



Alberta's Royalty Regime

Perspectives of an Alberta-Based
International Oil & Gas Producer

Prepared for the Alberta Royalty Review Panel by

Talisman Energy Inc.,

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Talisman Energy Inc. – Profile

Talisman Energy Inc. was formed in 1992 when BP decided to exit Canada because of its view that oil opportunities were too small and gas economics too marginal. Talisman has grown from 1992 production levels of 54,000 boe/d to an anticipated 485,000 boe/d in 2007 through a combination of active exploration and development activity and through a number of domestic and international acquisitions. Compared to other large North American E&P companies, Talisman is the most internationally diversified with more than half of its reserves and production volumes currently derived from international jurisdictions.

However, Talisman also currently ranks as Alberta's fourth largest natural gas producer, contributing roughly 5% of Alberta's natural gas production (circa 665 mmcf/d). Talisman is highly experienced in, and continues to focus on, deep natural gas exploration and, by a number of measures, is Alberta's leading deep gas explorer. The Company currently directs 90% of its North American investment towards natural gas opportunities and is also active in British Columbia and in the state of New York. Talisman has recently divested most of its relatively small interests in the oil sands and has no remaining producing oil sands assets. Given the Company's concentration on natural gas exploration and development in Alberta, this submission specifically addresses the existing Alberta natural gas royalty regime.

The chart below provides some Talisman highlights and the Company's current worldwide production profile.

independent upstream oil and gas company, created in 1992

Calgary headquarters

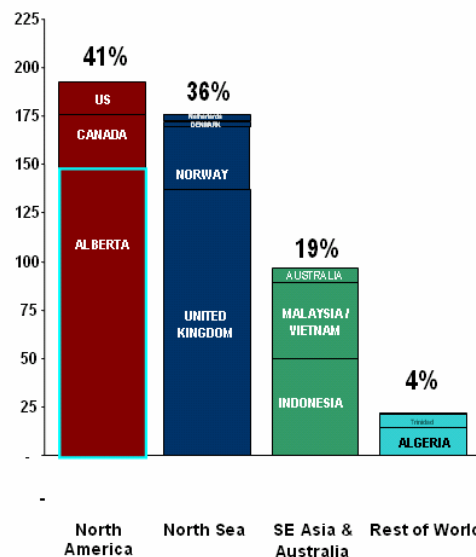
1048.5 million shares outstanding
(as of Mar. 31, 2007)

gas production: 1,325 mmcf/d
665 mmcf/d in Alberta

liquids production: 264 mbbls/d
30 mbbls/d in Alberta*

Focus on larger opportunities: deep gas in North America and multi-million boe international prospects

2007 Production Profile**



	North America	North Sea	SE Asia & Australia	Rest of World	Total
% natural gas:	77%	12%	52%	0%	46%
% oil & liquids:	23%	88%	48%	100%	54%

