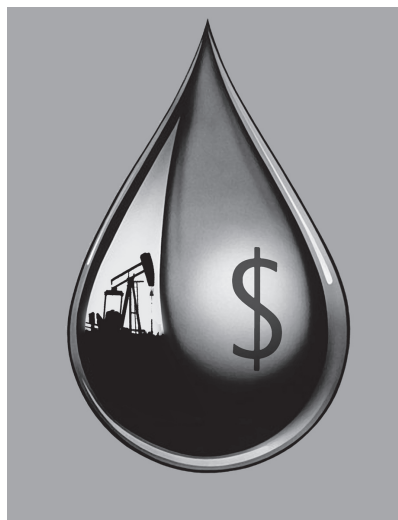


Parkland Institute, University of Alberta • October 2007



Selling Albertans Short: Alberta's Royalty Review Panel Fails the Public Interest



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Finally, the author would like to acknowledge the important work that many activists and organizations have been doing to ensure that the royalty debate has stayed alive since Parkland first released "Giving Away the Alberta Advantage" in 1999. Also, the Alberta Federation of Labour who will be supporting the dissemination of this report's recommendations and findings to their members in the energy sector and encouraging their full participation in this important discussion.

About the Author

Diana Gibson is the Research Director for the Parkland Institute, a public policy research center based at the University of Alberta. She has an extensive background in social policy research and has engaged nationally and internationally on topics ranging from health care and education to energy and international trade agreements. Prior to joining the Parkland, Diana was on faculty at Capilano College before which she worked in labour relations for a number of years in Ontario, B.C. and Alberta.

About the Parkland Institute

Parkland Institute is an Alberta research network that examines public policy issues. We are based in the Faculty of Arts at the University of Alberta and our research network includes members from most of Alberta's academic institutions as well as other organizations involved in public policy research. Parkland Institute was founded in 1996 and its mandate is to:

- conduct research on economic, social, cultural, and political issues facing Albertans and Canadians.
- publish research and provide informed comment on current policy issues to the media and the public.
- sponsor conferences and public forums on issues facing Albertans.
- bring together academic and non-academic communities.

I. Introduction

“The report’s recommendations fall far short of what Albertans said they wanted, and what groups like the Parkland Institute have been calling for over the past decade.”

Bill Hunter, the chair of Alberta’s 2007 Royalty Review Panel, articulated clearly how Alberta’s royalty system should work. In an interview with CBC he said “As Albertans we own 100 per cent of the resource, and we should expect nothing less than 100 per cent of the rent. It’s up to industry to convince us why we should take a decrease ...”¹ Unfortunately, the Panel’s “Our Fair Share” report, released in September 2007, falls well short of fulfilling the spirit of that statement.² Even by the Panel’s own admission, implementing all of the report’s recommendations would only take Alberta from the basement internationally on rent collection to somewhere near the bottom.

It is clear that this report is a compromise. The majority of submissions from the energy industry claimed that the system should be left alone. Public input was heavily in favour of an increase in royalties. The report’s recommendations fall far short of what Albertans said they wanted, and what groups like the Parkland Institute have been calling for over the past decade. The recommendations also fall far short of what Albertans should be receiving as owners of the resource. Albertans are entitled to more than a fair share of their resources; as owners, they are entitled to the maximum revenue possible from those resources while still encouraging the appropriate level of investment. The Panel does not acknowledge or achieve this goal.

This paper provides an analysis by the Parkland Institute of the set of recommendations made by the Panel. It is very significant that the Panel –a group of high-powered execs, corporate consultants, and high level economists– acknowledged that royalties are too low in Alberta compared to other jurisdictions. The Panel recommended that the government raise the rates by 20%. The Panel also noted that accountability and transparency were sorely lacking in royalties management, a message echoed by Alberta’s Auditor General, Fred Dunn.³ However, the rates recommended by the Panel, when compared to other jurisdictions, are too low.

This report will begin with a general discussion of the problems with the way in which the royalties review was structured and flaws in the base assumptions made by the Panel.⁴ The second section will provide an analysis of the specific recommendations within the panel’s report that fall short. Finally, a set of recommendations are proposed on how the royalties reform should proceed.

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- 1 CBC News, Premier won’t be bullied into royalty decision, September 20, 2007. <http://www.cbc.ca/canada/edmonton/story/2007/09/20/stelmach-royalty.html>
 - 2 Royalty Review Panel, Our Fair Share, Government of Alberta, September 2007. http://www.albertaroyaltyreview.ca/panel/final_report.pdf
 - 3 Fred Dunn, Annual Report of the Auditor General 2006-07, Government of Alberta, Edmonton, 2007. p. 106.
 - 4 For the purposes of this report, royalties are considered to be a mechanism for recovering rent. Rent is the value at the point of sale less all prior costs incurred, including a suitable return on investment. The net resource value itself is termed economic rent. To illustrate this, assume for the purposes of this example only that oil extraction makes a 10% return on investment at \$25/bbl. At \$40/bbl the rent (revenue minus costs minus a return on investment) would be the balance of \$15.

