

**SUBMISSION TO
THE ALBERTA ROYALTY REVIEW PANEL**

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PART ONE

INTRODUCTION

SUMMARY CV

N.A. (Nick) Rost van Tonningen

- Number of years of policy-advisory experience:
 - 13 in the Department of Finance, Ottawa
 - 2 in Treasury Board, Ottawa;
 - 11 in Alberta Treasury, Edmonton;
 - 2 in the Finance Ministry, Nairobi, Kenya; and
 - 2 in the Ministry of Finance, Halifax.

PART TWO

OIL SANDS ROYALTY ISSUES

THREE KEY ISSUES

- » The owner's take.
- » Types & distribution of risk.
- » The appropriateness of the economic rent/risk distribution.

ISSUE No. 1 : THE OWNER'S TAKE (OF TOTAL OIL & GAS REVENUES)

- The Province has a 20-25% policy target range for its share of oil & gas revenue stream.
- By comparison :
 - Norway gets 70-78% (on a sliding scale inversely related to the price of oil), but is exposed to ownership risk;
 - The UK in 2005 doubled its special tax for oil companies, in effect raising their corporate tax rate to 50%;
 - Alaska has seen its take slide to 30% today from 40%, more or less, in the 90's, and a high of 60% in 1979 (& is now conducting a revenue policy review of its own).
- By its very design the 25% of net formula ensures the Province cannot ever achieve its revenue target from the oil sands.

ISSUE NO. 2 : RISK

- Two types of risk :
 - Market risk : the price of oil (which is beyond the control of both owner & operator); and
 - Operating risk : the cost of production (which is solely within the purview of the operator & beyond that of the owner).

ISSUE NO. 3 : ECONOMIC RENT/RISK DISTRIBUTION

- In conventional oil & gas the operator assumes 100% of the operating risk, and the Province & the operator share the market risk on a pari passu (equal footing) basis.
- In the existing oil sands royalty regime the Province shoulders the operating risk while the Province & the operator share the market risk on a disproportionate (25%/75%) basis.
- Thus the existing oil sands royalty regime shifted risk onto the owner & financial gain potential onto the operator.

ALBERTA OIL SANDS' RELATIVE GLOBAL APPEAL

According to the Alaska Institute for Social & Economic Research Alaska's fiscal regime was, from an industry perspective, the sixth most attractive in a free market environment.

The US Gulf of Mexico was the most attractive followed by the Alberta oil sands, Nigeria & the UK (with Norway being 11th).

Hence there is a move afoot in the US Congress to 'claw back' up to US\$15 billion annually from the 'excessively generous' royalty structure granted to Gulf of Mexico producers in the 1990's.

OIL SANDS ROYALTIES

- The problem lies not with the initial 1% royalty regime but with the 25% of net formula after the operator recovers his costs.
- For once all costs are recovered, the operator's investment in the project is zero; hence any net cash flow derived from it generates an infinite RoI on capital for the operator.
- A share of net arrangement lacks transparency, promotes inefficiency in both private & public sectors, and involves a downloading of exogenous risk onto the resource owner.
- 25% of **net** also is out of line with the traditional standard in Western Canada for farm land rentals which entitled the resource owner to one-third of the **gross**.

OIL SANDS OPERATING COSTS

- There are two benchmarks in the public domain :
 - In reporting its Fourth Quarter results, Suncor's CEO indicated operating costs had risen from \$21.50 to \$22.50 & estimated that for the year as a whole, due to maintenance costs & shutdowns, they would be \$25.78.
 - Last fall, when queried about the impact of skyrocketing construction costs for the latest expansion of its oilsands operation, the then Shell Canada's CEO told shareholders the project would be viable with oil at US\$30 (i.e. it covered all costs plus royalties & still generated an acceptable RoI).

OIL SANDS PROFITABILITY

- While the RoI on capital for a project in which the operator has zero capital invested may be infinite, it does nevertheless not constitute an altogether free ride. For generating cash flow still requires the 'rolling' use of working capital for operating costs.
- The following table seeks to approximate the return to Suncor on its working capital under various oil price assumptions and the existing operating cost- & royalty structure, furthermore assuming for simplicity's sake that US\$1.00 = C\$1.00.

