

# The Alberta Royalty Review

Submission by



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**Presented by:**

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- **An Alberta-based company founded in 1989**
- **Largest energy-focused private equity firm in Canada**
- **Managing \$1.9 billion of equity capital**
- **Long track record of helping to grow successful energy companies in Alberta (over 140 investments)**
- **We are a large stakeholder in Alberta's financial community**
- **We are now operating with a global strategy**

# Discussion Points

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- The Alberta Government is conducting a Royalty Review to determine if the citizens of the Province are receiving a fair share of 'rent' from the natural resources they are providing to the oil and gas industry.
- In considering changes to oil and gas royalties, we believe the Government of Alberta must be mindful of the following key requirements: maintaining **prosperity**; ensuring **energy security**; advancing **sustainability**; and defending the Province's impeccable reputation of **political and fiscal stability**.
- Recent economic trends and indicators (within the last nine months) suggest that:
  - Prosperity is at risk, especially within the natural gas sector of the industry;
  - Existence of long-term excess rent on commodities is not evident;
  - External perceptions of Alberta's fiscal stability are vulnerable;
  - Maintaining a proper 'biodiversity' of small, medium and large companies is at risk; many junior companies are struggling right now; and that
  - Canada is one of the highest cost sources of oil and gas in the world; investment capital for natural gas exploration and development is migrating elsewhere.
- Today's risks and vulnerabilities suggest that the timing is not good for burdening Alberta's oil and gas industry with additional royalties.
- **We suggest maintaining the current royalty structure, until Alberta's citizens can be assured that risks and vulnerabilities are mitigated, and that a sustainable level of excess rent is available.**

# Key Requirements

## Description and Determinants

Requirement	Description	Determinants
<b>Prosperity</b>	Albertans want a <i>healthy rate of economic growth</i> with a <i>low level of unemployment</i> . The oil and gas industry, especially conventional activity, is a major contributor to the economy.	Ongoing prosperity requires an optimal balance between the oil and gas industry's access to Alberta's resources, its labour and capital. Capital investment is necessary to maintain prosperity.
<b>Energy security</b>	Albertans want a <i>secure and affordable supply</i> of petroleum products and natural gas.	Ensuring secure and affordable supplies of oil and natural gas is heavily dependent upon investment to maintain production. External forces like weather, currency fluctuations and geopolitics introduce more risk.
<b>Sustainability</b>	Good environmental practices and <i>sustainability</i> is a growing demand by Alberta's citizens.	The operating bounds of companies are mostly determined by government legislation.
<b>Political and fiscal stability</b>	Alberta has an international reputation for <i>stable government</i> and a <i>durable fiscal regime</i> that doesn't change on up and down cycles.	Democracy, the rule of law and a constant fiscal regime are key determinants in upholding our stature as a 'blue chip' place for investors to direct their capital.

# Adam Smith and The Wealth of Nations

## Factors of Production Driving Alberta's Prosperity



### Land

The citizens of Alberta are endowed with vast tracts of primary energy resources, especially oil and natural gas. The availability of resources is not a constraint to prosperity, however conventional resources are 'maturing' and costing more to exploit as time goes on.



### Labour

Alberta's labour pool is very small in proportion to its energy resources. A lack of skilled labour during periods of high demand breeds aggressive levels of wage inflation within the industry.



### Capital

The development of primary energy sources requires massive capital investment (and re-investment) just to maintain a secure supply of constant production. Development of our energy supplies are very reliant on domestic and foreign capital.

