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Commerce**
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Submission to the Alberta Royalty Review Panel

May 22, 2007





I. Introduction

The Calgary Chamber of Commerce represents over 3,200 Calgary based businesses. The Chamber seeks to raise the consciousness and quality of public discourse on key policy issues confronting its members and stakeholders, through informed discussion grounded in fact and reasoned analysis.

Alberta's oil and gas sector represents a fundamental component of the broader provincial economy. It is estimated that 42% of provincial GDP is derived from the oil and gas sector, but only approximately 15% (\$23 billion) is the result of direct mining and oil and gas activity.¹ The remainder of this contribution is attributable to downstream economic activity resulting from the oil and gas sector – both indirectly (through increased demand for geological, drilling, accounting and technological services) and through induced activity (such as increased consumption and investment associated with higher incomes and profits).

The Calgary Chamber puts forth this submission on behalf of more than 3,200 Chamber members that are tied directly or indirectly to the Alberta oil and gas sector. This submission is structured as a response to the following seven *Terms of Reference* discussion questions posted on the Royalty Review Panel's website².

1. How does Alberta's royalty system compare to other oil and gas producing jurisdictions, taking into account investment economics, industry returns and risks in Alberta?
2. Is Alberta's royalty system sufficiently sensitive to market conditions?
3. Is the current revenue minus cost system for oil sands royalties optimal?
4. Which built in royalty programs should be retained, adapted or eliminated?
5. How does the tax treatment of the oil and gas sector compare to other sectors and jurisdictions?
6. What are the economic and fiscal impacts of any possible changes to the royalty and corporate tax systems?
7. How should existing resource developments be treated if changes are made to the fiscal regime?

¹ For a discussion of the contribution of the oil and gas sector to the provincial economy, see Mansell, Robert and Schlenker, Ron (2006). *Energy and the Alberta Economy: Past and Future Impacts and Implications*. Institute for Sustainable Energy, Environment and Economy. Available at: <http://www.iseee.ca/whatsnew/reports/reports.shtml>

² See the Alberta Royalty Review Website at: www.albertaroyaltyreview.ca/panel/terms_reference.html



II. Discussion

1. How does Alberta's royalty system compare to other oil and gas producing jurisdictions, taking into account investment economics, industry returns and risks in Alberta?

Context

The Alberta oil and gas industry is increasingly oil sands dependent. Oil sands represent the vast majority of Alberta's proven reserves, while conventional oil and gas reserves are diminishing, with new wells becoming less productive and exploration and development costs among the highest in the world.

Alberta Established Fossil Fuel Reserves 2005	
Conventional	1.6 Billion Barrels
Oil Sands	173.7 Billion Barrels
Natural Gas	41 Trillion cubic feet

Source: Alberta Energy and Utilities Board

Other Jurisdictions

In a comparison of the international competitiveness of oil project fiscal regimes, Canada ranked 79th out of 324 regimes.³ Canada was comparable to projects in jurisdictions such as the US Gulf Coast, Alaska and Australia, but was less competitive than places like Brazil and the UK. This is a reasonable ranking, as the cost and investment structure of Alberta oil sands developments are deemed to be comparable to those of the US Gulf Coast and Australia.

The Investment Climate

While oil prices have been increasing substantially, so too have capital and operating costs. Increased domestic and international demand for steel, labour, construction and engineering services have driven up capital costs for oil sands projects (arguably, in proportion to oil prices) and higher natural gas, chemical, fuel and labour prices have increased operating costs. In 2006, the National Energy Board estimated that supply costs (operating and capital) per barrel of synthetic crude increased to US \$35– up from \$18-\$22 two years earlier. More recently, a 2007 CIBC study found that in order for investors to receive an 11% rate of return on oil sands projects, prices must be at least \$50 per barrel.⁴

³ World Fiscal Systems Report, as cited in Canadian Association of Petroleum Producers (CAPP). 2007. *Benefits to Alberta and Canada, Today and Tomorrow, Through a Fair, Stable and Competitive Fiscal Regime*. p. 31. Available at: <http://www.capp.ca/raw.asp?x=1&e=PDF&dt=NTV&dn=121342>

⁴ For a discussion of industry costs, see CAPP pp 12-17.