The specific recommendations in “Our Fair Share” that are highlighted as problematic include:

- **1% royalty holiday on tarsands oil** - The report recommends maintaining the royalty base rate of 1% of gross revenues until capital costs have been recovered. The net royalty rate of 33% of net profits would be effective only once those costs have been recovered at which point both the 1% and the 33% would apply.
- **Higher net royalty rate** - The report recommends an increase from 25% to 33% for the net royalty once capital costs on tarsands oil have been covered.
- **Windfall profits tax** - The report recommends a windfall profits tax (severance tax) for the tarsands when the price reaches over \$40 per barrel. This tax starts at 1% and increases at 0.1% for each \$1 dollar of oil price increase. It caps out at a maximum of 9% at \$120/barrel oil. Total maximum capture at high oil prices would be only 42%.
- **Coal Bed Methane - Cuts in royalties for low producing wells** - The report recommends a reduction in royalties for low producing wells, partially to address the issues related to Coal Bed Methane (CBM). CBM wells tend to be shallow and lower producing than conventional gas. However, they also have larger landscape and water impacts that were not given consideration.
- **Value Added Incentive** - The Panel recommends a royalty credit be given for corporations that include an upgrader in their operations as a measure to encourage the industry to upgrade the bitumen in province. Alberta Energy estimates that this will result in a \$3.2 billion reduction in royalty revenue over five years.

II. General Flaws in “Our Fair Share”

The Panel's report failed to consider significant issues related to royalties, leading to notable shortcomings in the recommendations. Some of these include:

- The complete absence of any consideration of aboriginal issues. There are notable unresolved land claim issues and native rights issues related to oil and gas investment in this province. Though it is beyond the scope of this report to provide a full analysis of these issues, it is imperative the government's consideration of a new royalties structure include addressing aboriginal rights related to royalties and development.
- The Panel refused to address issues related to the pace of development or environmental impacts of that development. These issues are inseparable from the debate on royalties and need to be acknowledged in a royalty structure.
- The Panel did not consider issues related to how the royalties revenues would be used. This opens the Panel up to the criticism that with Alberta's coffers already overflowing, there is no need for more revenue. A solid long-term savings and investment framework is needed to ensure that increases in provincial revenues are used for the long term health of the province's economy.

Other general flaws in the Panel's report are outlined in more detail below.

Royalty revenues still projected to fall off dramatically

Despite the Panel's recommendation that royalties be increased for some oil and gas projects, revenues from oil and gas are still projected to fall by \$3.8 billion by 2016 or a net \$2 billion from current revenue levels. This is in spite of a projected doubling of tarsands production and predictions that oil prices will increase dramatically (see later section on prices). These revenue losses do not include the \$3.2 billion in revenues that will be lost over five years due to the upgrader royalty credit.

The chart on page 17 of the Panel's report estimates the royalty revenue impacts (see Figure 1). The 2006 projection of revenues was \$9,533 billion while the projection for 2016 with full implementation of the report's recommendations is only \$7,595 billion. And that doesn't take inflation into account, meaning that in real dollars, the revenue fall would be even greater.

“ Even if the Panel's report is implemented in full, revenues from oil and gas are projected to fall by \$2 billion by 2016. ”

This net drop in revenues can be partially explained by the cuts proposed for royalties on conventional oil and gas. Note from the same chart that natural gas revenues are projected to fall by over 50% or over \$3 billion per year, even though production is projected to drop by only 14.5%. On the oil sands side, the shortfall in royalties can also be seen. Oil sands production is expected to rise by 111% while royalties are projected to rise by only 81%. These differentials illustrate the shortcomings of the Panel's recommendations.

FIGURE 1

Estimated Royalty Revenue Impacts						
	Current			Proposed		
	2006	2010	2016	2006	2010	2016
Production						
Gas	5,268	5,059	4,503		Same	
Conv. Oil	538	469	396			
Oil Sands (Mb/d)	1,291	2,121	2,726			
Prices						
Gas	\$6.22	\$6.34	\$6.18		Same	
Conv. Oil	\$66.22	\$56.44	\$66.60			
Oil Sands	\$75.10	\$60.69	\$71.61			
Alberta Government Revenue						
Gas	\$2,204	\$4,769	\$2,362	\$6,825	\$5,412	\$2,737
Oil Sands under Crown Royalties	\$1,439	\$807	\$551	\$2,252	\$1,263	\$862
Oil Sands Bitumen	\$1,577	\$773	\$1,068			
Subtotal Oil Sands	\$627	\$966	\$1,578			
	\$2,204	\$1,739	\$2,646	\$2,354	\$2,405	\$3,996
Total Revenue to Albertans	\$9,522	\$7,216	\$5,559	\$11,431	\$9,079	\$7,595
<i>Alberta Department of Energy September 2007</i>						
<i>As referenced by the Royalty Review Panel in "Our Fair Share" Page 17.</i>						

Failure to consider public ownership

One of the reasons the Panel's recommendations are so weak is the failure to consider public ownership options. Elsewhere in the world, nations have been asserting greater control over their resources.

In fact, national oil companies (NOCs) are rapidly emerging as major factors in the competition for global oil reserves. For profit international oil companies (IOCs) control less than 10 percent of the world's proved oil and gas resource base.⁵ Indeed the super

⁵ Price Waterhouse Cooper, Changing role of national oil companies, website article <http://www.pwc.com/Extweb/industry.nsf/docid/49F2DB1ED1EB0236852571C6005ADC63>

majors themselves account for only 3% of oil reserves and 2% of gas reserves. When ranked on the basis of proved oil and gas reserves, 17 of the top 20 oil and gas companies in the world are NOCs. This changing dynamic is evident in Alberta's tar sands. Publicly owned oil companies from countries such as Norway, China, Korea, Japan and Abu Dhabi have made purchases in the tar sands.

It is ironic that the citizens of Norway, China, Korea, Japan and Abu Dhabi are profiting from Alberta's oil and gas while Albertans do not publicly own any of the companies involved. Public ownership is the best way to capture royalties, as 100% goes to the owners, the people of Alberta. It is also the best mechanism for ensuring appropriate development of the resource. With over 80% of the world's oil locked up by national oil companies, the rest of the world has realized that this resource is too valuable and strategic to be handed over to foreign multi-nationals. Canada, on the other hand, has allowed majority foreign ownership of both oil and gas. As an excellent illustration, one of the companies most vociferously opposing the royalties increase is ENCANA. This company was initially created by the Alberta government to enable Albertans to participate in the development of their resources. It was formed as a publicly owned corporation and subsequently privatized under Ralph Klein's government. Had that company remained public and true to its founding principles, it would not be opposing a policy change that serves the public interest.

