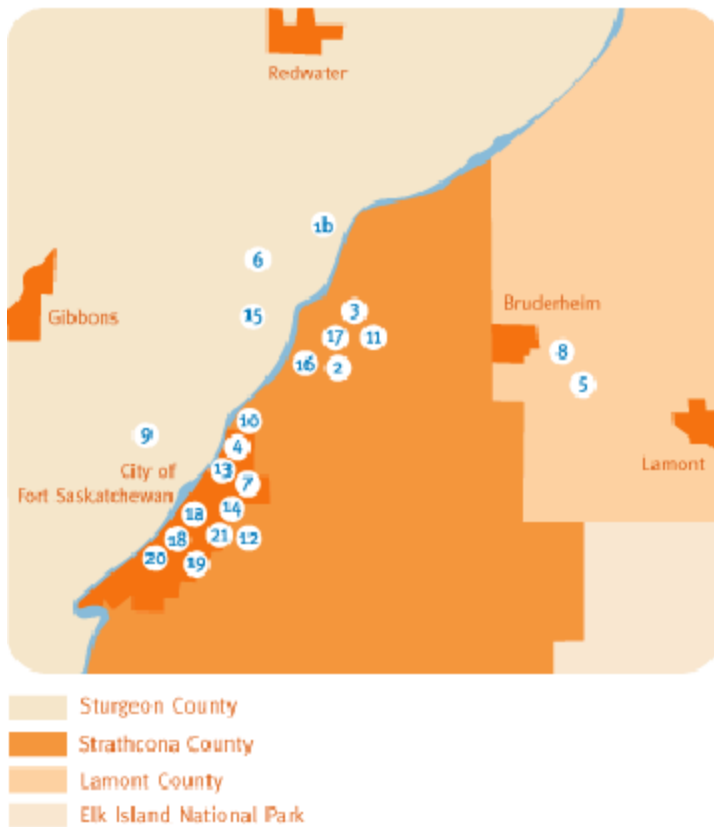




Northeast Capital Industrial Association

Submission to the Alberta Royalty Review Panel



Submission of

NCIA Members

- 1a Agrium Fort Saskatchewan
- 1b Agrium Redwater
- 2 Air Liquide Canada Inc.
- 3 BA Energy Inc.
- 4 BP Canada Energy Company
- 5 Canexus
- 6 Degussa Canada Inc.
- 7 Dow Chemicals Canada Inc.
- 8 ERCO Worldwide
- 9 Guardian Chemicals
- 10 Keyera Energy
- 11 KinderMorgan (Terasen) Heartland Terminal
- 12 Marsulex Inc.
- 13 MEGlobal Canada Inc.
- 14 Praxair Canada Inc.
- 15 Provident Energy Inc.
- 16 Shell Canada
- 17 Shell Chemicals Canada Ltd.
- 18 Sherritt International Corp.
- 19 Sulzer Metco (Canada) Inc.
- 20 The Westaim Corporation and Nucryst Pharmaceuticals Corporation
- 21 Umicore
- * North West Upgrading Inc.
- * Petro-Canada Oil Sands Inc.
- * Synenco Energy
- * Total
- * Enbridge Pipelines Inc.
- * Gulf Chemicals & Metallurgical Corporation
- * Hazco Environmental Services
- * Project Approvals pending

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Summary

Oil sands are attractive because of the large scale of the resource. On the other hand, they are very difficult to recover and costly to upgrade compared with light, conventional crude oils. As such, Canadian oil sands are among the world's marginal barrels – so how have Albertans and the Canadian government reaped such high rewards from such a marginal resource?

Oil sands royalties and corporate income tax terms were reformed in 1996 to a standard framework that is close to a percentage share of economic rent.* This structure is ideally suited to the characteristics of the oil sands industry with its high up-front capital, high operating costs and uncertainty over costs and prices. The structure was designed to encourage the growth of economic rent while directing a generous share to governments through taxes and royalties. The fundamental elements of the fiscal framework are the “R-C” (revenue minus costs) formula for Alberta royalties and the “ACCA” (accelerated capital cost) provision in corporate income tax. Every departure from this structure will serve to reduce the incentives for economic efficiency and maximizing economic rent.