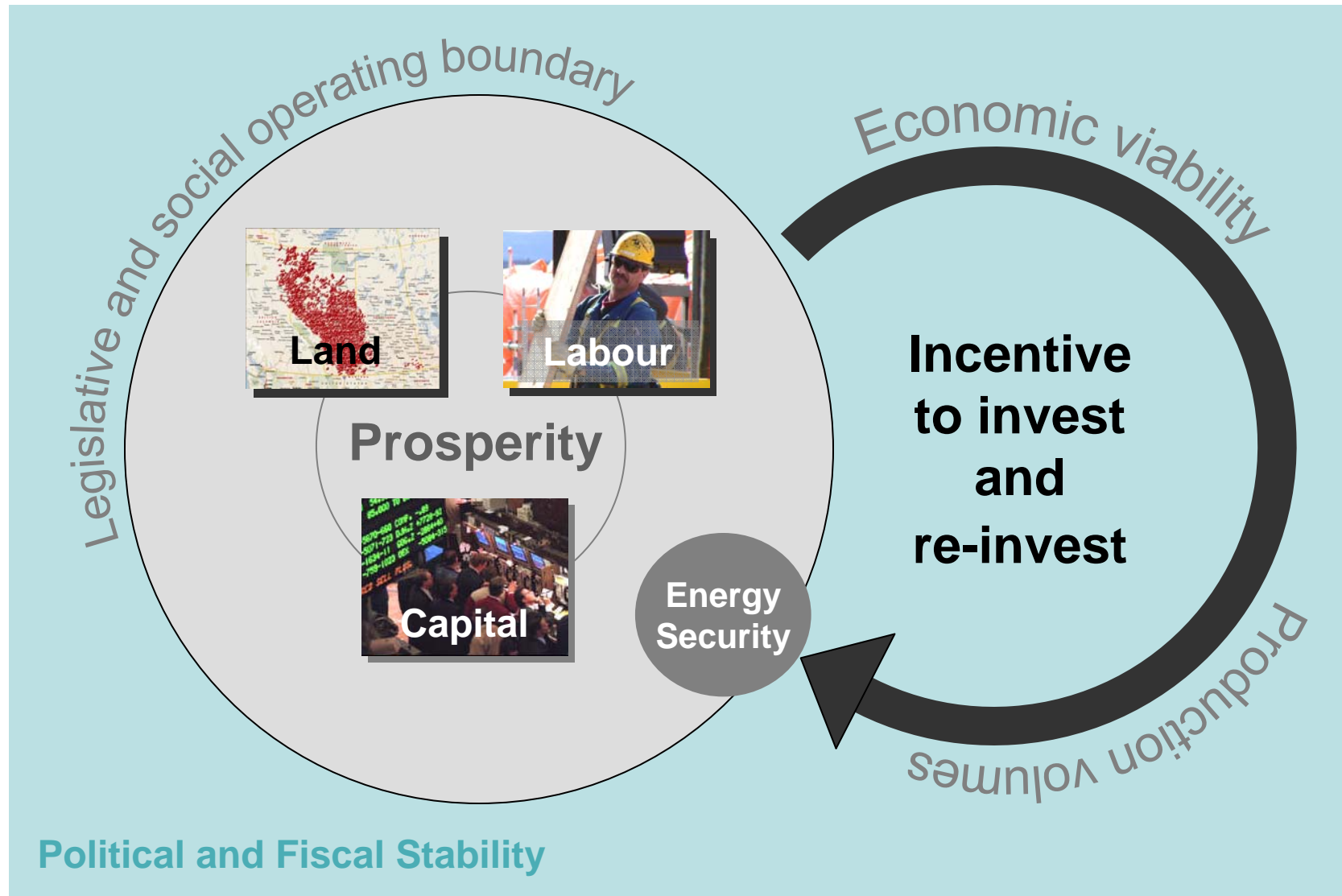
**These Factors Must be Optimally Balanced!**

# Factors of Energy Production

## Providers, Characteristics and Costs of Input

	Land	Labour	Capital
<b>Provider</b>	The citizens of Alberta.	The working population of Alberta and others from outside the Province that may temporarily offer their services.	Providers of debt and equity capital offer financial capital. Service providers and manufacturers offer equipment and oilfield services.
<b>Characteristics</b>	In the context of oil and gas, 'land' is characterized by reserves of hydrocarbons, that are most often below the surface of the ground.	Labour is composed of all the workers that directly or indirectly contribute to finding, developing and bringing crude oil and natural gas to market.	Financial capital is largely 'recycled' or reinvested within the industry. Costly heavy equipment and large infrastructure projects are characteristic of the oil and gas industry.
<b>Cost of Input</b>	On behalf of the citizens of Alberta, the provincial government offers oil and gas companies the right to explore for reserves in exchange for 'rent'. The Province's 'rent' takes the form of land bonuses and royalties on production.	Workers charge wages for their services.	Interest rates dictate the cost of debt. Equity capital is globally mobile and is only reinvested in Alberta if there are not better opportunities elsewhere. <b>Canada is one of the highest cost sources of oil and gas in the world!</b>

# Prosperity, Viability, and Security And the Dynamics of Investment



# Some Observable Trends (1)

## With Interpretation of the Consequences

Observable Trends	Interpretation
<p>Average, year-to-date <b>conventional drilling activity is down</b> approximately 31% year-over-year<sup>1</sup>. Most of the drilling slowdown is on the natural gas side of the business.</p>	<p>Most of the slow down is because the economic incentive to drill for new natural gas reserves has substantially diminished. Finding and development costs, as well as operating costs, have inflated to the point where marginal exploration and development of natural gas is no longer viable for many companies. The aggressively falling rig count is a clear indicator that capital investment is declining in natural gas exploration and that no excess rent is available. Prosperity is at threat.</p>
<p><b>Well licensing is down</b> 35% year-over-year<sup>2</sup>.</p>	<p>Well licensing activity is a leading indicator of the industry's view of future drilling economics. Based on falling licenses, drilling activity is not likely to substantially recover this year, and 2007 could be a 'down year' on par with 1999 and 2002. Like drilling activity, the well licensing trend suggests that the economic viability of conventional natural gas is insufficient to justify more investment.</p>
<p><b>Natural gas production in Alberta peaked last year and is now falling</b><sup>3</sup>. Year-over-year pipeline receipts are down by an average 0.3 Bcf/day.</p>	<p>Steep decline rates for natural gas reservoirs mean that any retreat in drilling activity translates directly into lower production volumes. The 31% decline in rig activity is starting to be felt at the pipelines. Falling natural gas production, at a time when consumption in Alberta is rising, increases citizen's vulnerability to price spikes and in extreme cases supply issues (energy security).</p>