The Threat of an Investment Strike

The timid recommendations made by the Panel are also partially explained by the refusal to consider issues related to investment levels. The discussion as to the appropriate level of investment in Alberta's oil and gas is a critical one. Investment is a tool to be harnessed towards social goals, not an end in itself. Thus, it is important to give consideration to the level of investment in oil and gas extraction that is in the interest of Albertans. This is a critical aspect to the royalties debate as rent is considered to be the balance after corporations have deducted costs and a reasonable return on investment. Determining a reasonable return on investment for the sector requires a discussion of the goals for that investment and the desired levels and pace of that investment.

The Panel deemed such issues to be outside of their mandate, even though much of the public input they received related to the need for a slow down in the pace of development. By default, their goal was set as ensuring maximum short term investment by keeping Alberta's rates low by international standards. Nonetheless, the

“ Alberta is currently the lowest tax and royalty jurisdictions in North America and one of the lowest in the world. ”

discussion since the report has been released has centred on whether investment would be jeopardized by the new royalties structure. This Parkland report will confirm the Panel's assertion that, for a number of reasons, investment is very unlikely to relocate due to the Panel's recommendations.

Though this report will show that Alberta's rates will still compare favourably internationally, this may not prevent all investors from holding back. It is possible there will be a 'capital strike' that is based on principle, in an attempt to deter other governments from following step. However, with the economy overheated and the majority of Albertans feeling they are not benefiting, an investment slow down would be an appropriate policy goal.⁶ Additionally, there is little question that oil will continue to gain value in the future as demand skyrockets, due in part to dramatic growth in demand in China and India. Thus, a better strategy would be to leave the oil in the ground to be extracted at a later date when it has greater value. This would allow for a much higher royalties structure immediately, one that places Alberta closer to the top in terms of revenue capture, not the bottom.

Being competitive can mean more than having the lowest royalties

Alberta is currently the *lowest* tax and royalty jurisdictions in North America and one of the lowest in the world. The Panel acknowledges that changes in rates will not significantly alter this, keeping Alberta's rates low by international standards.⁷ The Panel's stated goal is to remain competitive internationally - interpreted as being one of the lowest tax and royalty jurisdictions. The Panel didn't consider Alberta's other competitive advantages such as access to the oil, relative exploration costs, secure transport infrastructure to guaranteed markets or political risk.

The international oil companies would have Albertans believe that there is tremendous risk involved with oil sands projects and that costs are prohibitively high. The real picture is quite different.

⁶ For an analysis of the need for a slowing of the pace of development see *Taming the Tempest: an Alternate Development Strategy for Alberta*, and for a discussion of how Albertans are being left out of the benefits of the boom, see *Spoils of the Boom*. Both reports are by Diana Gibson, published by the Parkland Institute, University of Alberta, spring 2007.

⁷ Royalty Review Panel, op cit.

1. Most other jurisdictions have already significantly increased their royalties and taxes.
2. Most of the world's oil reserves are off limits to private, for-profit oil companies.
3. Alberta is low in terms of political risk compared to other jurisdictions.
4. Tarsands costs are a red herring - the proposed tarsands royalties are based on net profits, meaning costs are already deducted.

Also, costs of production have actually fallen in relative terms and exploration costs are comparatively very low.

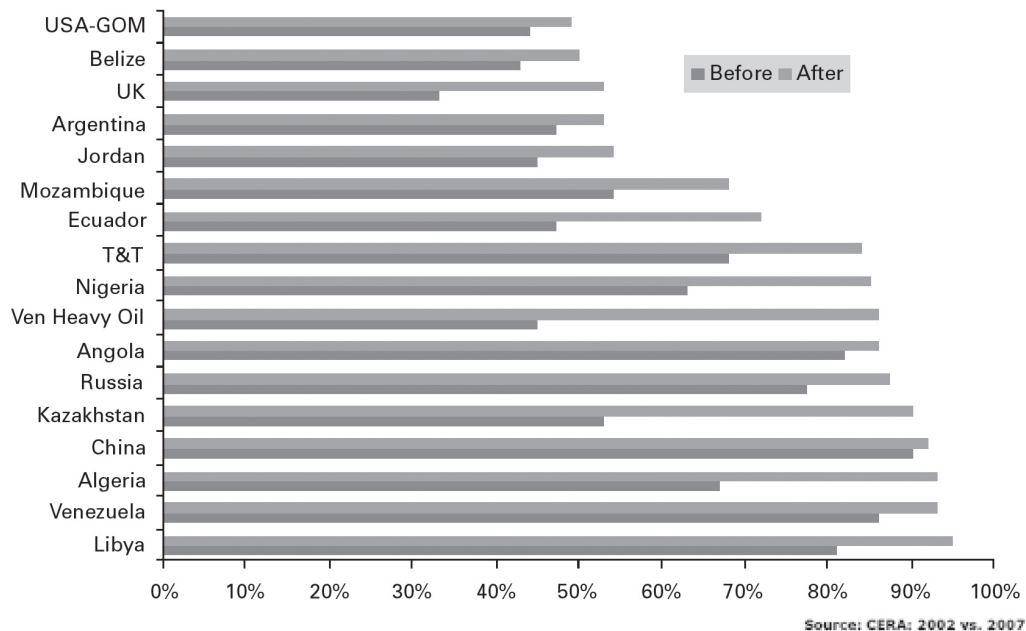
5. The demand for the resource is virtually guaranteed and the market price for oil is projected to rise significantly over the long term.