The Government Taxation and Regulatory Climate

Recent environmental and tax policy changes implemented by the federal and provincial governments have created a climate of uncertainty and instability in the industry:

- In April 2007, the minority federal government announced a new *Regulatory Framework for Industrial Air Emissions*, which proposes an 18% emission intensity reduction in greenhouse gases for existing facilities by 2010, and a 20% reduction in total emissions by 2020.
- In its 2007 budget, the federal government announced the phasing out the Accelerated Capital Cost Allowance (ACCA) for oil sands projects, which allowed for 100% of oil sands construction/ equipment expenditures to be used against the amount of tax it has to pay on income from the project.
- The Alberta government recently adopted regulatory changes to its *Climate Change and Emissions Management Act*, which call for a 12% emission intensity reduction below 2003-05 average levels for facilities emitting more than 100,000 tonnes of carbon dioxide annually, beginning in July 2007.
- The Alberta government recently eliminated the *Alberta Royalty Tax Credit*, which was a royalty rebate program designed to encourage oil and gas exploration in the province, and was of particular benefit to small oil and gas companies, injecting approximately \$100 million per year in the upstream oil and gas sector.

These changes continue to have a significant effect on Alberta's oil and gas sector, the full impact of which will not be realized until sufficient time elapses for the industry to absorb the economic impacts of these system shocks. The risk to continued investment and investor confidence is significant.

Summary

The Canadian oil and gas fiscal regime is internationally competitive relative to jurisdictions with similar cost structures and governance models. However, increased industry operating and capital costs, combined with recent (and proposed) changes to government environmental and tax policies have created a climate of uncertainty that puts Alberta at a competitive disadvantage relative to competing jurisdictions such as Alaska, Australia and the US Gulf Coast. Additional changes to Alberta's royalty regime will likely further undermine investor confidence.



2. Is Alberta's royalty system sufficiently sensitive to market conditions?

Alberta differentiates between conventional oil and gas and the oil sands in levying production royalties.⁵

Conventional Oil and Gas

The current conventional oil and gas royalty system is designed to incorporate factors such as year discovered, well size, density (conventional oil), composition (natural gas), production and price in setting royalty rates:

- **Year Discovered** - Lower rates are applied to new wells because the cost of discovering and developing oil from newer pools tends to be higher due to decreased pool size.
- **Density** - Higher royalty rates are applied to production of lighter oil to reflect the higher market value of the oil.
- **Composition** - Different royalty rates are applied to different natural gases to reflect the market value of each gas.
- **Price and Well Production** - Lower royalty rates are applied for low producing wells and royalty rates increase with price.

The conventional oil and gas royalty system is well established and capable of accommodating the various levels of risk associated with different types of conventional oil and gas projects. As such, it is sensitive to market conditions.

Oil Sands

The oil sands royalty regime was established in 1997 with the objective of stimulating oil sands investment and development. One of two royalty rates may apply to oil sands production, depending on the whether the project is in the "pre-payout" or "post-payout" period:

- **The pre-payout** royalty rate is 1% of gross project revenue, which occurs when allowable project costs (including capital and operating costs for new projects and project expansions as well as a reasonable return equal to the long-term government bond rate) have yet to be recovered.
- **The post-payout** royalty rate is equal to the greater of 1% of gross revenues and 25% of net revenues, which occurs after allowable project costs are recovered.

The pre- and post- payout model for oil sands developments represents a government-private sector risk-sharing arrangement that seeks to accommodate the sector's unique structural constraints. Oil sands projects require substantive initial capital outlays and exhibit significant time lags before production begins (measured in years rather than days

⁵ For a discussion Alberta's oil and gas royalty system see the Royalty Review Panel Background document available at: http://www.albertaroyaltyreview.ca/more_info/background.pdf



for conventional oil and gas), but can maintain peak production levels for periods longer than conventional sources (operating on up to a 40 year time frame). The model encourages companies to invest the necessary resources required to develop the oil sands during the pre-payout phase, and contribute full royalties in proportion to their net revenues after their eligible costs are recovered during the post-payout phase.

Under this arrangement, if oil prices increase, costs are recovered more quickly and projects enter the post-payout phase sooner. Similarly, as project costs (e.g. labour and natural gas) increase, net revenues decrease and provincial royalties decrease proportionately. The net revenue approach also implicitly incorporates elements such as productivity and oil quality – factors contemplated in the conventional oil and gas royalty model, which is sensitive to market conditions. As such, the oil sands royalty model is also sensitive to market conditions.

