

JP-05: A RECOMMENDED  
PRACTICE FOR THE NEGOTIATION  
OF PROCESSING FEES

February 2, 2006

# HISTORY & CONTEXT

Mike Taylor

JP-05 Roll-Out February 2, 2006

# PRESENTATION OUTLINE

- History / Context
- C2C and ADR Processes
- Negotiations of Capital Fees
- Operating Cost Fee
- Lost GCA Fee
- Regulatory Considerations
- EUB ADR Processes
- Examples and Wrap-Up

# HISTORY OF FEE DEVELOPMENT

- Public Utilities Board Decision – Shell Jumping Pound Plant 1954
- 1989 letter from Energy Minister (Rick Orman)
- JP-90 Task Force
  - CAPP and SEPAC predecessors
- JP-95 Task Force
  - CAPP, SEPAC, PJVA

# HISTORICAL INTENT OF JP-90/95

- Balance the economic interests of gas producers versus gas processors
- Recognize the value of infrastructure
- Deal with “natural monopolies”
- Avoid facilities proliferation
- Treat royalty holders fairly
  - Freehold and crown

# So Why the Need for JP-05?

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# Fee Issues

- Wide range between upper and lower limits
- Little disclosure of information
- Failure to negotiate (“take it or leave it”)
- Too many degrees of freedom
- Address compression and pipeline capacity
- Need for one guideline

# Mandate of JP-05 Review

1. Provide clarity on content and negotiation processes in fee determination and negotiation; and
2. Incorporate the C2C Dispute Resolution principles and processes for resolving fee disputes.

# JP-05 PARTICIPANTS

- CAPP
  - Jerry Harvey-CNRL, Rob Kerr-Anadarko, Rick Steffensen-PetroCanada
- GPAC
  - Paul Nelson-Taylor Gas Liquids, Frank Serpico-Provident
- PJVA
  - Kevin Gilliam-Burlington, Tim Reimer-Conoco Phillips, Noel Smyth-Keyera, Mike Taylor-Devon
- SEPAC
  - John Kingsbury-GPMi
- EUB
  - Georgette Habib, Bill Remmer

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# JP PROCESS PRINCIPLES

- Negotiate
- Collaborate
- Disclose

# APPROPRIATE DISCLOSURE

- 3 times lucky?
  - Recommended (but not followed) in both JP-90 and JP-95
- Probability of disclosure is inversely proportional to the breadth of the range between upper and lower limit
- Likelihood also varies with the number of debatable parameters in the fee formula

# ENDORSEMENTS / SUPPORT

- CAPP
- SEPAC
- PJVA
- GPAC
- C2C ADR COUNCIL
  
- AEUB

# General Recommendations

1. JP-05 should not apply to existing contracts
2. Freely negotiated arrangements are preferred
3. JP-05 be the recommended practice should parties fail to reach a negotiated outcome
4. The use of JP-05 be aligned with the EUB processes
5. JP-05 be a stand alone document
6. The fee calculation be simplified and the relevant range narrowed
7. The same methodology be used for midstreamer and producer owned plants

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QUESTIONS?

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# C2C and ADR

Bill Remmer

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# C2C Disputes - ADR

- 15% of 1400+ EUB equity applications had industry objections
- Most included issues on Fees, Access and Assurances
- Increasing issues and concerns in 2002 about C2C negotiations

# C2C Task Force

- Began in April 2002
- No similar business ADR Task Force
- 70+ Participants
- 4 Committees: ADR guidelines, Regulatory Alignment, Contractual Provisions, Communication & Education

# C2C Regulatory Alignment

- Completed interviews with 31 companies who used the EUB regulatory process for C2C Disputes.
- Investigated and analyzed all feedback including any concerns raised:
  - Abuse of the process
  - Timing
  - Lack of disclosure
  - Poor Communications

# Some Common Barriers *(from feedback)*

- Differing negotiation styles and approaches
- Refusal to meet face to face  
(correspondence based negotiations)
- Non-communication and delay tactics
- Non disclosure of information
- Unable to get to the real issues
- Unskilled negotiators

# C2C Task Force Themes:

- Proactive, collaborative communication among parties;
- Resolve issues while they are small;
- Providing industry with some tools to resolve conflict on their terms, creatively and early;
- Optimize the value of current and future projects.

# Recommendations from C2C Task Force

- Legal/Regulatory process should be used as last resort
- Sharing of information
- Face-to-face dialogue
- Use of ADR tools and techniques

# C2C Guidelines & Procedures Tools

- Development of “Scenarios”, “Case Studies”, “Decision Tree” and “Tool Box” for resolving company disputes.
- Develop an evaluation guide to assist in the choice of the most appropriate DR tool.
  - How does my company assess the situation?
  - What are my options?
  - How do we evaluate and move forward through the situation?