# Some Observable Trends (2)

## With Interpretation of the Consequences

Observable Trends	Interpretation
<p><b>Legislative pressures are mounting</b>, especially as they relate to carbon mitigation.</p>	<p>Climate change legislation at Federal and Provincial levels will add to the cost burden of the industry. Although, each piece of legislation is not debilitating on its own, the collective burden of legislative initiatives is chipping away at the incentive to invest.</p>
<p><b>Wages are still rising</b> at a rate of about 6.5% per year<sup>4</sup>.</p>	<p>The latest data from the Alberta Government (February 2007), suggests that wage inflation is still rising unabated. Average wages for oil and gas workers are now at \$1,523/week. This trend implies that costs will be quite 'sticky' and not likely to come down quickly. Therefore, the propensity to invest will be sticky too.</p>
<p><b>Junior oil and gas equities are substantially lagging the performance of larger publicly-traded companies</b><sup>5</sup>. We estimate the relative equity market discount of junior companies against peers in the large-cap TSX E&amp;P Index to be between 25% and 30% on a value basis. Junior oil and gas companies are biased toward exploring for and producing natural gas.</p>	<p>The 'biodiversity' of oil and gas companies operating in Alberta is under threat. Junior companies are most affected by inflating cost pressures including a much higher cost of capital as a consequence of the federal government's announcement to phase out income trusts on October 31, 2006. Equity markets are correctly assuming that junior companies will have difficulty growing in the current economic environment. Alberta's oil and gas industry now favours large independent and multinational companies over small entrepreneurial ones, which is not fertile for breeding local prosperity.</p>

# Land, Labour and Capital Assessment by Commodity Type

	Land	Labour	Capital
<b>Natural Gas</b>	<ul style="list-style-type: none"> <li>• Very steep decline rates, difficult to grow production<sup>7</sup>.</li> <li>• Basin is 'maturing' quickly after over 100 years of exploration; smaller pool sizes means rising costs independent of other inflation forces.</li> </ul>	<ul style="list-style-type: none"> <li>• Costs to build infrastructure for natural gas distribution – pipelines and facilities – are still rising.</li> <li>• A large component of the infrastructure cost inflation is wages.</li> </ul>	<ul style="list-style-type: none"> <li>• Natural gas prices have been very volatile over the past few years; e.g. since 2004 price have ranged from \$3.50 /GJ to \$14.00/GJ.</li> <li>• Volatile prices translate to volatile and diminishing netbacks as prices rise.</li> <li>• Investment capital will be reluctant to return until costs retreat.</li> <li>• Between 70% and 80% of drilling activity is targeted toward natural gas.</li> </ul>
<b>Conventional Oil</b>	<ul style="list-style-type: none"> <li>• Very difficult to find meaningful new reserves of conventional oil due to resource maturity.</li> <li>• Aggregate production of conventional oil in Alberta is on a decline.</li> </ul>	<ul style="list-style-type: none"> <li>• Costs to build infrastructure for oil production and distribution is still rising.</li> <li>• Oil operating costs are still rising.</li> </ul>	<ul style="list-style-type: none"> <li>• Profitability on conventional oil is attractive enough to catalyze investment, but plays are difficult to find, therefore the opportunity to place capital is very limited.</li> </ul>

# Land, Labour and Capital Assessment by Commodity Type

	Land	Labour	Capital
<b>Oil Sands</b>	<ul style="list-style-type: none"> <li>• Vast amounts of oil sands resources have been identified.</li> <li>• Character and quality of oil sands resources vary greatly, therefore so do cost structures.</li> <li>• Exploitation of oil sands resources is subject to changing fiscal policy (e.g. ACCA), and increasing environmental costs (e.g. Provincial Bill 3; Federal Budget).</li> </ul>	<ul style="list-style-type: none"> <li>• Building infrastructure for extracting and process crude oil from oil sands is an extremely labour intense business.</li> <li>• Wage inflation is acute in the oil sands region and is unlikely to retreat any time soon.</li> </ul>	<ul style="list-style-type: none"> <li>• Like wages, the costs for equipment capital and services have soared, putting pressure on marginal investment economics.</li> <li>• Domestic and foreign capital continue to be attracted to the oil sands, however uncertainty in oil prices, costs, environmental policies, fiscal regimes make new investment in oil sands projects uncertain.</li> <li>• Junior oil sands companies are much more vulnerable to these uncertainties than larger independents and multinationals.</li> <li>• Land, labour and capital in the oil sands appear balanced for now, but the stability is fragile.</li> </ul>