* conventional

**Forecast midpoint of 2Q 2007 Guidance range (+/-5%)

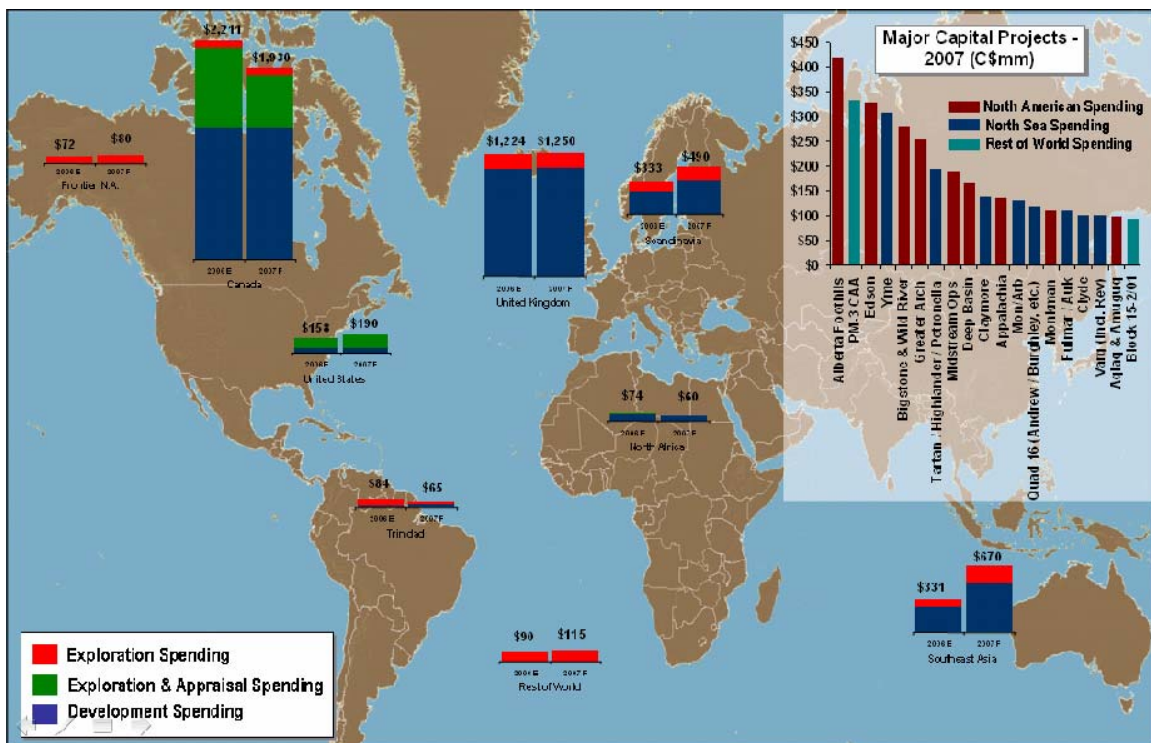
Talisman has been an active investor in Alberta since its inception in 1992 and, given the appropriate economic and fiscal environments, intends to continue with active investment in Alberta for the foreseeable future.

Talisman Energy Inc. – Planned Capital Spending

Talisman has budgeted approximately \$4.8 billion of capital expenditures in 2007 of which roughly 35% is planned for natural gas exploration, development and land acquisitions in Alberta. The Company operates in many countries outside North America and is therefore directly exposed to a wide range of fiscal regimes. It is therefore well placed to assess the attractiveness of the Alberta fiscal regime in a global context, and Alberta is clearly not the most attractive as demonstrated by analyses contained in this paper.

Talisman ranks its worldwide investment opportunities based on DPI (Discounted Profitability Index) which is useful in determining relative capital efficiency. Essentially, the approach is to divide the risked net present value of all cash inflows and outflows associated with an investment opportunity discounted using our weighted average cost of capital (WACC), less the initial investment, by the capital outlay required. To illustrate, a \$6 million discounted return on a \$5 million investment would generate a 0.2 DPI $[(6-5)/5]$, whereas an \$11 million discounted return on a \$10 million investment would generate a 0.1 DPI $[(11-10)/10]$. Although the positive NPV on both investments is the same (\$1 million), the intent is to optimize returns above our WACC to ensure maximum capital efficiency. The investment yielding a 0.2 DPI is more efficient because it generates the same value increment for only half the capital outlay.

The following illustration shows Talisman’s relative proportion of planned 2007 capital spending by category and region. Note that the six largest North American major capital projects are all located in Alberta.



The current Alberta natural gas royalty regime results in the producer taking on substantially more risk than the resource owner as the Crown collects royalties and taxes on successful

wells, but bears only a fraction of the cost of unsuccessful wells through the tax deductibility of the related dry hole costs. In addition, the resource owner benefits from land purchase bonus bids whether future drilling is ultimately successful or not. The auction process effectively awards acreage to the highest bidder who presumably has the most optimistic view of the land's potential mineral content. This is an effective mechanism for ensuring that any projected economic rent that is not collected as royalties is efficiently captured by the resource owner through the competitive land bidding process. In other maturing basins around the world such as the UK North Sea, royalties have been abolished in favour of a "tax only" fiscal regime, which results in all stakeholders sharing in the full cycle risks and benefits of capital investment.