# Recommendations from C2C Task Force to EUB

- Need to tighten up processing of non-routine applications
  - Establish standing and validity of objections
  - Point parties towards ADR sooner in the process
  - Clarify admissibility of new hearing evidence not provided in mediation
  - Set deadlines for ADR and date for hearing
- The EUB to endorse an industry-sponsored review of the appropriate use of the JP-90/95 fee guidelines

# JP05 Negotiations

- Incorporate the C2C principles and processes for resolving fee disputes
  - Chapter 2 “Keys to Successful Fee Negotiations”

# JP05 & EUB

- EUB supports JP 05, just as it supported the principles that led to the establishment of JP 90/95
- Industry solutions are more preferable to regulatory interventions
- An industry acceptable fee structure could promote negotiation

QUESTIONS?

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JP-05 Task Force  
Sections 3 and 4  
Negotiation of Capital Fees  
&  
Special Circumstances

John Kingsbury, Noel Smyth, Paul Nelson

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# JP Economic Principles

- Fees for capacity involve returns reflecting investment risks
- Because of differing circumstances and risks, there is a relevant range for fee negotiations
- The risk of unused capacity remains with the facility owners

The JP guidelines are a methodology to determine the economic value of gas gathering and processing fees within a negotiation framework.

That negotiation centers around only 1 variable that best represents the processing circumstance and risk

# JP Processing Fee

**Processing Fee =**

+ Capital Charge

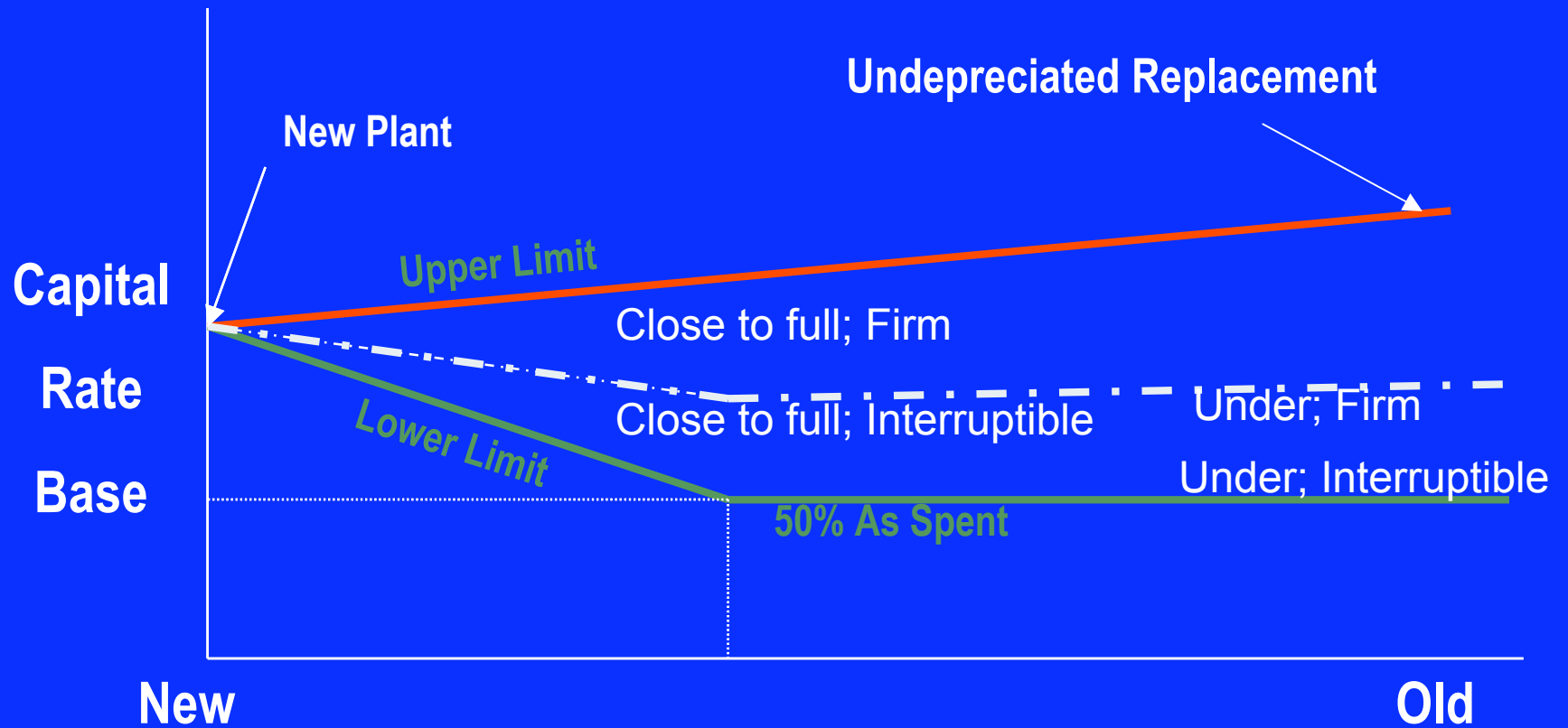
+ Operating Charge

+ Lost GCA Charge

# JP-90/95 Structure

- Uses capital base to define risk to processors
  - Upper Limit - Replacement Cost
  - Lower Limit - 50% of As Built Cost
- Depreciates capital base to a minimum of 50%
- Fixes processors rate of return to 5% above long term bond rate
- Formula for calculating before tax ROR
- Operating costs allocated based on throughput
- Provides guidelines for negotiations
- Provides means of resolving disputes (EUB)