Most other jurisdictions have already raised their rates

Figure 2 shows the increases in royalties in a number of energy producing countries around the world where royalties regimes have been updated since 2002. The changes in these other jurisdictions were not minor - of the 17 jurisdictions surveyed, ten increased their rent capture to over 80%. Alberta is actually lagging well behind by not revising its outdated royalty regime. With total revenue capture (all taxes and royalties) of between 47% (oil sands) and 58% (natural gas), Alberta would fall at the lowest end of this chart.

FIGURE 2

Changes in Government Take 2002 to 2006



Source: Cambridge Energy Research Associates, as referenced in Mark Nelson, Chevron president, presentation to the Review Panel, 2007 http://www.albertaroyaltyreview.ca/public_meetings/submissions/2007_0515_mark_nelson_chevron01.pdf

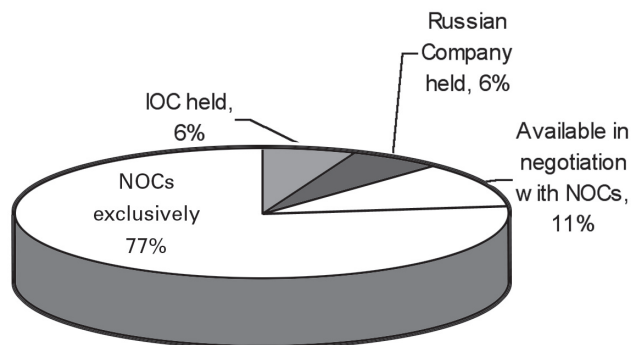
“According to Canadian Imperial Bank of Commerce analysis, Canada represents anywhere from 50-60% of the investable oil reserves in the world.”

Other reserves not open for business

Firstly, private for profit multinationals can access Alberta's oil. Although overlooked by much of the discussion, this is significant because most other oil producing nations have shut out the major private oil companies, moving instead towards greater public control and ownership of their oil resources. As seen in Figure 3, only 6% of the world's oil is held by independent oil companies (IOCs). The vast majority of the world's oil is nationally owned and processed, making it off limits to private, for-profit oil companies. According to Canadian Imperial Bank of Commerce analysis, Canada represents anywhere from 50-60% of the investable oil reserves in the world.⁸

FIGURE 3

Global Oil Reserves



Source: J. Robinson West, PFC Energy, 2005, as quoted by John C. Felmy, American Petroleum Institute, Power point presentation, Delivering America's Energy Security, http://www.api.org/meetings/proceedings/upload/Delivering_Americas_Energy_Security_John_Felmy-2.pdf

Political risk and security of transport infrastructure

The second advantage Alberta's tarsands offer is a low level of political risk. The small portion of global reserves that is accessible to the international for profit companies is often located in areas that are politically volatile and in violent regions. Transportation infrastructure such as pipelines is often at risk as are other infrastructure and staff. These amount to higher costs for corporations whether due to commercial insurance costs or to self-insured risk. Alberta is a stable political jurisdiction by international standards, with secure infrastructure to guaranteed markets.⁹

⁸ Jeff Rubin and Warren Lovely, The Vanishing Consequences of a Parity Exchange Rate, CIBC World Markets Inc. StrategEco, June 15, 2007. p.5.

⁹ With only four changes in the governing party in 100 years, Alberta is perhaps one of the most stable jurisdictions in the world.

Figure 1 shows other jurisdictions by tax and royalty cost. Though Alberta is not in the chart. However, with Alberta's rates ranging from 49% for conventional oil to 64% for the oil sands, Alberta would sit squarely in the bottom third. Alberta can compete favourably with most of the jurisdictions with higher royalty rates in terms of political stability and the security of the transportation infrastructure to a large guaranteed nearby market. For example, Nigeria and Angola are less attractive because they are: politically unstable; infrastructure and staff is not secure; they are not close to guaranteed markets; and exploration costs are high. Yet both those jurisdictions have combined tax and royalty rates of over 80%. In fact, all jurisdictions with over 60% royalties compare poorly to Alberta in both exploration costs and political risk. These include Venezuela, Ecuador, Trinidad and Tobago, Nigeria, Angola, Russia, Kazakhstan, China, Algeria and Libya (see Figure 2). Thus, on the basis of political risk competitiveness alone, Alberta can easily compete while being in the highest royalties range for oil.

Industry is crying wolf on Costs

The oil and gas industry is claiming that costs are high in Alberta's energy sector, and that with the royalty changes their investments will be jeopardized. Imperial oil claimed that, "The prospect of higher royalties and taxes is yet another cost being foisted on squeezed Alberta oil producers".¹⁰ Encana said that "if the royalty Panel's recommendations are adopted in full, many of Alberta's new and emerging resource plays will simply not be economically viable."¹¹ Encana went on to threaten to cut its 2008 capital investment in Alberta by about \$1bn, equivalent to 30-40% of the \$2.5bn-\$3bn it had planned to spend.¹² CNRL also weighed in saying that "the proposals pose the risk of turning the oil and natural gas industry in Alberta into a "shrinking" or "blowdown" model."¹³

Especially for the tar sands, these claims of costs are a red herring. First and foremost because costs are already included in both the 1% royalty holiday period and in the subsequent 33% which is based on net profits. The tarsands royalties calculations are revenue minus costs (R-C). By definition in the 1% write off period, industry would not have to pay the 33% royalty rate until all of their capital costs are written off. In the post-payout period, the calculation is on net profits meaning revenues after costs have been deducted.