# Summary Points

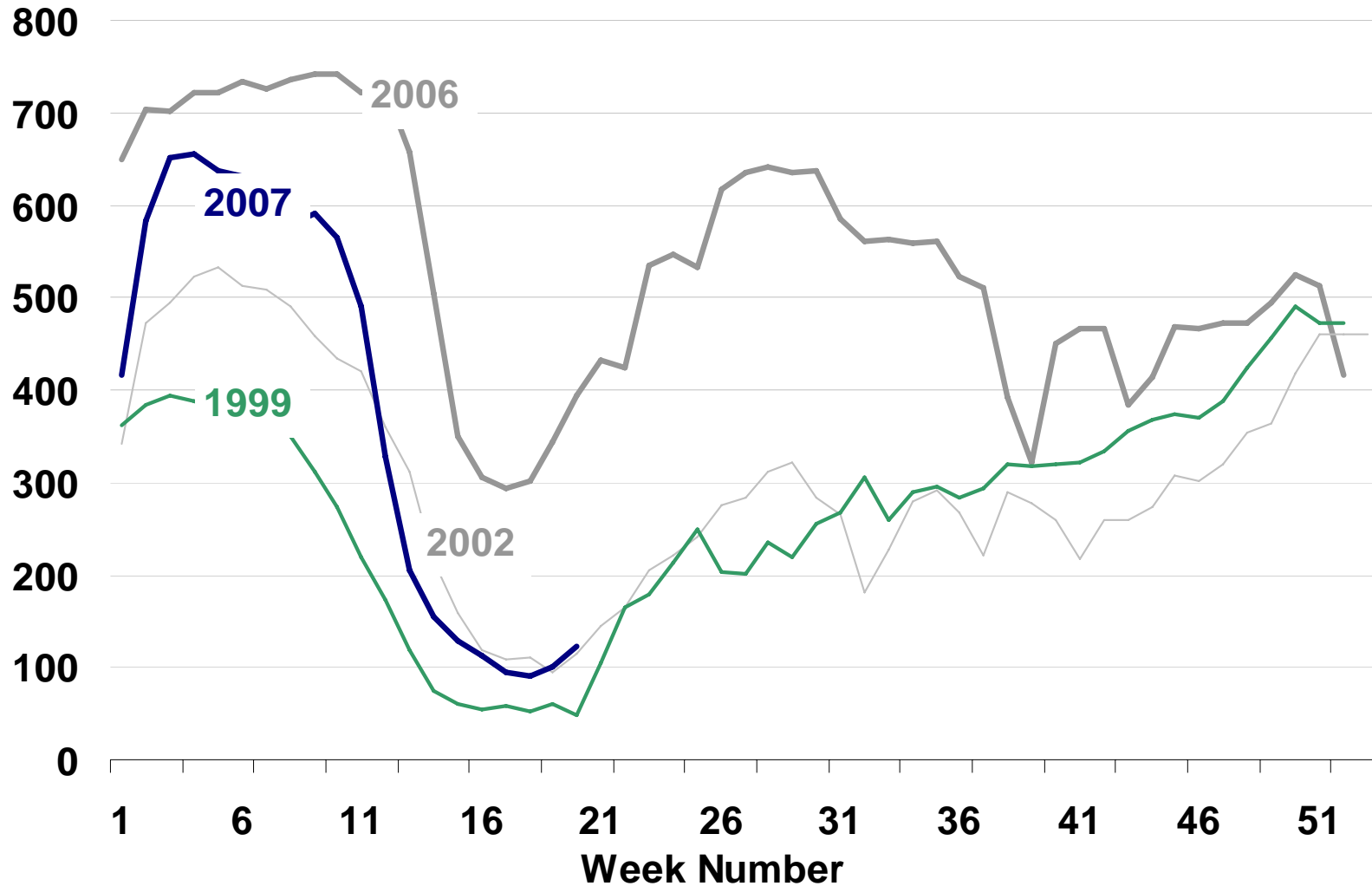
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- Alberta's prosperity, energy security and affordability are all dependent on a healthy climate for investment and re-investment within the oil and gas industry.
- The investment climate is uncertain right now:
  - An aggressively declining rig count and other indicators are real-time measures of deteriorating economic viability;
  - Cost pressures and exogenous factors (including a rising Canadian dollar) are creating an uncertain environment for investment and reinvestment;
  - Canada is now recognized to be one of the highest cost sources of crude oil and natural gas in the world;
  - Legislative initiatives surrounding environmental policy and fiscal reform is challenging the longstanding notion that Alberta's oil and gas industry has a stable fiscal framework for investment<sup>6</sup>;
  - High costs are putting junior oil and gas companies at a substantial competitive disadvantage.
- The existence of sustainable excess rent for the purposes of additional royalties is highly debatable; real-time indicators suggest no such excess rent exists now.
- **Alberta's oil and gas industry is in a vulnerable and uncertain period** – now is not a good time to be imposing additional financial burdens.