# Relevant Range



# Fee Issues

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# Common Methodology for Producers and Midstreamers

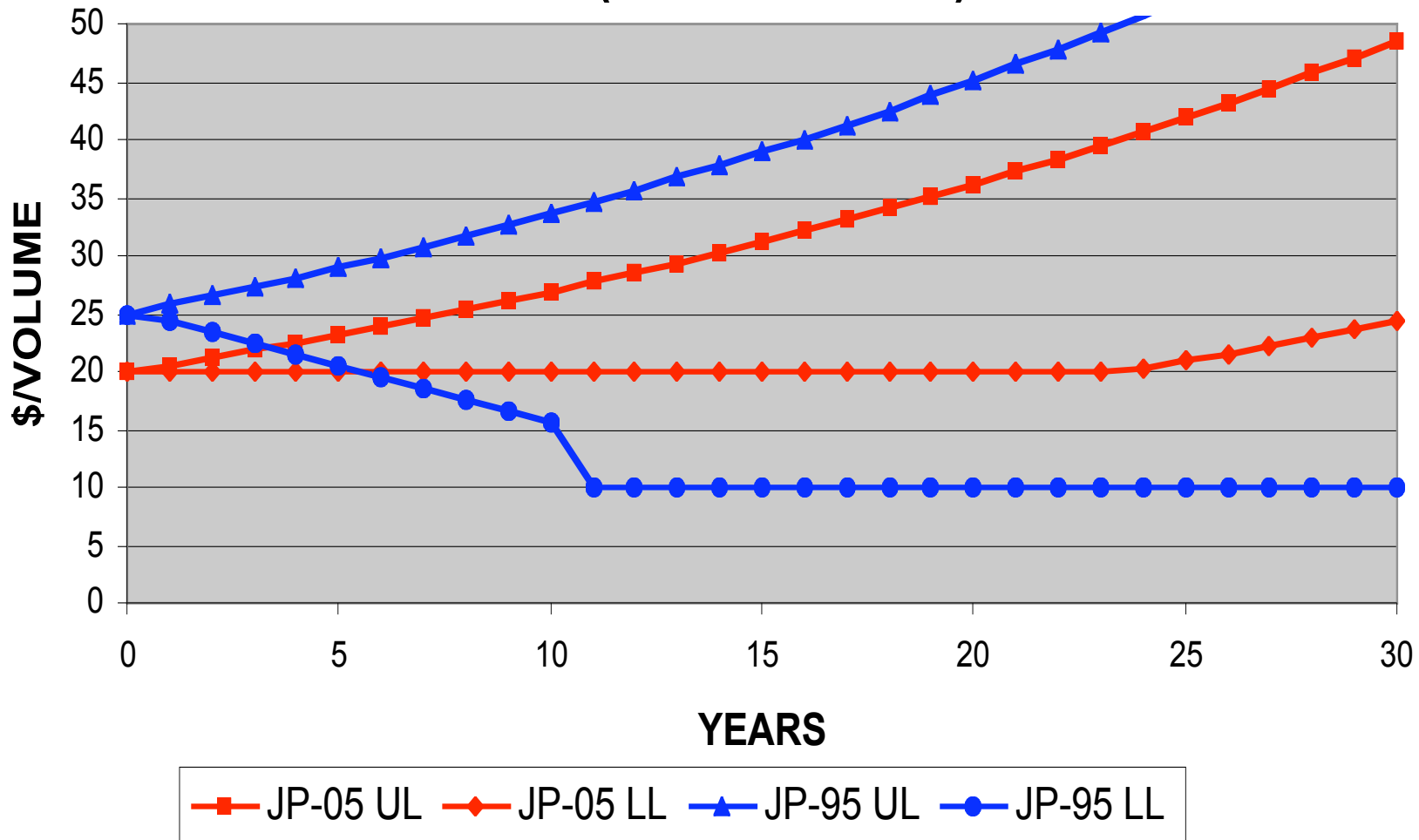
- Partners in facilities
- Own facilities that provide equivalent services
- Are competing for the same assets in the marketplace

# Changes from JP-95 Methodology

1. No depreciation
2. Fixed Rate of Return (20%)
3. Lower limit - as-spent capital,  
Upper limit - replacement cost
4. Lower limit and upper limit difference max at 50% of replacement cost
5. In certain situations, use accepted distance fees for pipeline tariffs (\$0.01 - \$0.015/Mcf mile)
6. Compression capacity based on performance curves and loading