Nonetheless, a closer look at costs reveals a different picture from that being presented by the industry. Costs include both development and exploration costs. Elsewhere exploration costs are high and increasing. In the tar sands, exploration costs are low as the location of

¹⁰ Sheila McNulty and Bernard Simon, Industry attacks Alberta oil royalty plan, Financial Times, October 7 2007. <http://www.ft.com/cms/s/0/3a4cb312-7501-11dc-892d-0000779fd2ac.html>

¹¹ Ibid.

¹² Ibid.

¹³ CNRL, Canadian Natural Resources Limited Expresses Concerns Over the Alberta Royalty Review Panel Report, Press Release, Tuesday, October 09, 2007. http://www.oilvoice.com/Canadian_Natural_Resources_Limited_Expresses_Concerns_Over_t/10975.htm

“...once the exploration costs associated with conventional oil elsewhere are taken into consideration, with the drilling of dry holes, “Alberta oil sands developments are very competitive.””

the reserves is known. The Fiscal Evaluation commissioned by Alberta Energy, conducted by renowned energy analyst Pedro Van Meurs, reports that once the exploration costs associated with conventional oil elsewhere are taken into consideration, with the drilling of dry holes, “Alberta oil sands developments are very competitive.”¹⁴

This is borne out by international trends where the “dry holes” cost issue is significant. Conventional oil reserves are declining around the world and this means that the incidence of dry holes is on the rise so much so that it has become a major cost for the corporations involved. In 2006, the global energy sector spent a record amount of money (\$401 billion US) in their efforts to find new reserves. However, it only succeeded in bolstering reserves by a meagre two per cent.¹⁵ They are simply not finding the oil. The largest part of those new global reserves (over half) was in Canada’s tarsands.

Even on the operating cost side Alberta compares favourably. The technical paper by Pedro Van Meurs on fiscal comparisons finds Alberta’s oil costs to be comparable to slightly below average in comparison with the rest of Canada and the United States.¹⁶ According to the same analysis, Alberta’s natural gas is also very competitive on costs - the Alberta basins were all below average costs for Canada and the US. Out of the 76 basins identified, Alberta’s were all within the bottom 20 for cost, with 4 of the 6 in Alberta being in the lowest 7.

Costs for tarsands are not escalating in relative terms

For investment decisions, relative costs are as important as absolute costs, if not more so. International oil companies will relocate investment elsewhere only if it is relatively cheaper than Alberta, all other conditions being equal. Though costs have been increasing in the tar sands, costs have been driven up much more elsewhere. According to the international management consultants Price Waterhouse Coopers, exploration and development costs in the tarsands have increased 26 to 32% while globally those costs are up 50 to 55%.¹⁷ This latter is being driven in a large part by the increases in exploration costs. This means that in spite of cost inflation, relative costs have actually fallen for the tar sands.

Drilling predicted to fall in Natural Gas

The natural gas side is slightly different in that prices have actually fallen and are not predicted to rise in the same way as oil prices.

¹⁴ Ibid p.3

¹⁵ Deborah Yedlin, Tar Sands, Peak Oil and Lack of New Discoveries, The Calgary Herald, Calgary, Alberta, August 30, 2007, Pg. E1. <http://oilsandstruth.org/tar-sands-peak-oil-and-lack-new-discoveries>.

¹⁶ Alberta Department of Energy, Technical Report OG#1, Alberta’s conventional oil and gas industry - investor economics and fiscal system comparison, Edmonton, 2007, p. 8. <http://www.energy.gov.ab.ca/Oil/pdfs/RISConvTechInvestorCompar.pdf>

¹⁷ Price Waterhouse Coopers, Canadian Energy Survey 2007, p. 17. <http://www.pwc.com/extweb/pwcpublications.nsf/docid/DCCFBC5BEC26B3D7852570CA00178E98> http://www.pricewaterhousecoopers.sport.hu/caleng/ins-sol/survey-rep/ces_07.pdf

“Threats for reduced exploration in natural gas are real, but not as a result of the Panel’s royalties recommendations”

Also, the Western Sedimentary Basin is considered to be mature and production has already peaked. Increased numbers of wells have been drilled but less gas is being discovered. Thus exploration costs in the basin are on the rise. However, as mentioned above, costs for natural gas in Alberta are still quite low by North American standards.

Companies such as ENCAN and CNRL are reacting negatively to the Panel’s royalties report on the basis that exploration levels will be impacted. Threats for reduced exploration in natural gas are real, but not a direct result of the Panel’s royalties recommendations.

Other factors are behind the fall off in gas exploration. As a recent National Energy Board report states, drilling and development activity in the WCSB hinges primarily on the price of natural gas in the North American market. That price is volatile, influenced by uncertainties such as weather-driven market demand, availability of imported liquefied natural gas (LNG), and possible supply disruptions in the Gulf of Mexico.¹⁸ That price has fallen lately, lowering the incentive for exploration. A slowdown in natural gas drilling began in 2006 and has now persisted for over a year.

The Panel actually recommends a decrease in royalties on low producing wells. This measure was included as a mechanism to ensure that only lucrative wells would pay the higher royalty and that exploration would be encouraged.

Where costs are out of control industry is partly to blame.

Low royalties and the 1% holiday period act as disincentives to industry to control costs. Additionally, the lack of government regulation and collection of royalties act as incentives to inflate the costs through such techniques as transfer pricing.¹⁹ In recognition of this, Pedro Van Meurs recommends an increase in royalties partly as a measure to encourage cost efficiency.²⁰

Sustained high prices make Canada’s oil incredibly lucrative.