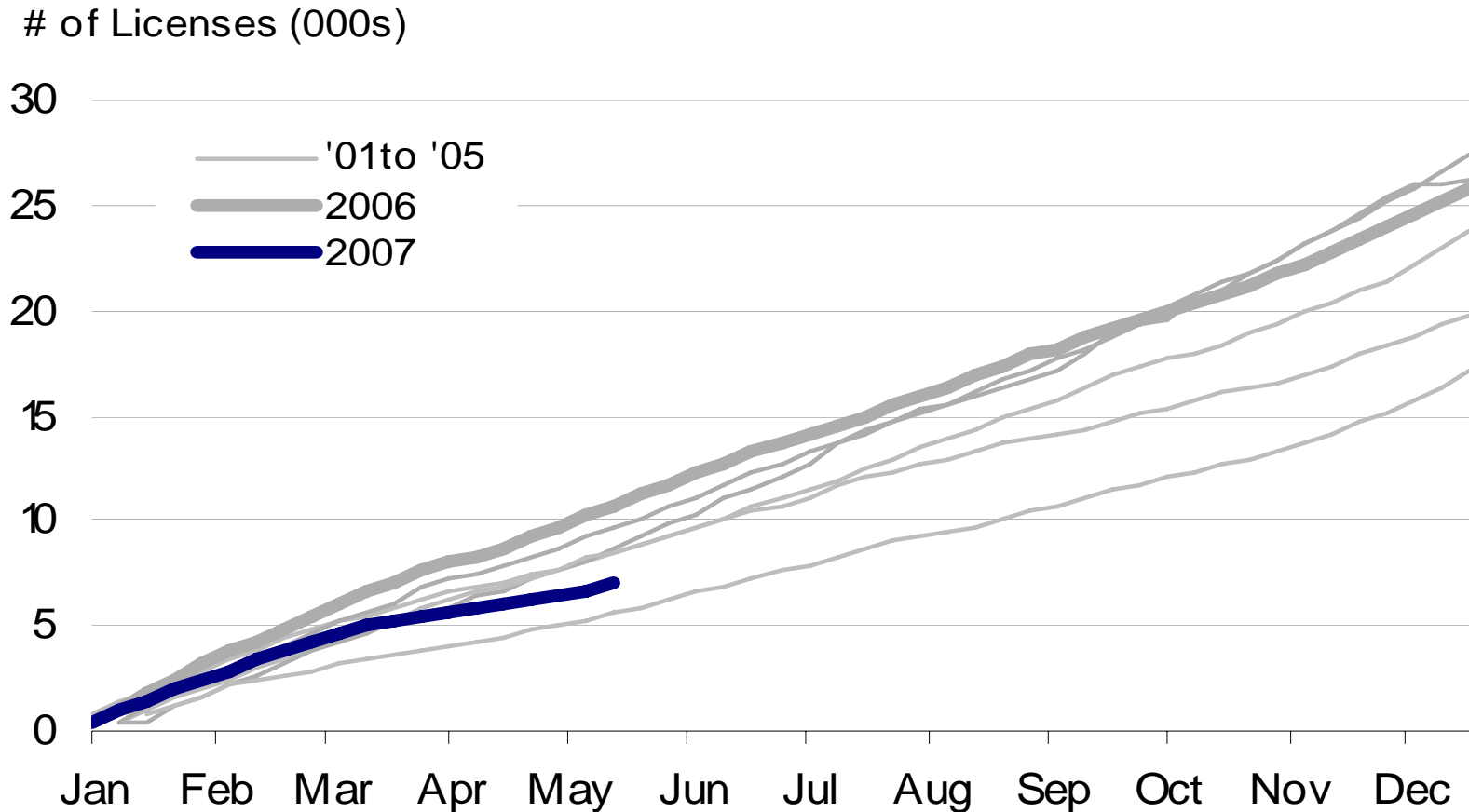
# Some Supporting Charts

# 1. Comparison of Canadian Rig Activity

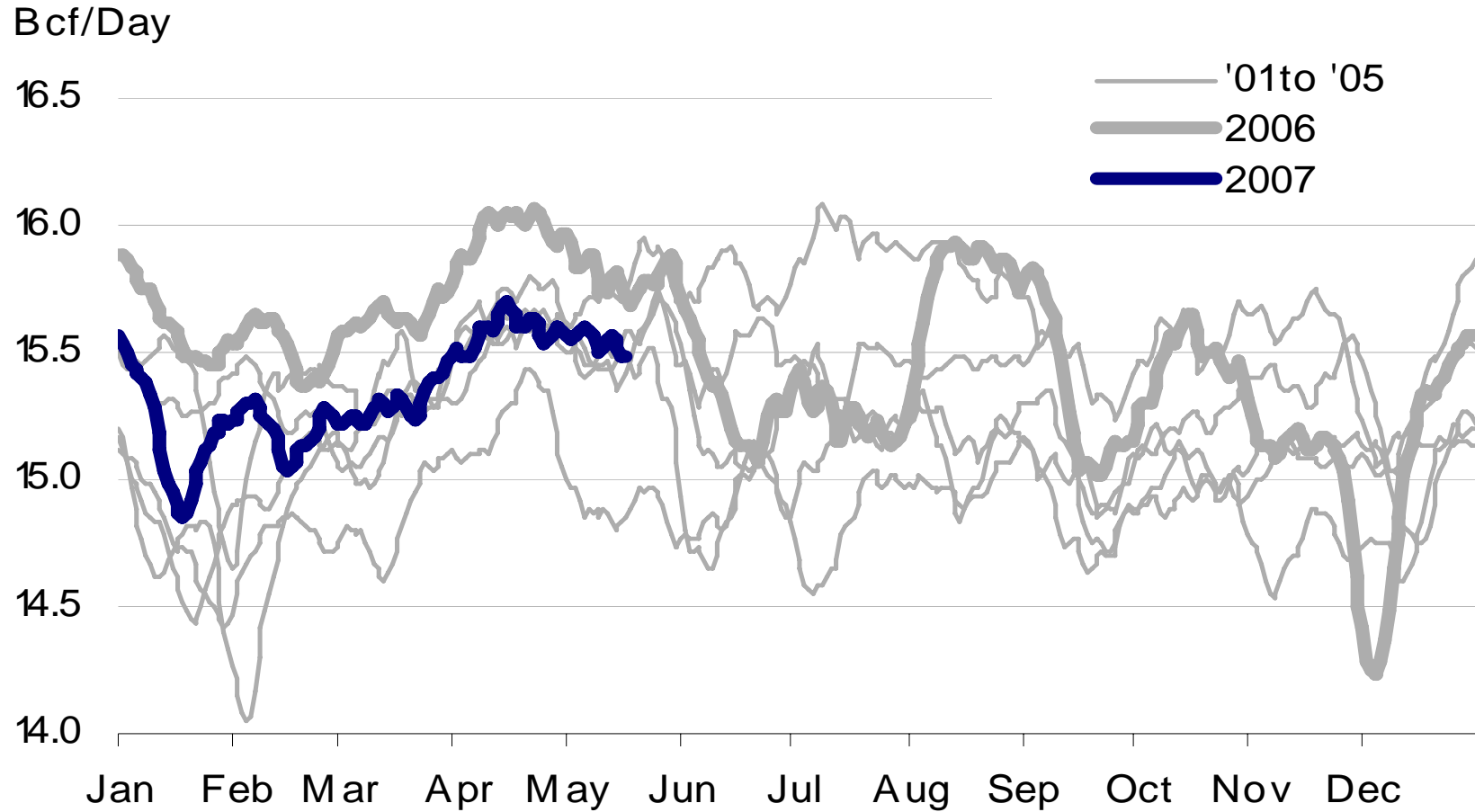
## Years 1999, 2002, 2006 and 2007 YTD



## 