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## JP-05 / JP-95 FEE COMPARISON (20 YEAR LIFE)



Fee at \$100 investment per unit capacity

# Capital Fee Determination

$$\text{CapFee} = \frac{20\% * \text{Capital Rate Base}}{\text{Facility Capacity}}$$

# Elimination of Depreciation

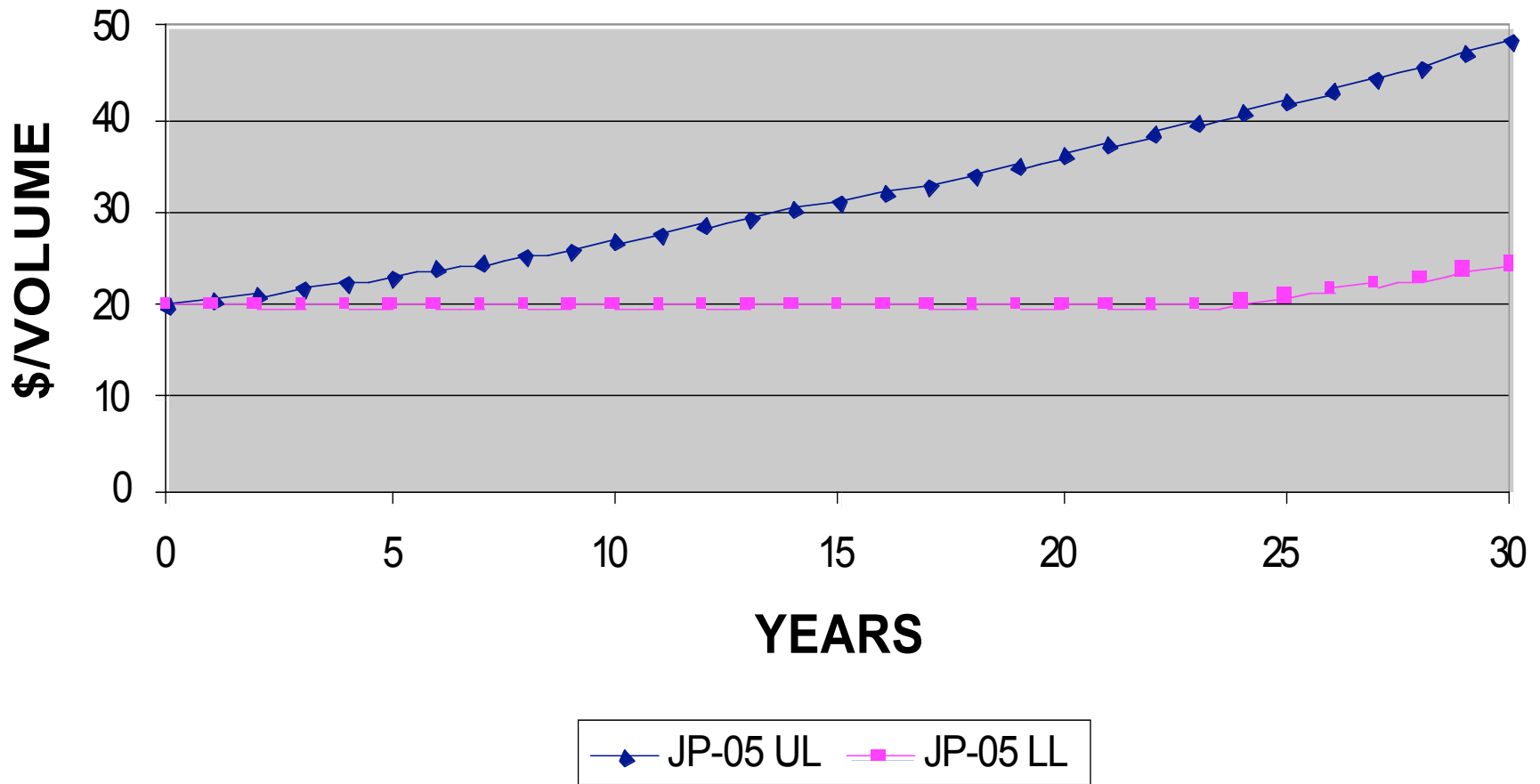
- Narrows the relevant range for negotiation.
- Fairly recognizes the value of older plants.
- Facilities generally have longer use than the original reserve life. Fixed depreciation rates don't recognize this.