3. Is the current revenue minus cost system for oil sands royalties optimal?

Oil sands projects continue to require substantive initial capital costs and exhibit significant time lags before production begins, but can maintain peak production levels for periods longer than for conventional sources. The revenue minus costs model is appropriate for oil sands projects because it represents a long-term, risk-sharing arrangement between the government and the private sector, in which both parties share in the risks during the pre-payout phase and the rewards during the post-payout phase. As noted above, the model is sensitive to market conditions in which changes to productivity, costs, quality and price will proportionately affect both profits and royalties.

4. Which built in royalty programs should be retained, adapted or eliminated?

Provincial oil and gas royalty programs should reflect the current and future structure and realities of Alberta's oil and gas sector. With conventional reserves on the decline and a greater dependence on the oil sands, government should endorse an approach that encourages the development of lower productivity wells, enhanced extraction of unconventional petroleum resources (such as coal bed methane and shale) and investment in productivity enhancing/ environmentally sustainable recovery technologies (such as carbon capture and storage).

Relative to other Canadian industries, the oil and gas sector stands to gain substantially from increased investment in R&D activities. It is estimated that the sector spends approximately \$0.78 for every \$100 of GDP generated, which is one sixth the level of R&D invested by the manufacturing sector (\$4.80 for every \$100 of GDP).⁶

⁶ Ference, Weicker and Co. (2007). *Research and Development Strategy for Oil and Gas*. Draft discussion paper prepared for BC Ministry of Energy, Mines and Petroleum Resources.



Government could play a pivotal role in enhancing the competitiveness and sustainability of the industry through greater R&D investment. Incentives such as R&D capital cost allowances, favourable royalty rates/ rebates and technology trusts could be developed to encourage investment in advanced and greener technologies. The current *Experimental Project Petroleum Royalty* and *Innovative Energy Technologies* programs are examples of initiatives designed to encourage investment in new fossil fuel recovery technologies and methods.

5. How does the tax treatment of the oil and gas sector compare to other sectors and jurisdictions?

The Canadian oil and gas sector pays government revenues in the form of bonuses, mineral rights, royalties, income taxes and property taxes.⁷ Royalties are a charge levied by the owners of a natural resource (i.e. Albertans) for the right to develop the resource and, ideally, are priced to reflect the (market) value of the resource. Bonuses are upfront payments for the right to explore, develop and produce natural resources, and are issued via a competitive sealed bid auction process. Mineral rights are leased to the successful bonus bidder to encourage active use of the land. The Alberta corporate income tax rate is 10% of taxable income, and the federal corporate income tax rate is 21%. In aggregate, these elements comprise the fiscal framework of Alberta's oil and gas industry.

With respect to the oil sands, the estimated total government take on post-payout projects may be as high as 49%.⁸ Of this, 41% goes to the federal government, 36% to the province of Alberta, 9% to other provinces and 14% to municipalities. The total government take on Canadian oil sands is similar to comparable jurisdictions such as US Gulf Coast (47%) and Alaska (49%).

Oil sands deposits are about 10-12% crude bitumen (a viscous heavy oil that will not flow in a natural state), which is extracted via 2 methods:

- If the deposits are less than 100m from the surface, oil sands can be surface mined and the bitumen extracted using hot water to wash the oil out of the sand; or
- If the deposits are greater than 100m from the surface, the bitumen can be recovered via *in situ* - a process that injects of high-pressure steam (usually through steam assisted gravity drainage) into the deposit, separating the bitumen into a well, which is pumped to the surface.⁹

⁷ For more information on Alberta's oil and gas fiscal regime see the Royalty Review Panel discussion documents at http://www.albertaroyaltyreview.ca/more_info/index.html

⁸ For a discussion on government revenues from oil projects see CAPP 2007 pp 27-34.

⁹ For a discussion of oil sands extraction see Woynillowics, Severson-Baker, and Reynolds, (2005). *Oil Sands Fever: The Environmental Implications of Canada's Oil Sands Rush*. pp 11-15. Pembina Institute.



The cost and investment structure for Alberta oil sands developments have often been compared to those of mining operations. Oil sands investments require substantial initial capital costs, exhibit significant time lags before production begins, are dependent upon volatile market prices, have high financial risk, and generate long-term future revenue streams for governments.

In recognition of the unique structure of Alberta oil sands, the Accelerated Capital Cost Allowance (ACCA) was developed for oil sands projects. Under the ACCA, 100% of oil sands construction and equipment expenditures could be used against the amount of tax paid on income from the project, and costs could only be applied against the project revenue. The ACCA effectively shifted the timing of tax payments for projects, allowing for tax deferral until projects were generating revenues, encouraging initial capital investment through reduced upfront risk and cost pressures.

