

Speaking Notes
for Don Thompson
Alberta Royalty Review Consultations
Fort McMurray
4th June 2007

Mr. Chairman and members of the Panel, good afternoon.

My name is Don Thompson, I am the General Manager of Regulatory and External Affairs for Syncrude Canada, and I want to thank you for hearing from us today on the important topic of oil sands royalties.

As you know, Alberta adopted a generic royalty regime for the oil sands in 1996. Prior to that time, project developers each negotiated their own royalty terms with the Province.

Needless to say, that ad hoc system was hardly equitable to either the developers or the owners of the resource.

Moreover, the system that was in place then did nothing to promote economic sustainability or growth in the oil sands industry, which over the course of three decades had grown to only three operating projects producing about 450,000 barrels per day, about 330,000 barrels of which were upgraded. Nor did it work to enhance the industry's contribution to the GDP, despite the immense size and importance of the resource to Alberta's future prosperity. Likewise, it did not encourage industry efficiency by way of investment in technologies for the future.

In fact, the old system was such an impediment to Syncrude and the entire oil sands industry that we worked to found the National Oil Sands Task Force. If we had not done so, and had we not been successful in our quest for new fiscal terms, it is possible that our operation could have reached the end of its productive ability by 2003, and we may not be realizing the growth in our industry that we are today.

Accordingly, the goals of the fiscal structure that was implemented in 1996 were to promote economic sustainability and growth through development of the oil sands... recognize the large up-front capital investment needed to start these projects... recognize the long lead times before these projects would generate net returns... and at the same time ensure an equitable share of the economic rent back to the government, which is the owner of the resource. This new structure was also designed to provide fiscal stability and certainty over the 30- to 50-year life of these projects and to be robust over a range of crude oil prices.

Eleven years later, it is Syncrude's view that these goals have been met. What was designed to be fair, robust and effective then is still fair, robust and effective today. This is because the effort that resulted in these new terms was exhaustive and supported by considerable economic modelling and analysis that ensured it would be robust over a whole range of potential scenarios. We encourage the panel to review the reports issued by the National Oil Sands Task Force for more context on this issue.

The point is, that substantial economic growth has indeed been enabled, and the province is seeing a long-term income stream from established projects. In fact, the generic royalty regime has so far seen three new projects come on-line, two of which are into full royalty payout, with many more coming in the near future.

And while it is true that much has changed since the generic royalty regime was established... much more investment has been realized than was anticipated... and oil prices have also increased well beyond what was anticipated... factors that would suggest a rosy state of affairs for oil sands companies... it is also clear that not all of the changes have been positive.

Indeed, when the National Oil Sands Task Force first tabled its proposals, it worked to the assumption that the return on investment to developers should be about 15 per cent.

Subsequently there were reductions in the federal and provincial corporate income tax rates to ensure that all areas of the Canadian economy remained globally competitive... and this move benefited businesses of all kinds, including oil sands developers.

While higher oil prices have increased the returns enjoyed by developers, the self-adjusting nature of the generic fiscal regime means that the government also gets a higher take at both the pre-payout royalty of one percent of gross revenue... and the post-payout royalty of 25 percent of net revenue, which Syncrude achieved on its most recent expansion at essentially the same time as that expansion came on-line. The point is, if developers revenues are higher, so are those to the people of Alberta – exactly what the current fiscal terms were designed to achieve..

But the cumulative effect of many other factors has had an overwhelmingly negative effect.

Capital costs, for example, have more than doubled, meaning that where it was assumed that \$25 billion in investment would lead to production of 1.2 million barrels per day, it actually took about \$54 billion to achieve.

So that's one hit to overall project returns.

We have also seen a steady rise in the value of the Canadian dollar as compared to the U.S. dollar, and this isn't good because our product is priced in U.S. dollars while our costs are in Canadian dollars. So a higher dollar is effectively discounting the margin on every barrel produced.