# Fixed Rate of Return (20%)

- Eliminates the negotiations around a parameter that was supposed to be fixed but was used as a degree of freedom
- Recognizes the long term inherent value in facility infrastructure, and fairly compensates facility owners for renting out their capacity

# JP-05 Relevant Range

## JP-05 FEE



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# Relevant Range Positioning Factors

- Availability of Capacity
- Level of Reserves Commitment
- Term
- Level of Service

# Capacity Availability Risk



- Interruptible – Plant is underutilized
- Interruptible – Plant is near full
- Firm, Plant is underutilized
- Firm, Plant is near full
- Firm guaranteed throughput, Plant is full

# Compressor Fees

- Capacity of compressors is performance curve related
- Where compressor is fully utilized, capacity = throughput
- Where compressor is underutilized, capacity = capability at current operating conditions

# Pipeline Fees

- Where design parameters and costs are known, use JP-05 calculation based on capacity
- Where costs are known, but capacity is uncertain, and pipeline is fully utilized, use throughput
- Where data is not available or not known, and the prospective fees are small, use accepted distance fees for pipeline tariffs (\$0.01 - \$0.015/Mcf mile)

# Special Situations Not Addressed by the JP-05 Methodology

- Working interest owner financing
- Transaction based fees
- Anchor producer in new midstream facilities
- Production back-out

# WIO Financing

- Failure of WIO to participate in expansions of existing facilities
- Penalty financing – Separate arrangement amongst owners

# Transaction Based Fees

- Unique negotiation between seller and purchaser
- Should not be used to establish fees for other non-participating third parties

# New Midstream Development

- Unique negotiation between midstream facility developer and anchor producer
- May not necessarily be used to establish fees for other non-participating third parties

# Production Back-out

- Treated as a shortage of available capacity
- No recommended method for calculation of production back-out
- Recommended means to alleviate:
  - Custom users add facilities
  - Custom users request owners to add facilities
  - Wait for capacity to become available
  - Negotiate a back-out fee

QUESTIONS?

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# OPERATING COSTS

Tim Reimer  
Kevin Gilliam

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# OPERATING FEE DEVELOPMENT

- Basic Principle: Operating Fee is based on flow through of costs allocated to throughput

# COMPONENTS OF OPERATING COST

- Recommendation: Operating Fee Components made up of:
  - Operating costs, i.e. direct costs, plus
  - Overhead, plus
  - Working capital allowance
- The following are subject to any parameters that are specified in the facility's governing agreements

# COMPONENTS OF OPERATING COST continued

- Operating Costs: the JP-05 Task Force recommends the definition as set forth in the 1999 PJVA (CO&O) model: "... all costs and expenses, except Capital Costs, incurred in connection with the testing, operation, maintenance and repair of the Facility".
- Overhead: The indirect costs incurred by the facility operator (maintaining a central office, phone system, technical and administrative staff, etc.). Generally the operator is compensated by an amount equal to 10% of direct costs

# COMPONENTS OF OPERATING COST continued

- Working Capital Allowance: This is the premium paid to compensate the facility operator for carrying all facility costs during the average two month lag between billing and payment. Working capital allowance is calculated by applying the rate of return to 2 months of operating costs plus overhead:
- $[(\text{operating cost} + \text{overhead})/6] \times 20\%$

# ALLOWABLE OPERATING COSTS

- Thus the recommended per unit operating fee is:
- $[(\text{operating costs})+(\text{overhead})+(\text{working capital allowance})]/\text{total throughput volume}$
- The facility operator must be prepared to disclose pertinent information relating to direct costs and overhead during fee negotiations.

# TURNAROUND COSTS

- This can become a point of contention. Typically, a facility is “turned around” once every two to five years.
- As a default, the JP-05 Task Force suggests that turnaround costs be fully charged in the year incurred

# 13<sup>TH</sup> MONTH ADJUSTMENTS

- In some agreements, the operating cost component is re-adjusted at the end of the year.

# 13<sup>TH</sup> MONTH ADJUSTMENTS

continued

- Advantages
  - Processor is protected from insufficient operating cost recoveries
  - producer pays only those operating costs for which it is obligated; and
  - producer generally has audit rights
- Disadvantages
  - producer cannot accurately budget: large year-end adjustments are possible;
  - For the processor these are time and manpower intensive
  - For both parties the final charges or credits may not be realized until 180 days or longer following year-end;
  - processors may not be receptive to third parties auditing facility records

# FIXED FEES

- Another method is to “fix” the operating cost component for a given period, usually one year. The operator is now in a risk reward situation for increased/decreased operating costs and/or volumes
- Advantages include:
  - elimination of 13th month adjustments
  - better cost/revenue forecasting for both parties
  - elimination of audits
- Disadvantages include:
  - No provisions for after-the-fact adjustments for unforeseen expenses or volume throughputs

# FIXED FEES continued

- The JP-05 Task Force does not preferentially recommend either the fixed or 13th month adjusted operating cost methodology—both are acceptable. The method used must be determined by the facility operator subject to the facility governing agreements and in conjunction with the non-operating owners of the facility.

QUESTIONS?

