Deductions Guidelines for the Calculation of Lessor Royalties Payable to PrairieSky Royalty Ltd. ("PrairieSky")

PrairieSky has many lease forms, most of which do not allow for deductions. The following guidelines for the calculation of deductions are applicable to specific historical lease forms that permit certain deductions. In the event of a conflict between these guidelines and the lease, the specific terms of the lease shall prevail.

Non-Permitted Deductions

Costs upstream of the tie-in point on the gas gathering system for gas and before removal of basic sediment and water for oil are not permitted. These costs may include but are not limited to well costs, surface costs, well tie-in costs, wellsite compression, take-or-pay obligations, property taxes, freehold mineral tax, Alberta Energy Resources fees, administrative costs or any other costs of a similar nature.

Deductions based on Crown Gas Cost Allowance (GCA) methodology are not accepted. Royalty owner share of production is to be processed favorably in common with the Lessee's share of production, not as an arms-length third party arrangement.

Leases Where Deductions are Permitted

Costs must be reasonable and reflect those incurred by the Lessee to make the *leased substances* a marketable sales product. As an example, liquid fractionation costs would not be permitted as a deduction to make dry shallow gas and coalbed methane a marketable sales product.

Based on this over-arching principle, additional information on specific permitted deductions for leased substances is provided below.

Natural Gas Permitted Deductions

Where deductions for gathering, compression (excluding wellsite compression) and processing costs incurred downstream of the tie-in point and upstream of the point of sale are permitted, such costs shall be determined as outlined below.

Non-Lessee-owned Facilities (including Pipelines)
Actual charges invoiced to the Lessee by the facility owner related to the leased substances in accordance with terms of an executed service agreement.

Partial Lessee-owned Facilities (including Pipelines)
Actual charges for processing Lessee's production at the most current owner rates specified in the Facility CO&O Agreement or as approved by Operating Committee Mail Ballot.

Wholly Lessee-owned Facilities

I. Where the lessee is the sole owner of the facilities, excluding pipelines, and has third-party service agreements in place, PrairieSky will consider the lowest third-party service fee as a deduction charge for processing the royalty share of production, subject to the submission of a copy of all third party service agreements and sample invoices for a recent month; or

II. Where the lessee is the sole owner of the facilities, excluding pipelines, and does not have third party agreements in place for these facilities, PrairieSky looks to Jumping Pound

2005 - JP-05: A Recommended Practice for the Negotiation of Processing Fees dated October 2005*, using the Lower Limits and removing allowance for Lost GCA, to the extent only that the formula provides a fair representation of the actual costs that would reasonably be charged to a third party. Note that the Capital Rate is based on facility design capacity, and Operating Rate is based on annual throughput through each facility; or

III. Where the lessee is the sole owner of the pipelines and does not have third party agreements in place, PrairieSky will consider a fixed deduction rate based on JP-05 recommendations of $0.20/$10^3m^3$/km for pipelines greater than ten (10) years old. For newer pipelines, this rate may be increased up to $0.35/$10^3m^3$/km, as reasonably determined appropriate based on the relative age, size and material in comparison to typical industry third-party rates for similar pipelines.

A paper copy or MS Excel spreadsheet sample modified JP-05 template to calculate the deduction charges as allowed above will be made available by PrairieSky upon request.

Petroleum Permitted Deductions

Actual costs incurred to transport clean oil to market, after removal of basic sediment and water, but only if specified as an allowable deduction under the lease.

Plant Products (Natural Gas Liquids, Sulphur) Permitted Deductions

Deductions are to be determined separately for each substance obtained from each well, as and when processed or treated, and applied to the royalty calculations for that substance. Deductions for subsequent processing or treatment of any liquids or sulphur are not to be connected or transferred to the royalty calculation for any originating substance(s). For example, the actual costs for NGL fractionation or sulphur processing/forming and transportation are deductible against the sales proceeds from each product, but not as part of the natural gas royalty calculation.

Regardless of the foregoing or any lease terms to the contrary, and for accounting simplicity, PrairieSky will consider requests to include reasonable total costs for all gas and liquids (excluding sulphur) to be applied as a combined deduction rate against the gas gathered volume. Sulphur costs will continue to be deducted from sulphur sales proceeds only.

Supporting Documentation

Documentation is required to support deduction calculations. All such information provided to PrairieSky will be held in confidence.

A Note on Deduction Guidelines for the Calculation of Overriding Royalties

Where deductions are permitted under an agreement pertaining to an overriding royalty payable, PrairieSky will consider deductions in accordance with these guidelines; in which case, any reference to lessee and lease in these guidelines shall mean payor and overriding royalty agreement

**Note: If JP'05 is replaced or no longer represents general industry practice for determining costs, a replacement methodology that reasonably represents the actual cost will be used.*