Norway is sometimes cited as an example of a regime where, as a result of a high income tax rate and no royalties, economic rent has effectively been optimized and saved for future generations. However, the investor is permitted to deduct for income tax purposes 100% of exploration costs plus 130% of development costs, thereby reducing the effective income tax rate. Importantly, prospects in Norway generally need to exceed 30 mmbbls in order to be economic, but many such opportunities exist. Given that the Alberta basin is much less prolific and considerably more mature, a similar fiscal regime would be untenable as it would render virtually all conventional exploration and development prospects uneconomic.

Talisman has significant investment plans in Alberta that could be sharply curtailed as a result of any adverse changes to existing fiscal terms in the province, primarily due to our investment ranking approach and myriad of opportunities around the world.

Talisman Energy Inc. – Drilling in the Foothills

Alberta's remaining natural gas reserves tend to be in increasingly small reservoirs. This has combined with steep industry cost inflation to dramatically increase unit finding and development costs in recent years.

Talisman actively explores for larger, deeper and technically more challenging reservoirs as illustrated by the "cartoon" below. These wells are typically 3,000-4,000 meters in depth, difficult to image seismically and it is tough to find the "crest" of the structure. These wells are also very expensive at \$10-25 million per well. While there is a good chance of finding natural gas, the producer always faces the risk that it may not be of sufficient quantity to justify commercial development.

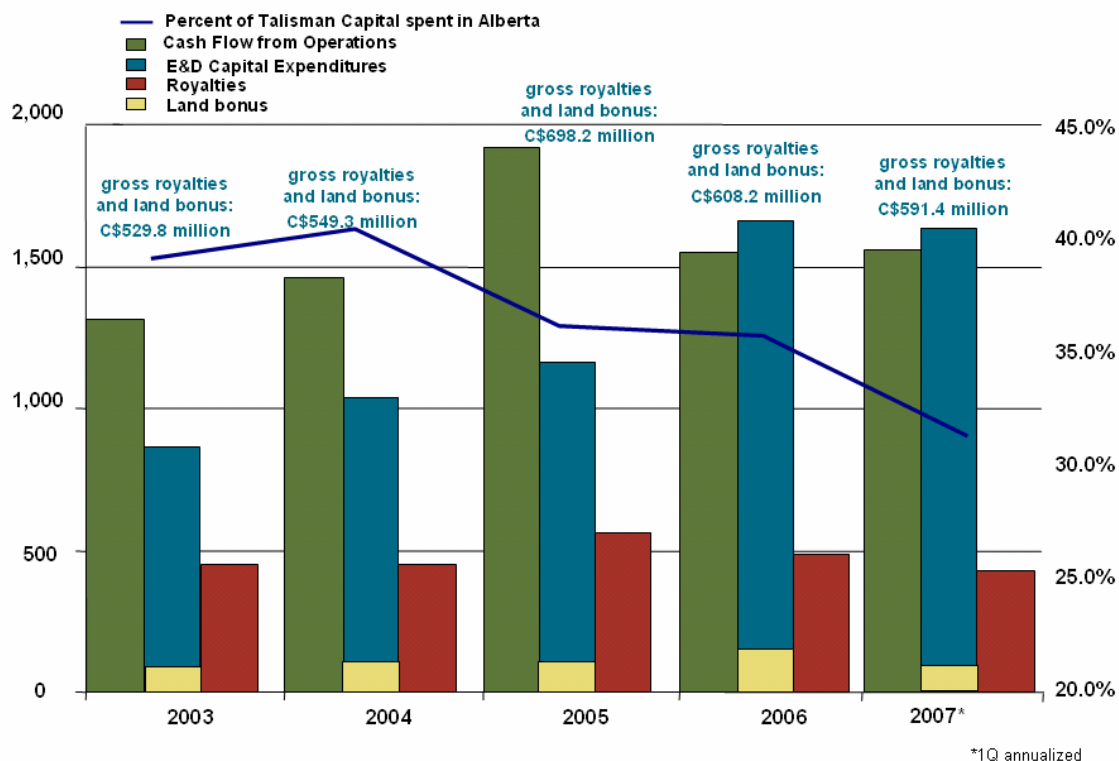
Alberta therefore requires a supportive and stable fiscal regime in order to optimize both future resource recovery and revenue in a rapidly maturing basin.



