

Offshore Oil Royalty Regulations effective November 1, 2017

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In this Update

- On November 1, 2017, the Province of Newfoundland and Labrador promulgated the *Offshore Oil Royalty Regulations*
- The 2017 Regulations will replace the *Royalty Regulations, 2003* for any future offshore leases
- Project proponents will want to carefully consider several changes in the 2017 Regulations:
 - the elimination of the incremental royalty and its replacement with a net royalty
 - the removal of all arbitration provisions; and
 - an update to the transportation provisions to make them more consistent with corresponding provisions applicable to current offshore development projects

In early November 2015, the Progressive Conservative-led Government of Newfoundland and Labrador introduced a new generic offshore royalty regime that was to apply to all projects going forward. We released an [Osler Update](#) at that time discussing the potential impact of this new regime.

However, in late November 2015, very shortly after the announcement of this new regime, the Liberal Party defeated the PCs. So while the Conservatives introduced the new offshore royalty regime, it is the Liberals that have brought it to fruition.

On November 1, 2017, the Province of Newfoundland and Labrador published (pursuant to section 39 of the *Petroleum and Natural Gas Act* (the PNG Act)) the *Offshore Oil Royalty Regulations* (the 2017 Regulations) in the *Newfoundland and Labrador Gazette*, bringing the 2017 Regulations into full force and effect.

The 2017 Regulations apply to any leases in the offshore area issued after its coming into force on November 1, 2017. In this regard, it will replace the *Royalty Regulations, 2003* (the 2003 Regulations) for any future offshore leases, although the 2003 Regulations will continue to apply to existing leases.^[1]

While the 2017 Regulations make a number of changes relative to the 2003 Regulations (many of which we consider to be fairly inconsequential), we want to focus on the following three items that any project proponents will need to be aware of and will want to carefully consider going forward:

1. the elimination of the incremental royalty and its replacement with a net royalty;
2. the removal of all arbitration provisions; and

3. an update to the transportation provisions to make them more consistent with corresponding provisions applicable to current offshore development projects.

However, while it is important to focus on the changes that have been made, it is also equally important to focus on one change that has not been made. To date there have been no amendments to section 33 of the PNG Act, and so far as we are aware the province is not considering or planning to amend section 33. As previously discussed, section 33 permits the province and project proponents to enter into royalty agreements that are inconsistent with and prevail over any royalty regulations promulgated under Part II of the PNG Act (which includes the 2017 Regulations). Barring any future amendment to or repeal of section 33, the province and project proponents will still be able to enter into project-specific royalty agreements that supersede the 2017 Regulations. Given the massive capital costs associated with any offshore development project, we fully expect that project proponents will look to discuss the application of the 2017 Regulations to any future project subject to this regime in the same way that project proponents have discussed with the province the application of the 2003 Regulations to existing projects and opportunities.

Net Royalty

Stated simply, the 2017 Regulations have eliminated the periodic incremental royalty (both tier I and tier II) and have replaced it with a monthly net royalty. Under the 2017 regulations, net royalty first becomes payable in respect of a project when payout occurs, which in turn happens when the recovery factor for that project first equals 1.0.

Recovery factor is essentially a fraction: the numerator of which is equal to gross revenue^[2] plus incidental revenue less basic and net royalty paid, and the denominator of which is aggregate eligible pre-development, capital and operating costs. Inherent in the calculation of the recovery factor of a project is one of the more significant changes under the 2017 Regulations – the elimination of the concept of return allowance, or the return on capital included as an element of the incremental royalty calculations under the 2003 Regulations and all other royalty regimes in effect for current development projects offshore Newfoundland and Labrador.

In addition to the return allowance, the 2017 Regulations also eliminate uplifts on eligible costs. Generally speaking, under the 2003 Regulations eligible capital costs are uplifted by 1% and eligible operating costs are uplifted by 10% for the purposes of calculating royalty share, including the calculations with respect to return allowance. Under the 2017 Regulations there are no uplifts – base costs are used to determine gross and net revenue, and as previously mentioned there is no return allowance.

Finally, along with the elimination of the return allowance and any uplifts, the maximum net royalty rate has also been materially increased. Under the 2003 Regulations, tier I incremental royalty is 20% and tier II is 10% for a total incremental royalty of 30%. The net royalty created by the 2017 Regulations starts at 10% when the recovery factor equals 1.0 and rises to a maximum of 50% when the recovery factor is 3.0 or more.

Any determination as to whether a particular project, at any particular time in its lifecycle, would be better or worse off from a royalty perspective under the 2017 Regulations relative to the 2003 Regulations, will be very fact dependent (including the aggregate amount and timing of both costs and revenue for the project). However, it is certainly the case that projects will potentially be subject to a much higher maximum net royalty under the 2017 Regulations. Further, with the elimination of the return allowance, it seems likely that a project will be subject to net royalty under the 2017 Regulations earlier than the same project might have been subject to incremental royalty under the 2003 Regulations – particularly projects with very significant and front-end loaded capital costs, which is often the case with

offshore development projects.

Arbitration

The new regulations remove all arbitration provisions.

Under the 2003 Regulations, a long list of matters may be submitted to arbitration for resolution, including disputes with respect to: (i) the assessment or reassessment of royalty share; (ii) the calculation or eligibility of certain costs and revenues; (iii) the allocation of certain costs; (iv) the fair market value of a cost, expense, price, or proceed of disposition; and (v) sections 19 and 37 of the PNG Act and sections 13, 45(2), 54, 55, 63(2), 68(1)(s) and 81(6)(b) of the 2003 Regulations.