The other important feature of the oil sands fiscal framework is that the terms are stable and predictable. Oil sands investments are large, long-term investments. Investment over time in R&D, followed by capital improvements are needed to keep these high cost barrels economic.

Since 1996 the industry has seen significant growth take place and a number of proposed projects are under consideration. Much of the proposed upgrading capacity is proposed for Alberta's Industrial Heartland – the location of the member industries of the Northeast Capital Industrial Association (“the NCIA”). The NCIA industries are engaged in a variety of value-added processing, most of which is based upon hydrocarbon feedstocks that will increasingly be derived from the oil sands as Alberta conventional resources decline.

Even now, as the industry faces higher costs fuelled by world demand for construction materials and services, growth is threatened on a number of fronts through proposals that depart from the economic rent formula, increase taxes, or both. Specifically, the NCIA members are concerned about the following:

- Oil sands being singled out for phase-out of the ACCA mining tax provision as tabled in the federal budget in March.
- The prospect that outcomes from the oil sands royalty review could further undermine confidence in fiscal stability and depart from the R-C foundation.
- Suggestions in the Minister's Report on Municipal Sustainability and the recent Hemson report commissioned by the city of Edmonton proposing increased taxes upon industry that would be distributed to regional municipalities. This would be

* Economic rent is the revenue that remains from a project after recovery of all costs including an allowance for the cost of capital.

tantamount to increasing the machinery and equipment (M&E) tax. The industry was successful in having the education portion of the M&E tax removed because it is detrimental to economic efficiency.

- The prospect that climate change provisions could make Canadian-based industries less competitive with other locations not faced with similar charges.

NCIA members are concerned that while most stakeholders support the idea of greater value-added processing of Canadian resources – particularly oil sands - actions underway or under consideration will succeed in precisely the opposite result and drive upgrading out of the country along with related industries such as petrochemicals.

NCIA members recommend that rather than eroding the fiscal system, governments at all levels need to be concerned with attracting and retaining these large investments with a focus on having an efficient overall fiscal structure that encourages upgrading and further value-addition of Alberta resources.

Why Taxes and Royalties Affect Our Businesses

The fiscal structure within which each of our member companies operates is fundamentally important to capital investment decision-making. In all cases local industries face choices within their companies of investing or not investing – in many cases competing for capital among world-wide investment opportunities.

In the case of oil sands firms, the royalty structure and resource taxation have a direct affect on total investment. Non-resource firms are impacted by the tax structure and indirectly by the prospects for oil sands because of the potential opportunities for feedstock availability, intermediate product and by-product exchange with oil sands operations and infrastructure synergies.

The NCIA Members

The NCIA members consist of 26 companies with industrial operations existing or proposed in Alberta's Industrial Heartland (AIH) in Fort Saskatchewan, Strathcona County, Sturgeon County and Lamont County. Member companies are engaged in a wide range of petroleum and petrochemical processing operations, fertilizer production and metal refining.

While some 150 km distant, petrochemical operations in Joffre are connected to the Heartland for feedstock and product storage and pipeline transportation.

Oil sands processing has been an important economic driver in the area since the start-up of the Scotford Refinery in 1984 and now dominates the future prospects of the region in terms of direct investments and feedstock availability.

Even now, the NCIA member industries are a huge economic driver in Alberta. For 2006, NCIA industries employed over 3000 people directly with many additional permanent contractor employees providing maintenance and further numbers engaged in maintenance turnarounds and other contract services. The industries contributed \$38

million in property taxes to the four Heartland municipalities. Excluding feedstock & utilities costs, over \$400 million was expended in the region for purchased goods and services.