ESTIMATED RETURN ON WORKING CAPITAL FOR SUNCOR IN ITS OIL SANDS OPERATIONS UNDER A 25% NET ROYALTY REGIME

Oil Price	Oper. Cost	Net	Prov. Share	Comp. Share	RoI on W/C
30	26	4	1.00	3.00	12%
40	26	14	3.50	10.50	40%
50	26	24	6.00	18.00	69%
60	26	34	8.50	25.50	98%

RISK/REWARD RATIOS FOR SUNCOR & ALBERTA UNDER THE EXISTING OILSANDS ROYALTY REGIME

- The primary risk for the operator is that of operating costs exceeding the price of oil; for this he is compensated by 75% of the 'economic rent'.
- The primary risk for the owner is that the operator allows his operating costs to get out of hand relative to the price of oil, for which he is compensated by 25% of the economic rent.
- So the operator gets a major share of the economic rent for taking a risk he **can** control, and the owner a minor share for a risk he **cannot** control (but the operator can).

IMPACT OF A SWITCH TO A GROSS REVENUE ROYALTY REGIME

- It shifts the operating risk back to where it belongs, i.e. the operator.
- The following table shows the impact of a 20% of gross royalty regime on the Province's take and Suncor's rate of return on the working capital employed in its oil sands operation.

ESTIMATED RETURN ON WORKING CAPITAL FOR SUNCOR IN ITS OIL SANDS OPERATIONS UNDER A 20% GROSS ROYALTY REGIME

Oil Price	Oper. Cost	Prov. Share	Comp. Share	RoI on W/C
30	26	6.00	24.00	-8%
40	26	8.00	32.00	12%
50	26	12.00	38.00	46%
60	26	15.00	45.00	73%

OIL SANDS ROYALTY AMENDMENT CONSIDERATIONS

- Rising commodity prices have invalidated royalty regimes worldwide and change is now the rule, rather than the exception. So, if Alberta decided to alter its oil sands royalty regime **retroactively**, it would be in good company.
- Alberta's bargaining position is enhanced by Washington's desire for getting more of oil from easily accessible, 'politically secure' sources. So it would likely be reluctant to accept a slowdown in oil sands' development because of a corporate unwillingness to accept a royalty regime that, while less favourable than before, would still be highly remunerative.
- The "it's inappropriate to break a contract" argument was invalidated by the oil companies themselves every time in the past 25 years they sought royalty relief.

CONCLUSION

- The oil sands royalty regime as presently constituted :
 - is fundamentally flawed, because it :
 - prevents the Province from ever achieving its target of a 20-25% share of the revenue stream;
 - saddles the Province with an operating risk that is within the purview of the operator, not the Province, to manage.
 - doesn't reward the resource owner adequately for the diminution of its asset base & its exposure to risk; and
 - is generous enough to permit the resource owner to recapture more of the economic rent & yet allow the operator to earn significantly above market rates of return

APPENDIX 1

KEY CONSTRAINTS ON OIL SANDS DEVELOPMENT

CONSTRAINT NO. 1 - WATER

- Existing technologies are water-intensive & any surface water used is, for all intents & purposes, forever lost from the hydrological cycle.
- Despite the progress made in reducing the water intensity of the current technologies, water will continue to be, and increasingly become more of, a serious constraint on oilsands development.
- Hence there is a need for pro-actively promoting the development of alternate, less water-intensive technologies.

CONSTRAINT NO. 2 – FUEL/ENERGY

- Reducing the imported fuel intensity of oil sands production is as urgent as reducing its water intensity.
- Nuclear power has been suggested as a “clean” energy source. But the disposal of used nuclear fuel is still problematic & its cost seldom, if ever, adequately priced (the UK estimates it will cost US\$100+BN to decommission its 20-odd plants).
- If nuclear power were to be the solution to the oil sands fuel needs, disposal might best be dealt with by generating the electricity at the mine head. For then the nuclear waste could be recycled to its place of origin, the mine. And while transporting radio-active material entails risk & the technology for nuclear waste disposal is still dodgy, that for long-distance power transmission involves known technology & little risk.

APPENDIX 2

IN SITU COMBUSTION

- Petrobank Energy & Resources Ltd. currently has a pilot “fire flood recovery” program underway that burns some of the oil in place in order to liquify the remainder sufficiently to permit it to be recovered by traditional means.
- This technology, if proven out, may help ease the constraints limiting oil sands development by minimizing water usage, eliminating the need for ‘importing’ fuel, reducing emission gases and leaving less of a surface ‘footprint’.
- Petrobank’s CEO also claims twice the bitumen recovery rate and half the capital & operating costs of the Current industry standard, SAGD.
- As such it may well be an alternate methodology for recovering oil from deep deposits worth monitoring (& encouraging).