In place of the former arbitration provisions, new sections 85 and 86 of the 2017 Regulations provide that (i) no appeal of a decision of the minister lies to the Trial Division of the Supreme Court of Newfoundland and Labrador (the Court), and (ii) a person aggrieved by a decision of the minister may, within two years of the decision, apply to a judge of the Court for judicial review of the decision *on a question of law or jurisdiction only*.

In our view, these changes may impact future project proponents in respect of three particular issues: (i) access to justice and expediency in resolution of future disputes; (ii) the availability of judicial review and standard of review of ministerial decision-making; and (iii) remedies available to proponents that challenge ministerial decision-making.

Access to justice: Under the 2003 Regulations, resort to arbitration risked lengthy and costly arbitration processes that could be appealed in the courts. While the 2003 Regulations provided for a full airing of disputes, on facts and law, the cost associated with the resolution of disputes was generally high, with long timelines both at the arbitral stage and on appeal. The new regime contemplates what is anticipated to be a speedier and less costly process, before the Court, on relatively expedited timelines – but on narrower grounds of appeal. Therefore a proponent may be more likely to have recourse to the Courts (with a speedier and less costly resolution), but the threshold grounds for relief appears intended to be higher (meaning fewer opportunities for appeal).

Availability of dispute resolution: Rather than a full airing of disputes in a trial-like process, section 86 contemplates judicial review proceedings grounded solely on questions of law or jurisdiction. Errors of fact made by the minister appear intended not to be reviewable by the Court. The intent of the 2017 Regulations appears to be to limit the evidentiary record before the Court on a judicial review application to focus on issues of law and jurisdiction. Moreover, ministerial decision-making appears to be intended to be reviewed on the higher standard of correctness, though some applications could be reviewed on a reasonableness standard. Thus, the 2017 Regulations appear intended to limit a proponent's recourse in circumstances where they have been aggrieved by ministerial decision-making, and to increase the standard against which decisions will be scrutinized. Whether this outcome is realized remains to be seen, as sections 85 and 86 provide many opportunities for judicial scrutiny of ministerial decision-making.

Remedies available to proponents: With some exceptions, the remedies available to an applicant on judicial review are limited, and typically decisions are remitted back to a decision-maker, often with judicial guidance. Accordingly, when proponents apply for judicial review under the 2017 Regulations, it will be necessary to carefully frame the relief sought. Careful consideration will have to be given to whether the minister can fairly reconsider a given decision, or whether the Court is better placed to determine the outcome of a given administrative issue.

Transportation

On the one hand, the 2017 Regulations make a positive change – they largely adopt the transportation principles and provisions developed for the Hebron Offshore Development Project and in connection with the Hibernia Southern Extension Project (which provisions have also essentially been implemented for the Terra Nova Offshore Development Project by way of a prior amendment to the 2003 Regulations).

As all current development projects offshore Newfoundland and Labrador share in the utilization of transportation and transshipment assets (and it is reasonable to expect that some form of sharing will continue for any future offshore development projects), it will be helpful if all projects are subject to the same principles and provisions regarding the proper calculation of eligible transportation costs. This will help to eliminate irregularities and inefficiencies that might otherwise occur when multiple projects subject to different royalty regimes are making use of, and sharing the costs of, certain assets.

However, in this respect the 2017 Regulations give with one hand while taking with the other. The transportation provisions in the 2017 Regulations are largely the same as currently apply to Hebron, Hibernia and Terra Nova, but unfortunately the Province has introduced some changes (and at least one significant change) that are likely to result in very different royalty consequences for new projects subject to the 2017 Regulations relative to these existing projects.

First, as mentioned above, the 2017 Regulations eliminate all uplifts on eligible costs, including for the determination of eligible transportation costs. While this is not likely to be a significant issue based on the existing commercial arrangements in place for transportation capacity, it could become more relevant if project proponents return to the early days of development offshore Newfoundland and Labrador where different proponents owned or time chartered transportation assets.

However, the second change worth noting is both much more subtle and potentially more impactful. Under the 2017 Regulations, the province has changed the methodology for allocating transportation costs between multiple projects that share the use of a transportation asset (such as a shuttle tanker). Where a shuttle tanker is being shared by multiple projects, the new methodology under the 2017 Regulations seems likely to result in significantly less costs being deductible by a project subject to the 2017 Regulations relative to Hebron, Hibernia, Terra Nova or any other project subject to a similar regime.

Differences in royalty treatment between projects using the same assets in a similar manner adds additional complexity and inefficiency to the commercial arrangements between project proponents, and often results in an additional transactional burden that all proponents must bear. It is unfortunate to see the province introducing such a difference for no discernable reason other than to increase the royalty share payable to the province.

In summary, the 2017 Regulations introduce some significant changes that any proponent of a project subject to this new regime will want to carefully consider – particularly if that proponent is accustomed to a royalty regime under (or similar to) the 2003 Regulations. Fortunately, section 33 of the PNG Act appears to continue to provide project proponents with an opportunity to discuss areas of concern with the Province in the hope of achieving a balance that would allow for a project to proceed (and to succeed), which is something that everyone interested in the Newfoundland and Labrador offshore area would dearly like to see happen sooner rather than later.

[1] Pursuant to section 2, the *Royalty Regulations, 2003* apply to any offshore leases issued after April 1, 1990.

[2] Gross revenue continues to be net of eligible transportation costs.