NCIA Mission and Role

The Northeast Capital Industrial Association (NCIA) is a not-for-profit cooperative that seeks to understand and reduce the environmental impacts of member industries through collaborative efforts with the community and all levels of government while supporting sustainable industrial growth. Our objectives are:

- To understand individual and member cumulative environmental impacts;
- To engage the community in the understanding of - and response to - regional environment, health and safety matters;
- To work with government at all levels respecting environment, health and safety matters that are of mutual member interest in the development of policies, regulations and legislation; and
- To work cooperatively with the regional school districts in matters involving science awareness education.

To carry out our mission NCIA provides funding and technical support to a number of regional initiatives:

The **Fort Air Partnership** operates the regional air monitoring network on behalf of its member companies and the public in the region. NCIA provides the majority of funding with support from Alberta Environment and special program funding from Parks Canada & Environment Canada. The region therefore has one of the best data bases in the country on regional air quality.

The **Regional Groundwater Study** is a cooperative program between NCIA and Alberta Environment to understand and protect local groundwater resources.

NCIA has also been proactive with its member companies in local **noise management** initiatives.

NCIA champions regional partnerships that provide innovative learning experiences that enhance students' skills and provides career opportunities in the sciences, technologies and trades so our industries and schools are globally competitive. This commitment is delivered to regional schools through the annual Young Scientists Conference and the *Partners for Science Program*.

Value Addition to Alberta Resources

The industries in Alberta's Industrial Heartland constitute the largest petroleum processing and petrochemical production centre in Canada. While still small by international standards, the AIH Association's goal is to leverage the growth of oil sands processing to make the AIH one of the world's premier petrochemical centres - and to

accomplish this growth in the context of world-leading land-use planning and environmental protection.

The economic activity generated by AIH industries has contributed substantially to economic prosperity and government surpluses in Alberta and Canada as a whole as well as constituting a significant proportion of Canada's international trade surplus. The AIH is central to Alberta's strategy to see greater value-added to exports of resource products.

Unlike agriculture, auto-assembly and commercial aircraft manufacture, which are internationally challenged with foreign subsidies, oil sands is one of the few export-oriented industries in Canada that has grown without subsidies or plant-location grants.

The Oil Sands Royalty & Tax Structure

The current oil sands fiscal regime was established in 1996 through legislation by the governments of Alberta and Canada following recommendations of the National Task Force on Oil Sands Strategies. It is important to remember that in developing the recommendations, the task force examined all proposed tax and royalty mechanisms against two criteria.

- The effect on investment decisions on the part of the industry developer* in relation to the fiscal impact on governments was evaluated for each tax and royalty change considered.
- Distortion of economic decision-making was evaluated by comparing social rates of return (i.e., intrinsic project returns without the effects of taxes and royalties) with after tax and royalty returns.

The recommended adjustments to the tax and royalty structure were based on the measures that:

1. Are most tax efficient (i.e., allowing the greatest value to governments in relation to the incentive to invest).
2. Minimize distortion in economic decision-making - comparing project returns before and after tax/royalty.

An overriding guideline was that the structure had to work over a wide range of economic conditions so that it would be stable – it would not require adjustment during high or low price cycles.

In the main, the two governments adopted the recommended revisions with legislation and budget measures in early 1996.

In summary, the following general conclusions can be drawn:

* Companies employ a variety of economic analysis tools to evaluate project returns. Among them: Project Internal Rate of Return (IRR), Net Present Value comparisons (NPV), and Discounted Profit to Investment Ratio (DPIR). The positive effects upon these measures were compared against the fiscal "cost" to governments at the government long-term cost of capital. In this way, the most tax-efficient structural changes could be recommended.