Talisman Energy Inc. – Spending in Alberta

The following graph is extremely telling and illustrates selected Talisman statistics in Alberta for the years 2003 to 2006, and for 2007 based on annualized first quarter results. Cash flow from operations has been calculated as revenue minus royalties and operating costs. Income taxes, corporate overhead costs and financing charges have not been factored in.

Talisman cash flow from Alberta compared to capital expenditures



Key observations are:

- 1) Capital expenditures exceeded cash flow from operations in 2006 for the first time in recent memory, and are expected to do so again in 2007. Activity levels have been more or less flat over the 2003 -2007 period, but cost inflation has turned a “cash generator” into a “cash user”. Talisman is investing significant amounts in Alberta despite expectations of only modest 3-5% per annum production growth. This is clearly not sustainable, particularly since the shortfall plus Talisman’s Alberta share of income tax and overhead costs must now be funded by surplus cash generated by the Company’s international operations.
- 2) Cash flow has been reduced by payments to the Crown in the form of royalties and land bonuses ranging between roughly \$500 million and \$700 million over the last four years, and based on annualized first quarter 2007 results.
- 3) An increasing proportion of the Company’s overall capital investment budget has been allocated to opportunities outside of Alberta for reasons that are clearly illustrated in the next section of this paper.

Talisman receives the natural gas price dictated by supply and demand fundamentals within the continental North American natural gas market. The Company is clearly a price taker. However costs are based on local market conditions and have increased quite significantly in recent years due to a number of factors, including increasing basin maturity, tight worldwide industry conditions and insufficient intra-Alberta capacity. On the last point, local industry has worked hard to mitigate a component of cost pressure in future by increasing capacity in the form of more drilling rigs, etc. Talisman’s cost levels have increased and support CAPP’s contention that overall industry costs now average \$3.50/mcf for finding and development and \$1.20/mcf for operating costs. Since the sales price of natural gas is

effectively denominated in US dollars, an additional exogenous factor which has eroded revenues and operating margins is the dramatic strengthening of the Canadian dollar over the period shown above, having risen from US\$/C\$ = .71 in 2003 to .88 in 2006, and to circa .93 at present.

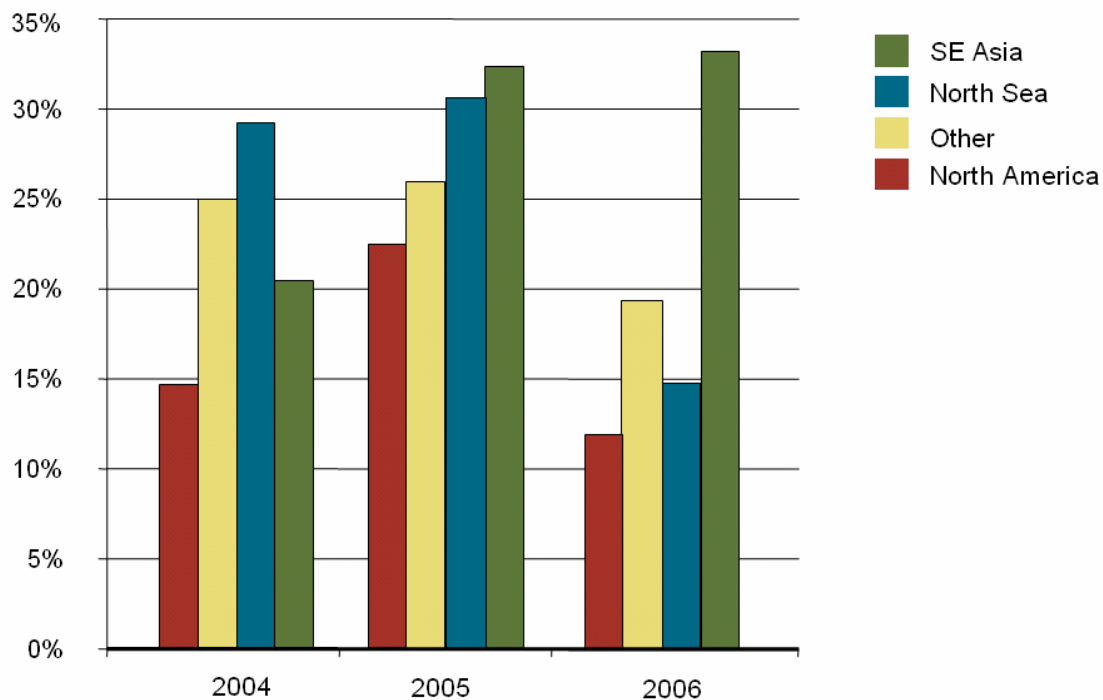
The argument has been made that higher royalty rates would have curbed local industry inflationary pressures. Talisman believes strongly that such an approach would have clearly reduced funds available for capital investment and led to lower industry activity levels. The overall result most certainly would have been reduced revenue to the Crown and a much less robust economy in the province.

