payable on or before the 15th day of the second month following the month in which the Leased Substances were sold or used by the Lessee for a purpose other than that described in Subclause (d) of this Clause.

- \- water disposal costs are introduced

Deduction language over time – CAPL Leases

- 2014 CAPL Petroleum and Natural Gas Lease

(p) **"Royalty Determination Point"** means:

(i) in the case of crude oil and liquid hydrocarbons extracted from natural gas at the wellhead, at the first point of metering, measurement or allocation downstream of the wellhead, as applicable, after any treatment for the separation, removal and disposal of basic sediment, water and other impurities;

(ii) in the case of natural gas and any liquid hydrocarbons processed, extracted or enriched at a gas plant, at the outlet valve of the gas plant; and

(iii) in the case of raw natural gas sold or used by the Lessee for purposes other than as allowed pursuant to Subclause 3(d), the first point of metering, measurement or allocation downstream of the wellhead after any wellsite dehydration.

3. ROYALTY

(a) Subject to Subclause 3(c), the Lessor reserves a royalty share of the Leased Substances and the Lessee shall pay to the Lessor, in satisfaction of such royalty share, a royalty (in this Agreement called the **"Royalty"**) in an amount equal to the Current Market Value at the Royalty Determination Point of ____________ percent (______%) of the Leased Substances produced, saved and sold from the Lands, or otherwise allocated thereto pursuant to any pooling or Unit Agreement, or used by the Lessee for a purpose other than that described in Subclause 3(d). In computing the Current Market Value at the Royalty Determination Point, the Lessee may deduct those expenses allowed by the Crown under the Regulations related to the Royalty percentage share of Leased Substances sold or so allocated or used, provided that such deductions shall not exceed fifty percent (50%) of the Royalty amount owing for the Leased Substances sold or so allocated or used by the Lessee in a month, before any such deductions.

- Introduction of Royalty Determination Point
- Return back to deductions allowed in the 1988 lease only beyond point of measurement
  - no wellsite separation or water handling
- Crown equivalent deductions allowed up to a specified cap %

Deduction language over time – CAPL Farmout & Royalty Procedure

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1997 CAPL Farmout & Royalty Procedure

(w) **"Royalty Determination Point"** means the first point at which Petroleum Substances are or can be metered, measured or allocated downstream of the wellhead after, as applicable: (i) any treatment of crude oil for the separation, removal and disposal of basic sediment and water; (ii) any extraction of liquid hydrocarbons from natural gas at the wellhead and any wellsite separation, removal and disposal of basic sediment and water from those liquid hydrocarbons; and (iii) any wellsite dehydration of natural gas.

5.04 Royalty Payor's Allowed Deductions If Overriding Royalty Not Taken In Kind

A. To the extent that the Royalty Payor disposes of Petroleum Substances comprising the Overriding Royalty on behalf of the Royalty Owner, the Royalty Owner's share of those Petroleum Substances will be free of any deductions for costs and expenses incurred by the Royalty Payor to and including the Royalty Determination Point. Subject to Subclause 5.04C, the Royalty Owner will be responsible, on a well by well basis, for the following costs and expenses incurred after the Royalty Determination Point with respect to the Royalty Owner's share of those Petroleum Substances:

(a) for crude oil and liquid products extracted from natural gas at the wellhead, any associated Facility Fees and any transportation costs to transport those Petroleum Substances from the Royalty Determination Point to the point of sale; and

- CAPL 1997 Farmout & Royalty Procedure Continued

- **ALLOWANCE FOR DEDUCTION OF FACILITY FEES**

- The CAPL procedure sets forth that fees can be assessed and deducted:

  - for…facility capacity owned by third parties…all costs and expenses paid by the Royalty Payor for that Facility Usage;

  - for…facility capacity owned by the Royalty Payor…an expense equal to…the fee ordinarily chargeable for the same use as the Facility Usage, if that facility is made available for use by third parties; or

  - in all other circumstances, a fee sufficient to cover that use of facilities, where the capital recovery component of that fee uses as a guideline the PJVA Jumping Pound-95 methodology…

- Sounds like any and all of these costs for Facility Usage can be deducted, but….

Deduction language over time – CAPL Farmout & Royalty Procedure

CAPL 1997 Farmout & Royalty Procedure Continued

(b) for Petroleum Substances other than those described in the preceding Paragraph, the associated Facility Fees if Alternate 5.01A(b)(1) applies.

A cost or expense attributable to more than one Petroleum Substance being sold by the Royalty Payor may only be deducted once.

B. The deductions applicable pursuant to the preceding Subclause will be subject to Alternate(s) 1 only _____/2 only _____/1 and 2 ______/neither 1 nor 2 _____ below (Specify Alternate):

Alternate 1:
The deductions must not exceed those permitted by the Regulations for the calculation of royalties if the lessor under the relevant Title Documents were the Crown in right of the Province in which the Royalty Lands are located.