In its 2007 budget, the federal government announced the phase out of the ACCA, effective 2010, which will accelerate the federal tax payment per year prior to the payout of the project. This change will not impact current projects, but it will have a major impact on new projects, as it will substantially increase the length of time operators will have capital at risk – increasing the rate of return required before projects can proceed.

This change effectively discourages new oil sands investment and places the oil sands at a comparative disadvantage relative to other mining projects in Canada (as well as other international regimes), contravening the fiscal policy principle of *horizontal equity* (i.e. those in equal positions should be treated equally).

The oil and gas tax regime that included the ACCA for oil sands projects compared favorably to other sectors and jurisdictions. As such, the Chamber recommends that the Alberta government continue to provide the ACCA for oil sands projects to maintain the industry's competitiveness and stability and encourage new investment.

6. What are the economic and fiscal impacts of any possible changes to the royalty and corporate tax systems?

As previously noted, 42% of the province's GDP is derived from the oil and gas sector, but only approximately 15% (\$23 billion) is attributable to direct mining and oil and gas activity. The remaining 27% represents the indirect, downstream economic activity that results from the direct oil and gas sector. As such, any changes to the provincial oil and gas fiscal regime will have significant economic consequences that impact all sectors of the economy – from the drilling contractor to the dry cleaner.

Given the importance of the oil and gas sector to the provincial economy, government should exercise extreme caution in proceeding (if at all) with any changes to the oil and gas royalty and tax regime – particularly during this heightened climate of uncertainty due to changes to government environmental and fiscal policies.



7. How should existing resource developments be treated if changes are made to the fiscal regime?

Companies seeking to develop oil and gas projects must consider all of the financial costs and benefits in making their investment decisions – including bonus costs, mineral rights, income taxes, property taxes and royalty rates. As such, any changes to the oil and gas royalty and tax regime should recognize this industry characteristic, and honour existing arrangements made with companies in good faith, by grandfathering the tax and royalty rates of all existing projects.

III. Recommendations

Based on the above discussion, the Chamber recommends that the provincial government:

1. Not change Alberta's oil and gas royalty system, as the current regime compares favourably to other jurisdictions, is responsive to market conditions, and reflects the unique structural and investment realities of the Alberta oil and gas sector;
2. Continue to provide the Accelerated Capital Cost Allowance for oil sands projects to maintain the industry's relative competitiveness and stability, and encourage new investment;
3. Exercise caution in contemplating any changes to the oil sands fiscal regime, particularly given the importance of the industry to the provincial economy, the sensitivity and higher risk profile of investment, and the current political uncertainty already surrounding the industry;
4. Grandfather existing fiscal arrangements for projects that have already made good faith investments; and
5. Endorse oil and gas programs that encourage the development of lower productivity wells, unconventional petroleum resources, and investment in advanced and greener technologies.

The Calgary Chamber of Commerce is the leading forum for discussion and debate on critical issues of public policy, and a leading advocate of new ideas, approaches and solutions. To learn more about the Chamber visit www.calgarychamber.com.



Witness

Heather Douglas
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Heather Douglas was appointed to the position of President and CEO of The Calgary Chamber of Commerce as of October 1, 2005. Prior to joining The Chamber, Heather Douglas was the Founder and President of Strategic Public Affairs (SPA), a worldwide combination of external and internal affairs and communications professionals. She has more than 20 years experience in journalism and public affairs, has directed media, government, and shareholder relations, crisis communications, and image and reputation management for three major Canadian companies (one a Fortune 500 affiliate).

Douglas is the former Manager, Public and Government Affairs for Mobil Oil Canada where she successfully directed several of Canada's largest public consultation programs – including the Hibernia offshore oil and the Sable natural gas projects. Mobil sent her to run Mobil's Public and Government Affairs Department in the United Kingdom and Norway, assigned her to special projects in the Far East, and brought her to Washington D.C. to work with several Asian embassies.

Douglas has also served as Vice President, Public Affairs and Government Relations with Atomic Energy of Canada (AECL); her duties included building relationships with foreign governments on behalf of the Crown Corporation. She also headed their worldwide media relations, stakeholder relations, crisis communications, and public consultation programs. She was an officer of the Corporation and a member of its Executive Council.

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