Measures that Promote Investment and Economic Efficiency	Measures that Impede Investment and Economic Efficiency
R-C (treating capital and operating costs the same) ACCA	Low rates of capital write down Delayed write off of capital
Allowance for the cost of capital (Indexed to a single published rate. Alberta uses the Canada 20-year bond rate)	No recognition of the cost of capital
	Gross production royalty or tax
	Capital taxes (e.g., On land, capital, M&E, etc.)

Lower rates of tax/royalty also promote investment but at a greater cost to governments. Governments receive large fiscal gains from investments encouraged by R-C and ACCA through the sharing of profits from taxes and royalties. Unlike lower rates of taxation, **the investment benefits of ACCA and R-C are only achieved where the capital is reinvested in Canada.**

The results of this analysis and the recommendations were also consistent with independent published academic analysis on the subject.*

The Alberta royalty component of the fiscal structure adopted in 1996 consists of:

- 25% royalty on revenue minus costs (R-C)
- 1% minimum royalty payable
- Costs carried forward (i.e., negative R-C) at the Canada 20-year bond rate

The tax revisions made to the pre-existing mining tax ACCA (Class 41B - available for all new mines and 25% expansions of existing mines in Canada) were to:

- Provide the same treatment to *in situ* recovery projects as is afforded to surface mining projects; and to
- Provide ACCA to yearly capital expenditures for a mine that exceed 5% of the gross revenue of the mine. This provision was provided to all mining in Canada.

The federal budget tabled in March 2007 proposes to **remove the ACCA for oil sands only and not the rest of mining in Canada.** This highly discriminatory action proposed without the consultation or analysis undertaken for the 1996 reforms undermines the

* For example see the ground-breaking paper:
Uncertainty, Risk Aversion and the Taxing of Natural Resource Projects
 Ross Garnaut, Anthony Clunies Ross
The Economic Journal, Vol. 85, No. 338 (Jun., 1975), pp. 272-287
 doi:10.2307/2230992

stability of the fiscal framework and is particularly damaging to investment in upgrading in Canada – investment that the Alberta government has been trying to promote.

The Structure Has Worked

Three factors determine the amount of revenue generated directly from oil sands operations through royalties and corporate income tax:

- Gross revenue (the amount of production and its unit value)
- The economic rent generated after all input costs
- The percentage of economic rent taken by governments through the tax and royalty system

The art in designing a fiscal regime for the oil sands is to ***structure*** the regime so that a substantial percentage can be taken by governments while maintaining the incentive for the industry to invest in capacity and improvements throughout the commodity pricing cycle. The resulting increases in production and productivity will generate increased tax and royalty payments.

A well-designed and stable regime that maintains a long-term focus by investors is of utmost importance to the oil sands because of the character of the resource:

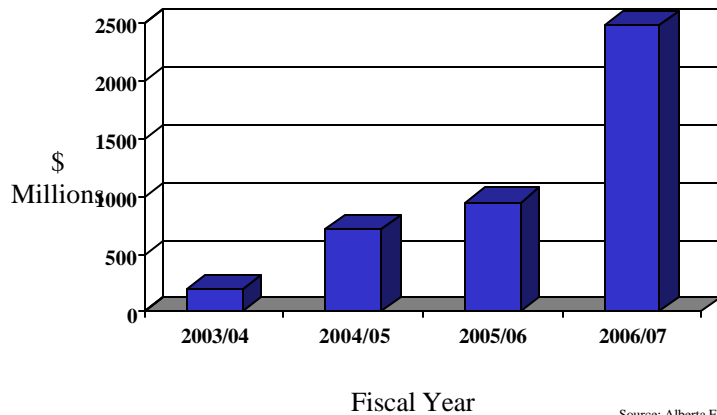
- As a marginal, difficult to produce resource, improvements through R&D ***and its application through investment*** will be critical – particularly as developers move to more marginal quality deposits. Unlike deepwater or small isolated deposits of conventional oil, the technical challenges of the oil sands are unique to Alberta. Therefore, the R&D and investment in innovation will only occur if there are incentives to invest in Alberta’s oil sands. The world won’t research oil sands solutions. A stable regime with strong incentives for economic improvement provides a constancy of purpose for the R&D in process technology and environmental management without the need for *ad hoc* grants and special royalty provisions that were employed in the 1980s to keep the industry progressing.
- The initial capital commitments are large, the operating costs are significant and the returns are unpredictable given price volatility. This means that regimes that are based upon attractive exploration terms followed by gross production share or royalties revised in response to price variation will not function for the oil sands.
- The structure is self correcting to conditions. Short-term price escalations drive completed projects to payout sooner. Hence, they reach a royalty and tax-paying position more quickly.