Alternate 2:
The deductions must not be greater than ______ % of the Market Price received by the Royalty Payor from the sale of the Royalty Owner's Overriding Royalty share of those Petroleum Substances, provided that the Market Price will first be adjusted for any deductions under Subclause 5.04C.

Allows for deduction Facility Usage Fees only beyond Royalty Determination Point **with optional Alternatives to "limit deductions"**:

- Deductions are limited to costs only as allowed by the Crown (Alt 1)
- Or capped by % of Market Price (Alt 2)
- Or Both (Alt 1 and 2)
- Or Neither Alternative

Evolution of Gas Deductions

- 1950's Oil is the prize. Gas is flared.
  - Little or no gas processing plants or pipeline infrastructure.
  - TransCanada Pipeline is built from Alberta to Ontario.

- 1960's Construction of Large Processing Facilities
  - e.g. Gulf Canada's Rimbey Gas Plant
  - Deductions start to include a return on capital investment

- Late 1980's Gas Market Deregulated
  - Gas prices plummet
  - Excessive deductions reduce freehold royalties to zero or negative.
  - AB government encourages industry to come up with a system of peer arbitration to avoid regulatory intervention.

- 1990's Jumping Pound Formula Developed
  - Used as a guideline for direction in negotiating third-party usage fees
  - Deductions in Royalty agreements must be honored
    - The guideline can provide an objective benchmark for comparison purposes

- Post 2000's, "No Deductions" language is introduced in many leases and royalty agreements

What are the actual costs?

- **Non-owned Facilities**
  - Invoiced costs
- **Partially owned Facilities**
  - Owner charged costs/mail ballot
- **Wholly owned Facilities**
  - Lowest third-party service fee
  - Average JP-05 rates where no third-party

Aligned: CAPL ‘97 Farmout & Royalty Procedure

Crown Equivalent Deductions

- Crown Equivalent Deductions pre-1994
  - equivalent to actual costs (point of measurement to point of sale)
  - generally accepted by other royalty owners as a reasonable proxy for actual costs
  - In 1994, AB Crown modified their allowable Gas Cost Allowance (GCA) as a simplified average of area facility rates for all wells per company
  - Use of Current Crown GCA not intended by the original parties

- What are Crown Equivalent Deductions?
  - Intended meaning is for deduction of **"reasonable"** actual costs that would be accepted by the Crown
  - A methodology rather than a GCA rate ($/E3M3)
  - Parties must agree on a facility area
  - Exclude costs upstream of Royalty Determination Point
  - Requires annual submissions and approval by Royalty Owner
  - Requires conversion of NGL's to gas equivalent
  - Does not apply Royalty Owner share
  - Complex and not well understood

Crown Equivalent Deductions

Simplified Example of Crown Gas Cost Allowance Calculation

- STEP 1
  - Operator/Company submits AC2 & AC5 forms to Crown for each Facility in an agreed to area
  - i.e. Total Area Facility Costs = $10,000,000

- STEP 2
  - Crown calculates FERR (Facility Effective Royalty Rate):

    = <u>Company's share of the Crown Volumes in the Facility Area X Ref. Price (per product)</u>

    Total Volumes in the Facility Area X Ref. Price (per product)

    i.e. 5%

- STEP 3
  - Company's Monthly Gas Cost Allowance:
    - = ($10,000,000 X 5%) / 12 months
    - = $60,000/Month*

    - *Can't exceed current month gross royalty payable

Crown Equivalent vs. Crown CGA Rate

Internal Crown GCA Rates

- Some royalty payors calculate an internal Crown GCA rate ($/E3M3)
  - **Facility Area Costs** **(AC2 and AC5 forms)**
    (*EAGEV)

- This rate is then incorrectly implemented in accounting systems to calculate LOR and ORR payments at a well level **– this is not Crown Equivalent.**

- Most LOR and ORR agreements do not allow for Crown Equivalent Deductions.

- ***EAGEV** = Energy Adjusted Gas Equivalent Volume report is generated by the Crown for all royalty clients and identifies volumetric allocations for volumes produced at ERCB facilities.

Royalties – "A Creature of Contract"

- The allowable deductions are a negotiated contractual provision and are governed by the terms of a lease or contract.
- Neither party can unilaterally alter the terms of those agreements.
- Deductions can be complicated.
- PrairieSky is open to simplified alternatives that are fair and **reasonable** for both parties.
- *"**Reasonable cost** is a price that is consistent with what a reasonable person would pay in the same or similar circumstances for the same business or for the same or similar item".*

PRAIRIESKY ROYALTY LTD

Questions?