Industry analysts are predicting that oil prices will stay in the high range - \$50 to \$70/bbl - for the foreseeable future. Jeff Rubin of CIBC World Markets goes even further, predicting an increase to triple-digit prices within two years.²¹ Lord Oxburgh, the former chairman of Shell, has issued a stark warning that the price of oil could hit \$150 per barrel, with oil production peaking within the next 20 years.²² The International Energy Agency has forecast what it calls an oil “supply crunch” by 2012.²³

¹⁸ National Energy Board, Short-term Canadian Natural Gas Deliverability 2007-2009, October 2007, NEB, Calgary. <http://www.neb.gc.ca/clf-nsi/rnrgynfmrtn/nrgyrprt/ntrlgs/ntrlgsgdlvrbly20072009/ntrlgsgdlvrbly20072009-eng.html>

¹⁹ Transfer pricing refers to the practice of charging inflated prices for the exchange of goods and services between different departments or operating divisions within the same organisation.

²⁰ Pedro Van Meurs, Comparative Analysis of Fiscal Terms of Alberta Oil Sands and International Heavy and Conventional Oils, 2007 Alberta Energy Technical Paper. http://www.energy.gov.ab.ca/Org/pdfs/RifInternationalHeavyOil_19.pdf

²¹ Rubin, Jeff, CIBC World Markets, 100 Oil, StrategEcon, July 18, 2007. http://research.cibcwm.com/economic_public/download/sjul07.pdf

²² David Strahan and Andrew Murray-Watson, Oil industry ‘sleepwalking into crisis’ Former Shell chairman says that diminishing resources could push price of crude to \$150 a barrel Independent News and Media Limited, United Kingdom, 2007. <http://news.independent.co.uk/business/news/article2966842.ece>

²³ Ibid.

“CNRL CEO told the Panel, ‘It’s a myth out there that this is a hugely profitable business.’ At the same time, the company announced record profits, telling investors to expect a ‘wall of cash flow’ that will be ‘sustainable for decades.’”

With oil prices so high, corporate operating profits, led by the oil and gas sector, have regularly been reaching record levels. For example, in 2006, Imperial Oil announced record earnings of more than \$3 billion and their share value has been skyrocketing, as seen in Figure 4. CNRL also announced record profits. Ironically, CNRL CEO Steve Laut told the Review Panel, “It’s a myth out there that this is a hugely profitable business”.²⁴ But Laut routinely presents a different picture to investors, telling them his company’s Horizon project will produce a “wall of cash flow” that will be “sustainable for decades”.²⁵ Last year, Mr. Laut took home \$11.5 million and, a few weeks before his presentation to the review Panel, Mr. Laut’s company reported a quadrupling of quarterly profits.²⁶

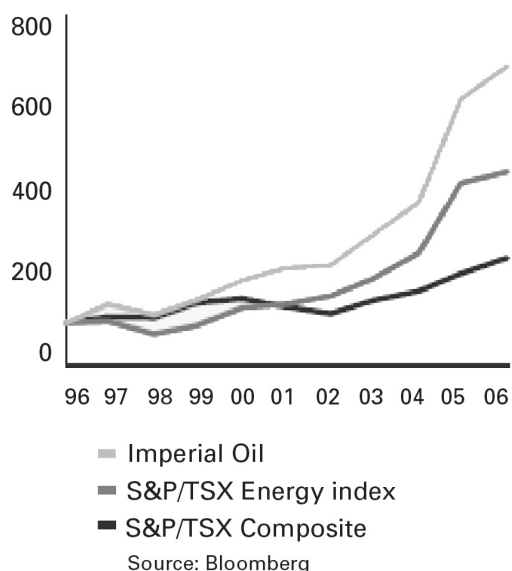
And this will only get better. With global oil harder to find, more expensive and located in high risk jurisdictions, there is room for a much larger increase in royalties than is being proposed.

FIGURE 4

Sustained increase in shareholder value

10-year cumulative total returns

Value of \$100 invested on December 31, 1996



Source: Imperial Oil Annual report 2006

²⁴ David Ebner, Hands off, oil patch tells royalty Panel, *Globe and Mail* (Toronto), 23 May 2007, pp. B1ff.

²⁵ David Ebner, As Big Oil pumps out profit, Alberta’s take is shrinking: Is it time to up the ante? *Globe and Mail* (Toronto), 18 August 2007, pp. B5-6.

²⁶ Lisa Schmidt, Oilpatch execs collect wide-ranging pay packs, *Calgary Herald*, 30 March 2007, p. D4; Shaun Polczer, Canadian Natural notches four-fold jump in profits, *Calgary Herald*, 4 May 2007, p. E4.

III. Recommendations within the Report that Fall Short

“...a mechanism serves to create an unfair playing field for other sectors in Alberta, placing them at a disadvantage in attracting investment dollars.”

1% royalty holiday for the tarsands

One of the most flawed recommendations in the Panel's report is that no changes be made to the practice of charging only the base royalty rate of 1 % of gross revenues until a project's capital expenses have been paid off. Although this policy may have made sense 20 years ago when there was little to no industry interest in the oil sands and the price of oil was low, there is no reason for it when oil is at \$80 per barrel and international corporations are lining up to buy oil sands leases.

The royalty holiday is an economic instrument, introduced to attract investment to a sector that was not attractive at the time (costs were high and oil prices were low). The instrument was effective at the time as evidenced by the high level of investment. However, it is very difficult to justify a special incentive for the sector at this point. Such a mechanism serves to create an unfair playing field for other sectors in Alberta, placing them at a disadvantage in attracting investment dollars. This incentive acts as a de-diversification mechanism, attracting investment to the tar sands, and further increasing the province's reliance on that sector over other industries. It is also hard to justify providing an incentive to the sector making the largest profits in the province. Finally, with the overheated economy in Alberta, there is an excellent rationale for slowing down the pace of new development of the tarsands. In this context, an incentive to attract new investment does not serve any public interest, and is in fact counter to it.