The regime as structured in 1996 has been an important factor in promoting what is by any measure a huge influx of investment into the oil sands. Production has been expanded by projects that proceeded through difficult price cycles in the late 90s. Oil sands royalty payments to Alberta are now rising as shown at right.

Interest in oil sands investment has occurred in spite of the fact that oil sands remain among the world's high-cost marginal barrels. Unlike other marginal resources (deep-ocean, smaller remote conventional) that are

primarily costly due to high up-front one-time costs, the character of the oil sands requires relentless pursuit of technical improvement and reinvestment to overcome the inherently difficult recovery of the heavy, viscous oil in severe climactic conditions. Oil sands are also faced with additional costs or charges to deal with or offset CO₂ emissions.

Oil Sands Royalties



Source: Alberta Energy

Over Heating

The perception of an overheated oil sands sector straining resources should take into account a number of factors:

1. Much of the initial development ramp up was driven by three mine-upgrader projects - Shell's Athabasca Project and expansions at Suncor and Syncrude. In a sense, this was a release of pent up demand and a result of a convergence of factors:
 - Prior to 1996, Suncor and Syncrude had both had very regressive fiscal arrangements.
 - The production technology had improved – much of it developed and implemented through a temporary (1983-1988) R-C structure and R&D incentives granted to Syncrude in the aftermath of the demise of the Alsands and Cold Lake mega-projects.
 - While Shell had a long-standing goal to develop an oil sands business, the Alsands Project was held in abeyance by Alberta in 1981 during the conflict over fiscal terms between the Alberta and federal governments. The Alsands Project never received its approvals. The assurance of a stable fiscal regime was needed before the Athabasca Oil Sands Project could proceed.

These factors, together with political instability in a number of other oil-producing regions caused a rush of involvement and project positioning in the oil sands.

2. Oil sands are not the only Alberta high growth sector – conventional oil and gas investment exceeded that of oil sands in 2006. (CAPP)
3. The demand for resources is not exclusively Alberta-based. There is a worldwide growth in energy projects. The emerging economies in Asia have placed a direct demand on resources but also fuelled the demand for energy.

Self-correction by market forces is likely the best way to achieve a sequencing of projects. Intervention by government to slow down the pace could well be ill timed, over-correct the market and induce a stagnation of development as occurred in the 1980s.

Future Investment and Development

The largest investments proposed for the AIH by NCIA members are the proposed bitumen upgraders and their expansions. However, there are numerous industrial linkages and synergies that can occur. Some of these have already been committed:

- A commercial hydrogen grid
- By-product hydrogen from ethylene production being used for hydroprocessing in an upgrader
- Recovery of LPG and olefins for petrochemical feedstocks

Other synergies are under active consideration for upgraders:

- Utilization of coke or asphaltenes to replace natural gas for thermal and electrical energy co-generation, hydrogen manufacture, and synthetic gas
- Interconnection of ammonia manufacture with NO_x & SO_x emissions control generating sulphate and nitrogen fertilizers

The industries will need incentives to meet future challenges of natural gas substitution and climate change.

Oil sands-based petrochemical feedstocks represent the future growth basis for current petrochemical operations.

As the investment base grows, so do the opportunities for local manufacture of equipment and other services for the projects that provide high-quality employment.