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# Lost Gas Cost Allowance

Rick Steffensen

## Frequently Asked Questions

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# Lost GCA

Factors to consider:  
The most complex calculation in JP-05

- Does not apply in certain processing situations
  - Fully depreciated facilities
  - Fully loaded facilities
  - 100% midstreamer owned facilities
- Apply when meaningful, not when trivial

# Q: What is Gas Cost Allowance?

A: The Crown recognizes that when processing a stream of raw gas, costs are incurred to process the crown's royalty share of gas.

Gas Cost Allowance (GCA) is an allowable deduction from Crown royalties to account for the Crown's share of the cost of processing royalty gas

## GCA is an:

- Allowable deduction for facility owners. The deduction uses a modified Jumping Pound Formula which is calculated on an AC2 form. A sample of an AC2 is provided in Appendix “C” of the JP-05 Document. Each eligible facility has its own Gas Cost Allowance, with facility owners able to claim their capital portion into a corporate Pool.
- Allowable deduction for non-owners (third party gas). In this case Custom processing charges are allowed as deductions for the non-owner

Q: Can you simply explain what is Lost Gas Allowance, and what is its purpose?

A: The Capital GCA for each facility is reduced by a “Custom Processing Adjustment Factor” prior to being allocated to the Facility owners. It is calculated based as a ratio of the custom processed, (non facility owner) volumes to the facility throughput. The Custom Processing Adjustment can be significant in facilities that have a high percentage of third party gas. That can have a direct impact on Facility owners Gas Cost Allowance, which impacts Royalties, which impacts cash flow. Lost Gas Cost Allowance simply put is a fee to compensate the facility owners for part of this impact.

Q: What do you mean by Part of the Impact?

A: There are two aspects to the reduction in GCA

1) the portion of GCA that was legitimately reduced because part of the facility capacity is being used for custom processing and

2) that part related to the Alberta Crown's Policy of disallowing capital devoted to custom processing on the basis of the ratio of custom throughput to total throughput, rather than the ratio of custom throughput to full capacity. It is the difference of these two that can be termed lost GCA.

# Q: Why not the entire impact?

A: Because the crown allocates the Capital GCA to the facility owners, based on throughput rather than based on total plant capacity.

In other words by providing custom processing, plant owners may end up with less deductions than would have been the case had they not provided capacity for third party processing.

LGCA component of the processing charge is meant to recoup what otherwise could have been claimed as deductions by plant owners.

**Q: Aren't there times in which the Lost Gas cost Allowance is just too small to worry about, why not include in the Capital Fee?**

**A: In some circumstances the Lost GCA is a relatively small component of the total fee. The purpose of Chapter 6 is educate both the Facility Owner Operators and third parties that there may be an impact. That impact should be known to both parties. It is then up to both sides to negotiate whether it is included in the total fee in the context of all other factors including the benefit of processing additional gas, capital charges earned and reduced per unit operating cost.**

Q: Chapter 6 has a lot of formulas, do I need to do all those calculations every time?

A: No, the formulas have been included to support the concepts and logic for the Lost Gas Cost allowance calculations. The example spreadsheets simplify this for you.

Q: In some cases the Lost GCA component is very large, in others very small, why ?

A: 1) The higher the undepreciated capital or rate base, the higher is the Lost GCA component.

2) The relative percentage of the third party volumes to Owners stream. The higher the percentage of third party gas the higher is the Lost Gas Cost component.

3) If overall throughput is low in comparison to the remaining capital, the Lost GCA component can be large.

Q: Are there circumstances where Lost Gas Cost Allowance is not applicable?

A: Yes, Section 6.5 provides a list of situations in which Lost Gas Cost Allowance should not be included. Fully GCA depreciated Facilities, Fully Loaded, outside Alberta, oil facilities and 100% Midstream Owned Facilities, should not have a Lost GCA Component.

Q: Who should get the proceeds from the Gas Cost Allowance Component of Fees?

A: Some suggestions in Section 6.4.

1) Working Interest Owners

2) Owner's Share of Excess Capacity contributed

3) Make allowance for owners who pay excess usage fees that are claimable as custom user fees in their GCA Submissions

- Operators should consider formalizing the distribution in their CO+O's or through Mail Ballots

Q: What are the key points to learn from this Chapter?

A:

- Apply when meaningful, not when trivial.
- Consider the benefits from additional throughput and operating cost reductions
- Additional third party volumes brought into a Facility that is still eligible for Gas Cost Allowance can have a significant impact on the current Owners GCA. Facility Operators should do an assessment of the potential impact.

QUESTIONS?

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# Regulatory Considerations

**Georgette Habib**

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# Regulatory Considerations

- Introduction
- Rights and Obligations (Directive 65)
- Misconceptions
- Modification to Board's Process (Amendment to Directive 65)

# Introduction

- Regulatory solution to access a gas plant or a pipeline and / or resolve fees issues should be an absolute last resort

# Rights & Obligations

- Rights and obligations for Common Processor and Common Carrier declarations under Sections 53 and 48, respectively, of the Oil and Gas Act (the Act) are set out in Directive 65

# Revision of Directive 65

The Board directed that Directive 65 be updated to make reference to Board's expectation with respect to:

- ADR
- Documentation of face to face negotiations and efforts to reach agreement
- How the proposed rates conform with JP 05
- If a party were to deviate from JP 05, a complete documentation of why the proposed alternative is superior to JP 05.