It is thus Parkland's recommendation that the royalty holiday until capital costs have been recovered is no longer necessary to stimulate investment in the tarsands and should be eliminated. The net revenue royalty should apply from the start of a project.

Net royalty rate increase

The Panel's recommendation to increase the tarsands post payout royalty rate from the existing 25% to 33% is a step in the right direction, but still grossly inadequate. Although this move would increase Alberta's total share (royalties and taxes) of tarsands revenues, it would still leave the province firmly entrenched in the bottom half of jurisdictions around the world in terms of rent collection.

With countries like Norway and Venezuela obtaining 78% and 90% respectively, Alberta can afford to be much bolder. And contrary to industry threats of late, these countries are experiencing no shortage of oil companies wanting to invest in their resources. Other nations are capturing a much higher percentage of the energy revenues. For example, in Bolivia 82% of all revenues from natural gas go to the government; in Kazakhstan 80% of oil extracted goes to the government in a production sharing agreement; in Abu Dhabi and the United Arab Emirates, the profit margin for companies is limited to \$1 per barrel; and in Russia the government takes 90% of the value of sales above \$25/barrel.²⁷

In light of the 1% royalty holiday period until costs are recovered, the 33% is even less meaningful. Auditor General Fred Dunn has criticized the Alberta government for not having adequate policies for regulating royalties collection. At the same time, the Panel notes that there are not clear policies on allowable costs for the purposes of determining when the higher royalty rate would kick in. Thus, there is a risk of projects continually expanding to avoid moving beyond the 1% rate.

The Panel's recommendations bring revenue capture to only between 49% (conventional oil) and 64% for tar sands. The total revenue capture rate should be at least 90%. Aside from full public ownership, the best mechanism for maximizing rent capture is to make corporations compete by bidding on a royalty rate for each project. This would be in addition to the current practice of holding auctions on land leases. It is this type of structure that Parkland has recommended in previous reports and recommends the Alberta government implement immediately.²⁸

Incremental royalty - windfall price capture

Other jurisdictions recognize that increased oil prices are not the result of anything the industry has done to add value, but rather a reflection of the increased value of the resource itself. As such, the lion's share of those increased prices should go to the owner of the resource. Russia charges 90% once the price is over \$25 US per barrel, Ecuador just introduced a 99% royalty for windfall profits, while Norway has a windfall profits tax that increases their take up to 90% once prices increase.

In this context, the Panel's recommendation for the tarsands of a 9% windfall profits tax on a sliding scale is far too low. Even the provincial government's own internal review of royalties in 2000 recommended

²⁷ J. Warnock, *Selling the Family Silver*, Parkland Institute, University of Alberta, Fall, 2006.

²⁸ See *Taming the Tempest: An Alternate Development Strategy for Alberta*, by Diana Gibson, Parkland Institute, University of Alberta, 2007.

that, "Caps on the oil royalty rates should be removed and (subject to further work by the Department) a higher marginal rate should be set for high oil prices."²⁹ It is also inappropriate to place a cap on royalty increases before those increases reach close to 100% of the rent.

The price capture recommended by the Panel is not steep enough and should not stop at 9%. With oil profitable at \$40 per barrel, the lion's share of the profits beyond that level should be captured for the owners. The rate should quickly hit the range of between 90 and 100% at higher price levels.

For conventional oil and gas there is no windfall profits tax, though the royalties are based on a formula that is price sensitive. However, the Panel unnecessarily caps this at a 50% royalty for a Cdn \$120 price for oil and \$17.50/MMBtu for gas. As seen with the current royalties structure, it is difficult to predict where prices will go and necessary thus to ensure that the regime will not be outdated simply because it did not predict a higher price scenario. The government's own review recommended removing the caps completely. They are unnecessary as once prices reach those levels, extraordinary profits will likely be earned, and thus, a much higher royalty rate will be warranted.

Coal Bed Methane - Cuts for low producing gas wells

The Panel included a recommendation for reduction in royalties on low producing wells to specifically target Coal Bed Methane gas production which tends to be in shallower, low producing and higher cost wells than conventional gas. The Panel claimed that environmental concerns were outside their auspices, yet made a recommendation to directly stimulate CBM development. This is a hugely controversial area for Albertans as Coal Bed Methane wells have a much greater landscape impact than conventional gas and have significant negative implications for water.³⁰ The decision to stimulate such investment cannot be made in a vacuum and is fundamentally an environmental one, one on which Albertans are entitled to have an informed debate. This recommendation should not be implemented until the environmental costs have been given adequate consideration.

²⁹ Fred Dunn, op cit.

³⁰ Griffiths, Mary, Unconventional Gas: The environmental challenges of coalbed methane development in Alberta. Pembina Institute, Calgary, 2003.

Value Added

The report recommends a royalty credit be given to companies that build upgraders in Alberta. Though the Panel makes significant steps in recognizing the need for value added processing of the bitumen in Alberta to be encouraged, the recommendation is problematic, because it means an estimated loss of \$3.2 billion in royalties over five years,³¹ and because it does not provide any guarantees that the capacity will be built in Alberta versus the United States.

This is a risky approach given that a number of American corporations have already begun to invest in retrofitting facilities to handle bitumen. Where the capacity is created in the US, Alberta's industry will have to compete with those American upgraders for access to the bitumen on the open market. Additionally, many of the companies involved in the tarsands are American companies with upgrading and even refining capacity in the States. These companies may choose not to proceed with an Alberta based upgrader if they can use one of their own regardless of the royalty incentive.