Bitumen Royalties versus Synthetic Crude

Syncrude and Suncor currently pay royalties on synthetic crude while all others pay on bitumen. If royalty is paid on synthetic crude oil, the upgrading capital and operating costs are deductible. Nevertheless, converting these operations to a bitumen royalty would represent a loss of Alberta revenue. However, it is hard to justify having firms that

invest in upgrading (as Alberta desires) pay greater royalties than those producing and exporting bitumen. Clearly, the province will need to develop the means to encourage upgrading versus exporting crude bitumen in the context of bitumen-based royalties. Investment in upgrading capacity and improved upgrading methods that reduce costs will result in increased bitumen values in Alberta. Having sufficient upgrading capacity will assure that bitumen receives its economic value.

Public-Interest Benefits from an Efficient Fiscal Structure

The benefits of an efficient fiscal structure based on removal of the bias against capital cost are so compelling it is remarkable that more attention has not been made of it*. In summary:

- Canada lags the G-8 in productivity growth (GDP/worker). ACCA would benefit any industry where internal efficiency and/or international competitiveness are important to the economy.
- ACCA is an inducement that is self-regulated by the profit motive. It requires no handouts or bureaucracy to administer and is only provided for reinvestment in Canada.
- By increasing their investments, companies will over time, generate more profits, pay more taxes and create more jobs.

Given these factors in relation to the industries of the NCIA as representative of capital-intensive industries in Canada, the following questions could be posed:

- Why not provide ACCA to the full chain of value-added processing including product refining & petrochemical production?
- Upgraders (smelter equivalent) and metal smelters associated with mines have always received ACCA. Why not provide ACCA to stand-alone upgraders and stand-alone metal refining?

The design of fiscal structure is of the utmost importance to Canada's economy – both for its internal efficiency and the productivity of the tradable goods sectors. Ideally, the federal and Alberta governments would work together, as occurred in the mid-1990s, so that the fiscal structure acts as an incentive to develop further value added processing in Canada. With the matter of ACCA application to oil sands having been raised through the federal budget, it is both timely and prudent for industry and the Alberta government to form a task group. This group would examine the current areas of application of ACCA for resource development, resource processing, manufacturing generally and transportation and would develop proposals for its application that are in the national public interest recognizing Canada's goal to be a leader in innovation and environmental responsibility.

* Although manufacturers and the transportation industry have periodically attempted to make the argument for faster write-off of capital costs.

Conclusions

1. The fiscal structure has worked well in encouraging investment in oil sands and has brought about the intended results.
2. Given Alberta's long-standing goal of preferring upgrading to bitumen export, any royalty and tax reforms Alberta undertakes should be consistent with encouraging upgrading.
3. Any changes that Alberta contemplates to encourage upgrading or to offset the negative impacts of the recent federal budget proposals should be consistent with encouraging oil sands investment and investment in economic efficiency.
4. The phaseout of ACCA proposed in the federal budget has reduced the incentives to invest in oil sands and in particular to invest in value-added upgrading. The proposal singles out oil sands – located only in Alberta and Saskatchewan. Other parts of mining in Canada (that benefited from the improved ACCA in 1996) remained untouched – as makes sense - recognizing the benefits to those industries and the regions where they are located.
5. The proposed ACCA change lacked the open consultation that was a hallmark in constructing the integrated tax-royalty fiscal structure introduced by the governments in 1996. It is not based upon a structuring of taxes to encourage the right investment behavior on the part of industry.

In light of this situation, we strongly encourage the Alberta Government to:

- Retain the ACCA for Alberta corporate income tax;
- Extend the application of ACCA to stand-alone merchant upgraders and metal processors;
- Consider extending the ACCA to further value-added processing;
- Consider simplifying and improving the measure by elimination of “available for use” rules;
- Join with industry in advocating retention of ACCA for federal corporate income tax and request that a study be undertaken to evaluate the benefits of broadening its application to all resource processing, manufacturing and transportation.