# Rights & Obligations (Cont'd)

- Owner's share of gas production from a pool – consistent with orderly economic and efficient development in the public interest

Among other things, an applicant for common processor or carrier must demonstrate that:

1. Producible reserves are available
2. Reasonable arrangements for use of facility could not be reached
3. The proposed common carrier/processor operation is either the only economically feasible or the most practical way to transport or process the gas in question or is clearly superior environmentally

All applications for common processor or carrier orders proceed to a public hearing

- If fee is under dispute, either the common processor/carrier or an owner may apply under the OGCA

# Rights & Obligations (Cont'd)

## Obligations

- An order under Section 53 obliges each common processor, among other things, to process gas that may be available for processing in the plant without discrimination in favor of one producer or owner as against another in the pool.
- An order under Section 48 obliges each common carrier, among other things, to transport production without discrimination as between any of the owners for whom transportation is provided

## Rights & Obligations (Cont'd)

- Board's practice has been a two-staged process. A common processor or carrier order is first issued and then the parties are normally advised to re-negotiate a fee. If unsuccessful the Board will set fees.

An applicant though can request that the Board deal with both issues at same proceeding

# Common Misconceptions

## Myth:

There is no justification for a common processor or carrier order if there is:

- No drainage
- Access is not denied, but the dispute is over fees or terms of access (Decision 97-2)
- Economically viable alternative

# Common Misconceptions Cont'd

## Facts

Drainage is only one of several equity-related issues.

Others include:

- Contractual terms leading to less than optimal resource recovery (conservation concerns, flaring, or other avoidable environmental impacts).
- An alternative may be economically viable but have adverse environmental implications, or unnecessary proliferation of facilities.

# Common Misconceptions Cont'd

## Facts

- Equity test implied in the common processor/carrier legislation compels the Board to consider all the factors that may prevent parties from obtaining fair value for their resources.
- While physical drainage typically has been the reason for such orders, the Board believes inequities could arise from commercial terms that could be unfair or prevent orderly development of resources

# Common Misconceptions Cont'd

## Myth:

We can use the Board process to initiate discussion

# Common Misconceptions Cont'd

## Facts

Not anymore, because...

- EUB endorsed C2C task force report including its recommendation that industry-approved fees guideline application be strengthened through regulatory requirements, and potential recovery of cost if a party refuses to move forward to the detriment of another
- EUB expressed support for industry approved guidelines and more specifically for JP 05

# Revision of Directive 65

The Board directed that Directive 65 be updated to make reference to the Board's expectation with respect to:

- ADR
- Documentation of face to face negotiations and efforts to reach agreement
- How the proposed rates conform with JP 05, hence encouraging the disclosure
- If a party were to deviate from JP 05, a complete documentation of why the proposed alternative is superior to JP 05

# Conclusion

## **EUB's position is that:**

- Industry solutions are more preferable to regulatory interventions
- An industry acceptable fee structure should promote negotiation of fees that are fair, reasonable and that enhance resource development consistent with the public good

QUESTIONS?

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# EUB ADR PROCESSES

David Hill

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# EUB Applications 2004

- 44,445 Total applications submitted
- 1438 pooling, carrier, and rate applications
- 264 C2C disputes
- 11 ADR cases
- 2 hearings cancelled