As well, Syncrude's operating costs have more than doubled, from \$12 to \$25 per barrel, and we continue to see cost escalation well above the rate projected by the National Oil Sands Task Force. Because about 65 percent of these costs are for contract labour, employee wages and benefits, and purchased energy, we do not foresee any abatement in this situation and, moreover, other than purchased energy, we do not see these costs being coupled to the commodity price for crude oil – if crude prices goes down, these costs will stay high..

Beyond that, sustaining capital... that is, the capital we must regularly invest just to maintain the operations we have built... has increased from \$1.50 per barrel to the \$5 per barrel range.

And just last year, the federal government chose to eliminate the Accelerated Capital Cost Allowance, a move which reduced Syncrude's return by another half of a per cent... and the impact of this loss will become even more significant as we move toward 2015.

Finally, the industry is now facing costs related to greenhouse gas emissions and other potential environmental levies and taxes. Alberta, for example, is the only province in Canada to have introduced a carbon tax... and some recommendations from the Multi-stakeholder committee have very high potential costs. Compounding this are increased municipal taxes for those operating in the Wood Buffalo region; indeed, Syncrude forecasts that its 2006 municipal taxes of \$32 million will increase to over \$65 million in

2007. This amount represents over 35 percent of all taxes collected in the Regional Municipality of Wood Buffalo.

In total, these hits have, by our estimating effectively reduced the envisioned return on investment for new projects from 15 per cent to about 8 per cent, a level which significantly limits the number of investors willing to accept the considerable risk inherent with new oil sands development, especially given the notorious volatility of oil prices. I should note that the drop in return from 15 to 8 per cent assumes an average oil price of \$50 U.S. per barrel over a 40-year project life, which is a very optimistic assumption. Those of you who read the newspaper will recognize that this projection is reasonably close to that recently publicized by another developer.

To my mind, a 50 per cent loss in value and project returns simply does not make a compelling business case for further development. That said, the only opinion that really counts is that of the conservative minded investor, because the investor ultimately decides what current and projected economic climate will exist and whether or not it will be good enough to justify their investment decision.

If the province were to further compound this situation by changing the fiscal regime upon which many of the projects now on the drawing board were premised, I believe a potentially negative investment climate would result, and many projects would need to be re-evaluated. A tremendous opportunity for the people of Alberta would then be at risk.

While we recognize the pressures the province faces in dealing with the impacts of economic growth, we do not believe the solution lies in increasing oil sands royalty rates. In fact, this move would likely lead to a significant slowdown in new development and it would effectively value the royalties from these cancelled projects at zero. If projects do not proceed, Albertans receive no benefit, either through economic activity or ongoing royalty payments.

Moreover, the debate over royalties has, in our view, clouded people from seeing what is the real golden egg, which is the many billions of taxable dollars that are spent each year on capital and operating expenditures.

In fact, between 1979 and 2006, the combined return to project owners and governments from the Syncrude Project was about \$12 billion dollars, half of which went to the government in the form of royalties and taxes. But this figure is dwarfed by the more than \$50 billion dollars that was spent on capital and operating expenditures. That's \$50 billion dollars that went directly into the economies of Alberta and Canada over that period which, in turn, generated \$7.5 billion to governments for business and payroll taxes, municipal taxes and other Crown charges.

If new projects do not proceed due to a change in the fiscal structure, the royalties from these will be lost, but more importantly, the greater loss will be all the taxable money that would have been spent building and maintaining these facilities... money that would have been spent on supplies and services provided by the many, many companies that depend on the oil sands... and money that trickles down to the thousands upon thousands of workers whose livelihoods also depend on the oil sands. Also lost would be the impetus to invest in long-term R&D to enhance efficiency and improve environmental performance all of which has the potential to extend the size of the resource base and extend the life of the industry.

So, again, the golden egg for government lies not in the royalties and taxes it receives directly from operations like Syncrude, but in the taxes and economic activity generated by the money we spend to build and maintain our operations.

On this, it is important to remember that the oil sands is not a cyclical business. Instead, it is more like a manufacturing business that operates without interruption, year in and year out. Once the investment has been made to build an oil sands facility, it cannot be shut-in during times of low oil prices.