2. Cumulative Well Licensing Activity 2007 YTD versus Years Prior

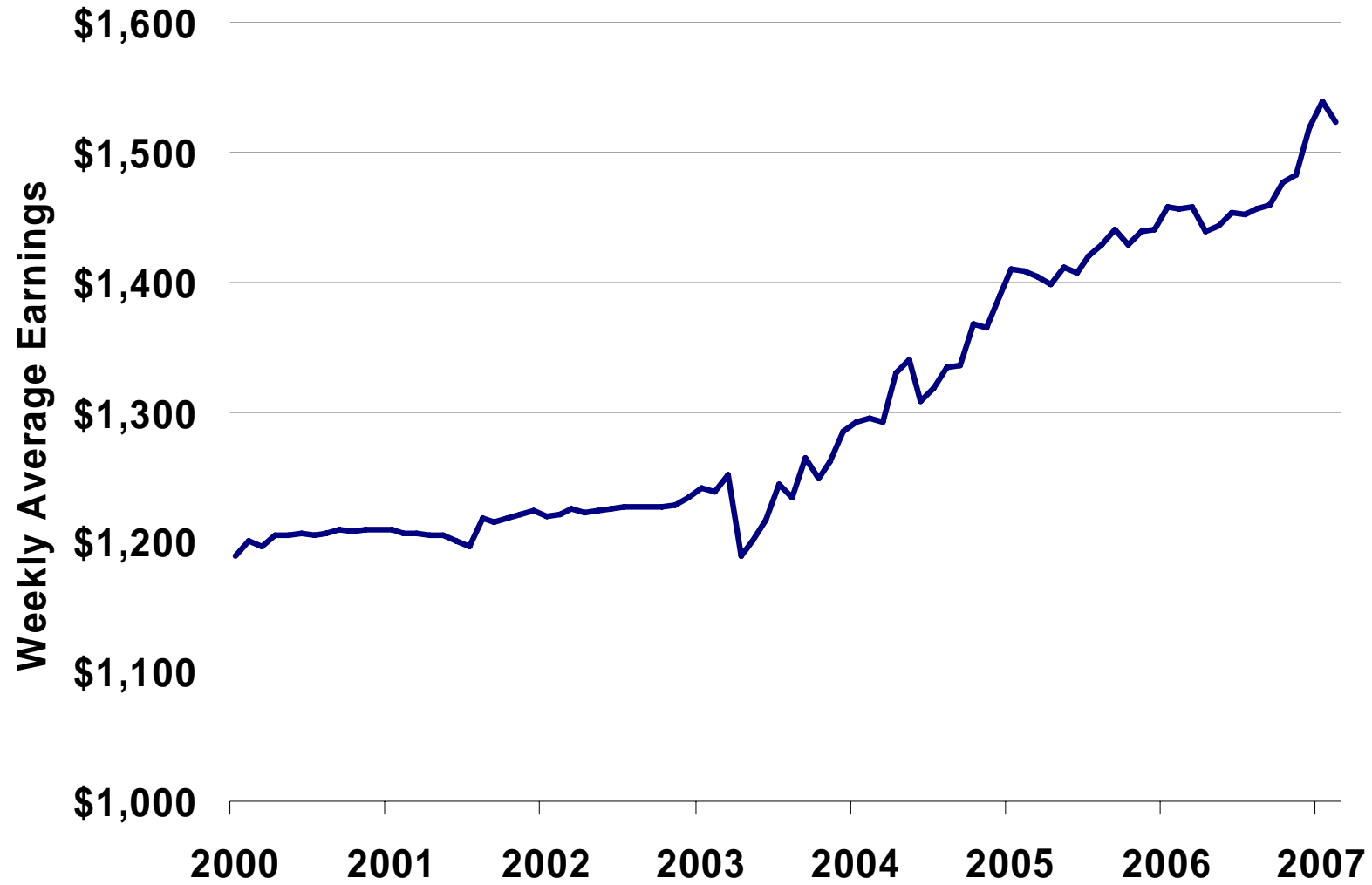


# 3. Daily Pipeline Volume Receipts\* 2001 to 2007 YTD



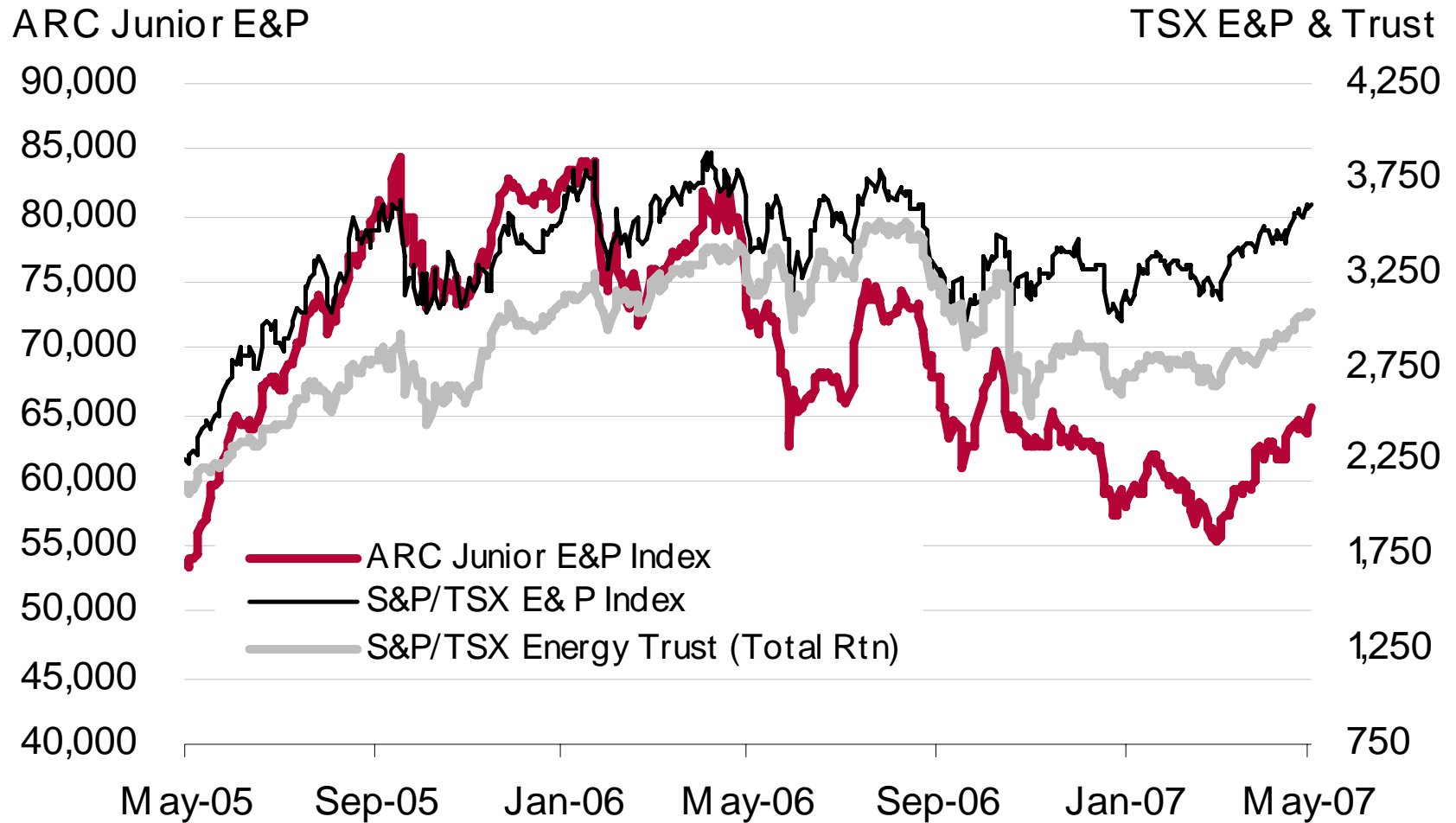