# EUB C2C ADR 2004

- 11 cases
- 6 mediations – 5 resolved
- 4 resumed negotiations
- 1 to hearing

# EUB Application Process and ADR

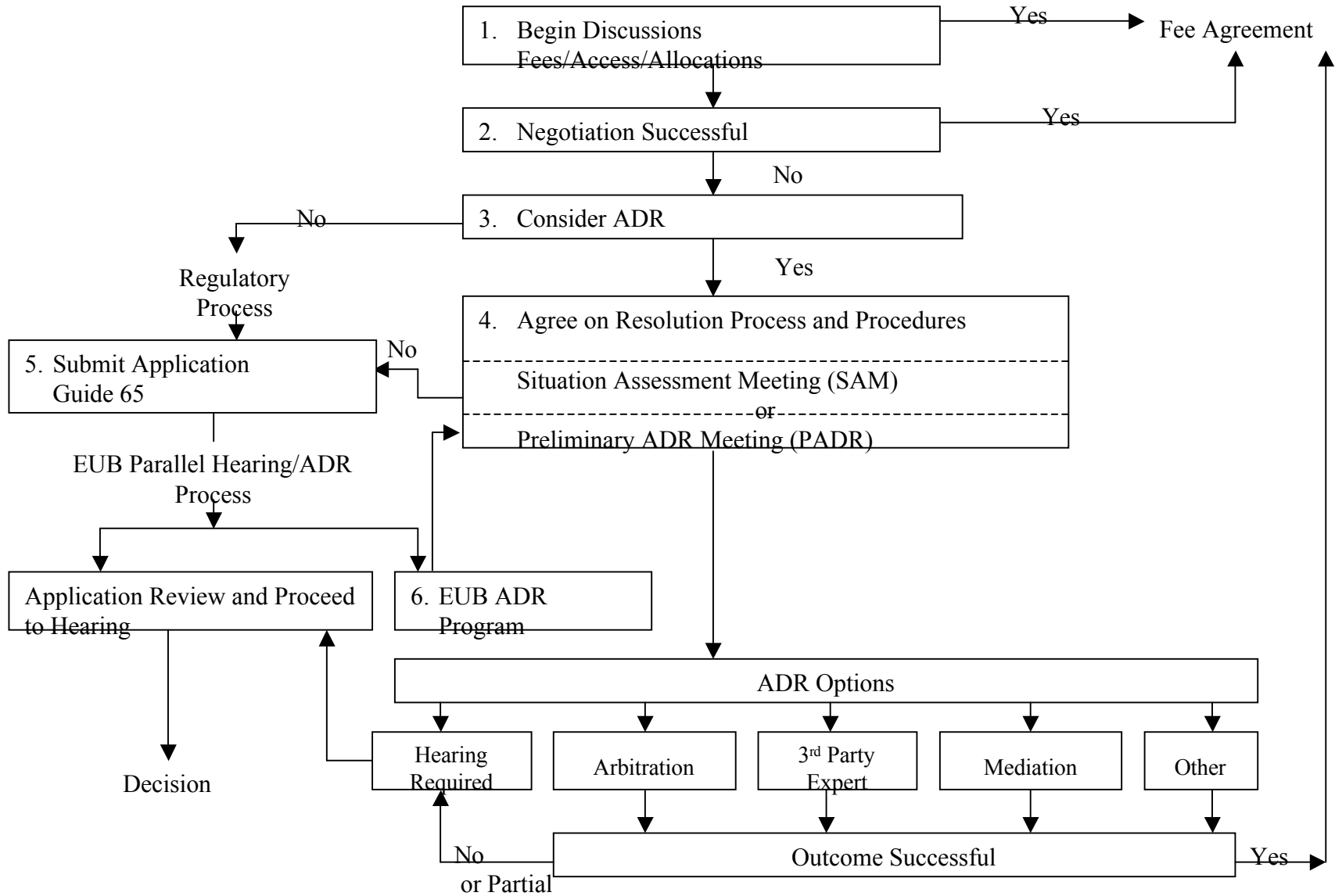
- Program outlined in IL 2001-1
- Goals of Program
  - Improved relationships
  - Better use of disputant's resources
  - Maximum control of outcomes
  - Lasting solutions
- Expectation that thorough negotiations have taken place
  - Face to face
  - Disclosure
- Submission must demonstrate some reasonable attempts or may be ruled deficient

# How is ADR initiated?

- Get consent from parties to at least go to a Preliminary meeting
- Engage service provider (SP) to set up preliminary meeting
- SP arranges logistics and arranges moderator/mediator to conduct meeting.

# JP05

## Resolution of Processing Fee Disputes



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# Preliminary Meeting

- SP arranges meeting logistics and the right people to be at the table
- Arranges for information to be available to assist in meeting
- Reaches agreement on dispute resolution tool(s)
- Reaches agreement on costs, confidentiality, and content

# Keys to Successful Fee Negotiations

- Face to face meetings early in process
- Proper authority at the table
- Disclosure of all relevant information
- Willing to listen and understand
- Separate issues from people
- Willingness to jointly design a process to resolve issues

# Resolution of Processing Fee Disputes

- Early engagement
- Consideration of ADR
- Preliminary Meeting or SAM
- Regulatory Process
  - Directive 65
  - EUB adoption of JP 05
  - Parallel process

QUESTIONS?

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# EXAMPLES FROM REPORT

- Chapter 12 – Users Guide and Examples
- Contains the fee history of an imaginary gas plant from construction in 2004 to 2034
- 2 of the 5 cases follow

# PLANT DATA

- Built 2004 for \$10,000,000
  - Capacity 1000 e3m3/d
  - Operating cost \$1,000,000 per year
  - Case 2: 850 e3m3/d, 50 e3m3/d, 2007
  - Case 3: 900 e3m3/d, 50+50 e3m3/d, 2009
- 
- SWITCH TO SPREADSHEET

# WRAP-UP

- JP-05 report and spreadsheet available at [www.pjva.ca](http://www.pjva.ca) (FREE!)
- Today's slides also available from website
- Questions?
  
- THANKS TO ALL