In fact, we must maintain, or even increase, production to survive downturns, meaning that the overall economic benefits remain high even when profits sag - something that cannot be said of the conventional oil and gas industry. With conventional, when times

are bad, the wells are not drilled or get shut-in, the revenues to government dry up, and jobs are lost.

In a similar vein, considerable sums must be spent to maintain oil sands facilities during good times and bad, and this fixed spending provides a reliable source of taxation revenue to government. Moreover, it keeps people employed in highly skilled, well paying jobs.

Given the very long life of these facilities... anywhere from 30 to 50 years... the reliability of the income stream is a very important consideration. And, outside of royalties, when you multiply the \$50 billion dollar effect Syncrude has had on the economy over its 28 years to date by the number of facilities now under construction or proposed, you arrive at a very large figure.

To date, the provincial government has already reaped more rewards than were anticipated by the National Oil Sands Task force back in 1995, and these will increase as projects now under development reach pay-out and convert to paying royalties of 25 per cent of net revenue.

As you consider the fairness of the current fiscal system, it is tempting to look only at the picture as it is today: high oil prices combined with robust industry growth would seem to suggest that the oil sands is a license to print money. But project proponents also assume a tremendous amount of risk in the uncertainties they face.

We have seen these risks move from the theoretical to the real, and if an increase in royalties is piled on to these, I fear that we may effectively kill the goose that is laying golden eggs. Industry growth may well come to a standstill, and all of the economic benefits that these new projects would have generated will have been lost.

So while some would argue that an industry slow-down would benefit the province, I would point out that the last slow-down in the oil sands lasted for about 20 years—that's the gap between the start-up of Syncrude in 1978 and the start-up of our North Mine in 1997 – and this project was primarily to sustain the Syncrude operation. The next “new” project was Suncor's Millenium which did not start-up until 23 years later in 2001. Importantly, it took the generic fiscal regime to bring this change about.

Mr. Chairman, I would remind the panel that the assumption of long-term fiscal and political stability is what helped attract all of the investment that we have seen come to the oil sands of Alberta. But global capital is mobile and it is fickle, and it will go where the best returns are to be found.

Unfortunately, with current projections suggesting that returns for new projects are now hovering around eight per cent... a figure which is close to the cost of capital for most investors... the oil sands risks being seen as marginal rather than attractive. Moreover, the mixed signal that the government will send to the markets on this issue also could have a negative effect on other Alberta industries that also seek capital from global markets.

Syncrude and our oil sands colleagues want to pay our fair share and we believe we have been since the implementation of the proposals put forth by the National Oil Sands Task Force. In our view, the 50/50 split is fundamentally about as fair as it can get.

Between 1979 and 2006, governments, through royalties and taxes, received 49 per cent of all returns, and looking forward with the system as it is today, we project governments will receive 48 per cent. I should note that this minor change.... just one per cent... is not due to a reduction in royalties but to a reduction in corporate taxes, a change enjoyed by businesses of all kinds.

In conclusion, Mr. Chairman, we at Syncrude believe Albertans are indeed receiving fair value from the development of their oil sands resource, and they will continue to do so over the long life of these projects.

Unlike the booms and busts that have characterized the conventional oil and gas business, the oil sands has provided a steady and reliable income stream to governments through direct payment of royalties and taxes by oil sands operators... and governments have also benefited—in a much more considerable way—from the many billions of taxable dollars that are spent to build these facilities, and more importantly to maintain them, for the 30- to 50-year duration of their operating lifespan.

While existing projects will continue to operate... and continue to pay substantial returns to Albertans... the fear is that new development will effectively be halted by an increase in royalties, thus negating any additional benefit Albertans might hope to receive through new project royalties, taxes and spin-off economic activity such as procurement and job creation.

With that, Mr. Chairman, I would like to again thank the panel for hearing from Syncrude today. We will be filing this submission and some additional explanatory view graphs with your recording secretary. Now, I would welcome your questions.

#