Talisman accepts that the government's mandate is to establish a fiscal regime that optimizes economic returns for the people of Alberta, but that requires high activity levels. This in turn requires positive economic incentives, directionally implying that lower, not higher, royalty rates should be contemplated.

Talisman Energy Inc. – Comparing Global Economic Returns

The following graph depicts Talisman's comparative return on capital employed (ROCE) in the Company's principal operating regions. Economic returns in Alberta are actually somewhat lower than the overall North American results since ROCE in the Northeast US Appalachia region are very high due to low costs and strong prices driven by close proximity to consumer markets. Alberta accounts for 75% of total production in North America and therefore the overall results are appropriate for comparison purposes. The region called "Other" includes primarily Algeria and Trinidad & Tobago.

Talisman – Return on Capital Employed by Region



The rate of return in North America, while decent, has certainly not been excessive. Returns achieved in the North Sea, Southeast Asia and Other regions have consistently exceeded those in North America.

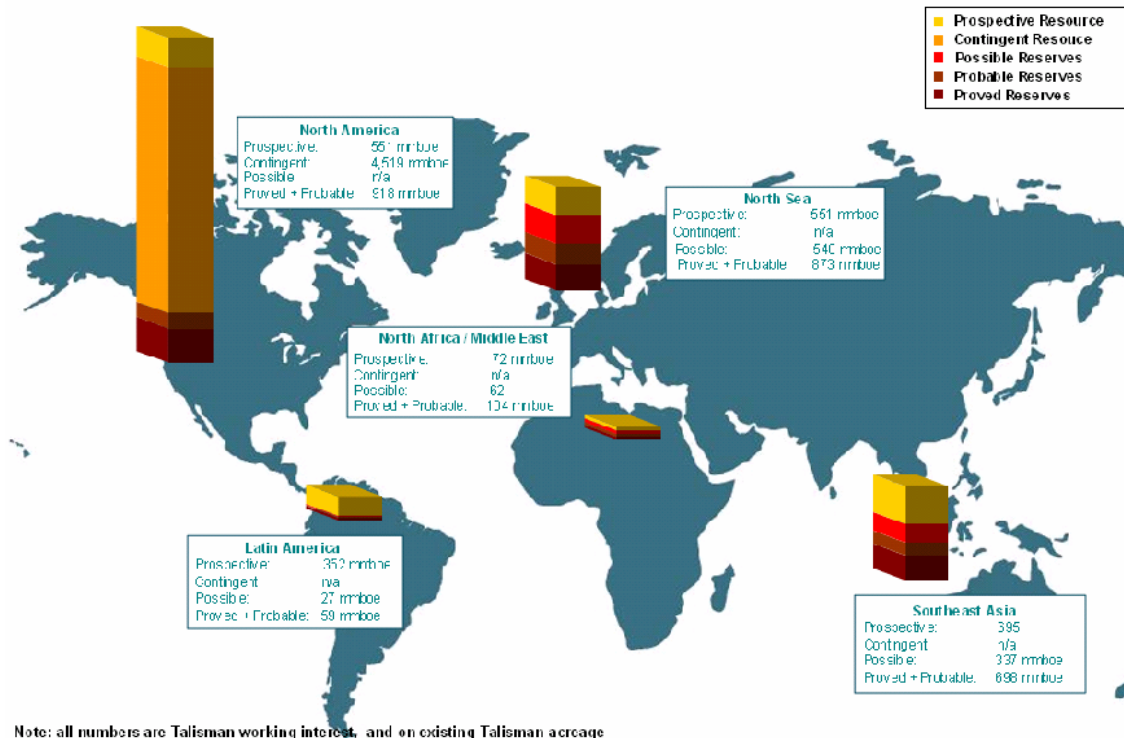
As discussed previously, Talisman ranks investment opportunities based on anticipated return and capital efficiency metrics, and given the comparatively poor results in Alberta, it is important to explain why Talisman continues to invest so heavily in the province. The key reasons are:

