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June 22, 2007

**Re: Invitation to respond to panel members' questions**

Dear Royalty Review Panel Members,

On behalf of the more than 3,200 members of the Calgary Chamber of Commerce, thank you for the opportunity to put forth a submission and present to the Royalty Review Panel on May 22, 2007 in Calgary.

This correspondence is in response to the invitation from panel members to provide further information on key areas of questioning during our May 22nd presentation. It addresses three issues: 1) royalty rates and the length of time before oil sands profitability; 2) conventional oil and gas royalties and price sensitivity; and 3) oil and gas expansion and labour market pressures.

**1. Length of time before oil sands profitability**

Relative to conventional oil and gas, oil sands projects require large upfront capital costs and exhibit long lead times before meaningful production begins (relative to investment). Industry estimates have consistently ranged from four to seven years before the first barrel of production, which the Chamber recognizes as materially longer than the equivalent timelines expected for conventional production.

The pre- and post-payout oil sands royalty model was designed to accommodate these unique structural constraints, by imposing a royalty rate of one per cent of gross revenue until eligible costs are recovered. During the pre-payout phase, oil sands developers take on many risks including technology, operational efficiency, resource quality, interest rate exposure, cost escalations, and commodity price fluctuations. Government, on the other hand, assumes little financial risk, but benefits from lease sales and the pre-payout royalty rate of one per cent of gross revenue.

While this model is able to accommodate long production lead times, in the event lead times decrease (through, for instance, regulatory efficiencies and/or technological advancements), eligible costs would be recovered more quickly and projects would enter the post-payout phase sooner – resulting in royalty rates of 25 per cent of net revenue. Consequently, the current oil sands royalty model is responsive to both cost pressures and market conditions, regardless of project production lead times.

## **2. Conventional oil and gas royalties and price sensitivity**

In its submission to the Panel, the Chamber argued that Alberta's conventional oil and gas royalty system is responsive to market conditions. The 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.

The royalty model progressively increases royalty rates as price increases, up until a maximum price, at which point the rate becomes constant. This price responsiveness accommodates the cost structure of the industry, which is characterized by increasing returns to scale (i.e. unit costs decrease as output increases) due to high initial fixed costs, up until a point where returns become constant or even decline.

By lowering royalty rates at lower prices, the model recognizes and responds to higher per unit costs when prices are low. By increasing royalty rates as prices increase, the model recognizes and responds to the increased per unit return when prices increase. By maintaining a constant royalty rate for prices above a certain level, the model recognizes and accommodates the constant per unit returns associated with higher prices and production.

In essence, this model maintains a proportionate per unit return on investment throughout periods of high growth and during temporary slowdowns, and is sufficiently sensitive to market conditions.

## **3. Oil sands expansion and labour market pressures**

Oil sands development in Alberta has created jobs, established the province as a centre of excellence for energy research and commercialization, and resulted in royalties and taxes – all of which has enriched Albertans' quality of life. These funds, in part, allow the provincial government to maintain a competitive tax system while delivering leading-edge social services. A recent Mercer Human Resource Consulting annual quality of life survey ranked Calgary 24 out of 215 cities worldwide.

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. 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).

Oil sands development has led to tremendous prosperity and career opportunities. Many Albertans have seized the chance to advance their skills and to make higher wages. But this has resulted in many sectors struggling to find replacement labour. In a 2007 survey, Chamber members identified labour shortages as the number one issue impacting their businesses.

However, the labour shortage challenge extends beyond the Alberta economy, and is driven by a number of factors including population demographics, life expectancies, fertility rates, retirement patterns, labour force participation, immigration, and economic growth.

Given the broad and complex scope of this issue, the Chamber argues that the Alberta royalty regime is not an appropriate policy tool for addressing labour shortages. Using the royalty regime in this manner will only serve to slow economic growth and significantly jeopardize the primary wealth-generating engine of the Alberta economy.

To address labour shortages governments should focus on tapping into underutilized pools of labour (such as the Aboriginal population) and removing barriers to labour force participation through improved inter-provincial mobility and greater workforce participation incentives. The solution to labour issues lies in increasing the labour supply, rather than the utilization of blunt and indirect fiscal policy tools that would limit or purposefully depress the province's economy in a broad, indiscriminate, unfocussed and uncontrollable manner. The latter would not only result in slower economic growth, lower per capita incomes, and a declining quality of life, but also add additional and ongoing uncertainty to the market, as royalty rate adjustments for macro-economic policy objectives would require constant changes in the royalty regime, and further undermine investment.

### **Position Summary**

The Chamber appreciates the opportunity to provide further clarification on key issues discussed during our May 22<sup>nd</sup> presentation. On behalf of our membership, we reiterate our position that no changes be made to the royalty regime – particularly given the importance of the industry to the provincial economy and the political uncertainty already surrounding the industry as a result of recent government taxation and regulatory changes. Additionally, the Chamber recognizes that the current model is responsive to market conditions and reflects the unique structural and investment realities of the Alberta oil and gas sector.

Any change to the royalty regime would only further undermine investor confidence, and severely jeopardize Alberta's economy – 42 per cent of which is driven by direct oil & gas investment and associated economic spin-offs.

Yours truly,

Heather Douglas  
President & CEO