The regulatory approach would be much more certain. This would involve simply setting a policy that the bitumen must be processed in Alberta (a phased policy that allows for Alberta's upgraders to come on-stream). This type of regulation has been very effective in the past. Under premier Lougheed, Alberta had a policy that ethane could not leave the province in natural gas exports. This policy played a significant role in building a world class petrochemicals industry in the province.

A fair share is not the same as maximizing value for the owners.

A large part of the reason this report falls so short is that it still does not take the perspective of Albertans as being the owners. The job of government is not to consider with industry what a fair share for the people of Alberta would be, but to ensure that Albertans get the maximum value for the natural resources we are selling. It is the job of government to determine what the minimum return on investment is for Alberta's oil and gas to maintain the level of investment that is in the public interest. The balance should all go to Albertans.

It is illustrative to use the metaphor of oil being a home owned by an Albertan named Henry. Henry hires a contractor to renovate his bathroom. He pays that contractor for costs plus a profit (the market rate) - enough of a profit that the contractor is willing to do the job, but the minimum necessary to ensure the job gets done well. That contractor does not suddenly become entitled to the increased value

31 Alberta Department of Energy, as quoted by the Royalty Review Panel in *Our Fair Share*, p. 17, note 4.

of the house due to the renovations and market increases. Henry is not suddenly in the position of having to justify a fair share of the house's sale revenues for himself. He owns the house and gets all of the proceeds. The contractor has already been paid adequately for his services.

Alberta's oil is owned by Albertans. The oil and gas industry is providing us a service by extracting and processing the oil and gas. This is a service for which they should be paid at whatever the rate is that is necessary to ensure that it is done adequately. The revenues from an increased market value for oil or gas should go in whole to the owners - Albertans.

IV. Conclusions and Recommendations

Conclusions

This report clearly shows that the Panel's report falls short of where it should. It is a compromise between the public interest and those of the oil and gas sector. An oil or gas executive does not earn a multi-million dollar paycheck by asking for a fair return. His shareholders expect him to maximize the return on investment. Should Albertans ask less from our political stewards?

The Panel's goal of ensuring that Alberta remained one of the lowest tax and royalty jurisdictions in the world was fundamentally flawed. Alberta can compete with the countries in the top for revenue capture on the basis of political stability, security of transportation infrastructure (pipelines), proximity to a guaranteed market, and exploration costs. Given these advantages, Alberta would still be able to attract investment even while being in the highest range for royalties.

The Panel is silent on key issues such as aboriginal rights, the environment and the pace of development. These are issues that are fundamentally impacted by royalty levels and need to be addressed within any new royalty framework. These issues are complex and involved, requiring an in depth analysis that is beyond the scope of this report. Unresolved land claims, access and development issues and dissatisfactory revenue sharing arrangements are all important outstanding aboriginal issues. These gaps are major oversights and need to be addressed.

Recommendations

Public Ownership - The single most effective mechanism for ensuring Albertans receive the best return on their natural resources is through public ownership. This also addresses the significant problems that exist currently regarding lack of accountability and transparency. It is also the most effective mechanism for ensuring that oil and gas interests do not wield undue influence on government policy. It is recommended that as part of this royalty review, the Alberta government implement a plan to regain public ownership in this sector.

NAFTA does not preclude such a measure as long as appropriate compensation is paid. With an appropriate increase in royalties, the Alberta government could easily afford such an initiative. Additionally, since public ownership would maximize royalties, the additional revenues that would be earned would help to cover the costs of the change.

1% royalty rate - The royalty holiday until capital costs have been recovered is no longer necessary to stimulate investment in the tarsands and should be eliminated.

The net royalty increase to 33% - This rate is far too low by international standards. This only brings revenue capture to between 49% (conventional oil) and 64% for tar sands. The total revenue capture rate should be at least 90%. The province should set the floor at 90% and use the market to ensure maximum royalties are received. This would entail using an open bidding process for access to production rights based on royalty payments.

Windfall Profits Tax - the marginal royalty rate should increase much more steeply as prices increase and should reach close to 100% at higher prices. The caps should be removed for conventional oil and gas.

Coal Bed Methane - Coal Bed Methane wells should not be given a royalty reduction as an incentive for development until the environmental costs have been given adequate consideration and adequate, informed public debate has been held.

Value Added - The royalty credit for upgrading capacity should be eliminated and replaced with a regulation that prevents the bitumen from leaving the province until it has been upgraded. This measure may necessitate a slow down in development until the upgrading comes on line. However, such a slow down is much preferable to allowing the capacity to be developed in the United States in the interim. NAFTA provisions and market competition would then make it difficult to limit that capacity to Alberta.

Accountability and Transparency - The Panel and the Auditor General's recommendations on independent auditing and accountability for royalties payments will need to be implemented in full. The current practices are grossly inadequate for a royalty structure that allows cost deductions. Clear definitions of allowable costs will be necessary and regulation and enforcement of those through independent audits will be required.

Grandfathering - The Parkland Institute agrees strongly with the Panel in recommending that there be no grandfathering of existing operations. These same corporations do not demand grandfathering when taxes are reduced or royalties have been cut. Those precedents exist for changing the terms for existing operations based on government policy reform. It would be inconsistent to grandfather the increases. It would also create a complex and unfair playing field that favoured some firms over others.

A Savings and Investment Framework - Finally, it is recommended that the government immediately implement a review of the use of revenues from royalties. With savings low, little investment in renewable energies and no security for social spending in the long term, it is imperative that a framework for spending and saving be developed. To this end, Parkland has made a series of recommendations in previous reports that should help to structure that framework.³² These recommendations include priorities on savings, investing in renewable energy and securing a long term future for the province's economy beyond fossil fuels.

³² Taming the Tempest op cit.



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