# 4. Average Weekly Earnings

## Alberta Mining, Oil and Gas Extraction Workers



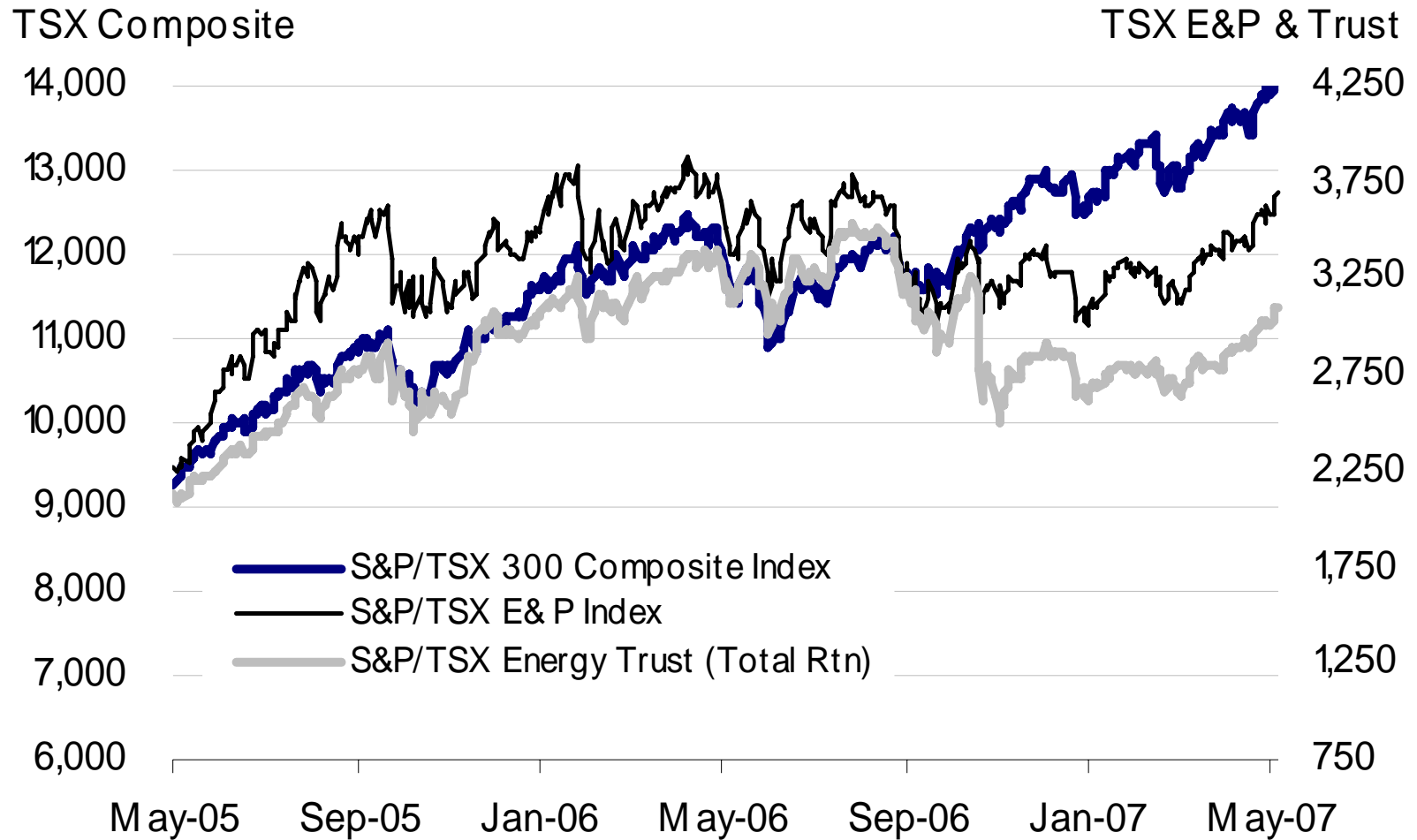
# 5. Performance of Oil and Gas Equities

## Daily Index Values; Rolling 24-Month History



# 6. Performance of Oil and Gas Equities

## Daily Index Values; Rolling 24-Month History



# 7. Canadian Natural Gas Production

## Profile by Vintage, 1950 - 2005