- 1) We drill many wells in Alberta, pursuing smaller opportunities than those targeted by fewer wells drilled internationally. This leads to statistically more predictable results in Alberta and less “lumpy” additions to reserves and production.
- 2) This approach is consistent with the Company’s stated strategy of maintaining a balanced product portfolio comprised of domestic natural gas and international oil, which balances commodity price risk since it is very difficult to predict the relative future direction of oil versus natural gas prices (although we believe the fundamentals are very supportive in both cases).
- 3) Alberta is viewed by Talisman as very stable and predictable. In the past, any fiscal changes that have been introduced have generally been applied prospectively, giving the producer confidence that large investments will not be undermined in future by adverse changes to fiscal terms.

Notwithstanding the reasons set out above, Talisman has reduced Alberta investment as a proportion of its worldwide capital expenditures in recent years. Any changes to the Alberta natural gas fiscal regime which result in higher royalty or other burdens would logically motivate an acceleration of this trend. Furthermore, changes to fiscal terms on mineral rights already granted would change Talisman’s perception of the predictability of Alberta’s fiscal regime and would affect its willingness to accept lower returns in the province.

Talisman Energy Inc. – Looking Forward

Talisman has been active in Alberta in one form or another since 1953 and sees at least 25 years of gas opportunities with 25 TCF of contingent resources on Talisman lands. The extent to which Talisman ultimately exploits this large potential resource is heavily dependent upon strong natural gas prices and a reasonable, predictable and facilitating fiscal regime. The interests of Talisman and the people of Alberta are more aligned than opposed in that effective development of this immense resource potential, albeit in smaller, harder to exploit prospects, enhances the wealth of all.



Talisman strongly believes that the current royalty regime has worked so far, although there are strong negative currents at work such as the income trusts issue, struggling juniors sector, the retreat of US companies and the slowdown in drilling activity in 2007. The Alberta government's effective fiscal management has resulted in:

- 1) unprecedented prosperity – the “Alberta Advantage”
- 2) a significant economic multiplier effect of \$45 billion of annual capital investment
- 3) more head offices leading to expanded intellectual capital in the province
- 4) more high paying jobs in a wide range of disciplines which has enhanced the provincial coffers through higher personal income tax payments

In summary, Talisman suggests that the government proceed with extreme caution and take action to ensure a continuing favourable investment climate through sustainment of:

- 1) **Predictability** – take no action that negates the economic assumptions used in making substantial capital investments and commitments in the past.
- 2) **Competitiveness** – ensure that prospective royalty decisions consider the relationship between royalty rates and royalty income as illustrated by the Laffer curve. i.e. Alberta gets zero royalties with a 0% royalty rate and also gets zero royalties with a 100% royalty rate. Talisman believes the current regime has observably enriched the people of Alberta and encouraged high levels of activity. Higher prospective royalty rates will not necessarily increase royalty take or the long term wealth of Albertans.

- 3) **Don't Forget the Lessons of the NEP** – The NEP led to a contraction of industry activity levels and significant economic hardship in Alberta. Investors are already very uneasy about trust taxation, potential environmental legislation relating to CO2 emissions, escalating costs and other signs of instability. Increased royalty burdens would merely exacerbate those concerns and reduce the industry's access to capital. This could have a devastating impact on already slowing activity levels in the province.

In short, the current natural gas fiscal regime has worked and has served the people of Alberta and the producer very well. Given the current difficulties in the industry, the government should not increase disincentives, but rather should consider improved fiscal terms.