

Petro-Canada's Submission to the Alberta Royalty Review Panel

June 18, 2007

Introduction

Petro-Canada is pleased to submit this document and to be part of this very important royalty review process.

The recommendations this panel makes to government on Alberta's royalty system, inclusive of oil sands, conventional oil and gas and coalbed methane, will have significant and far-reaching implications for the health of our industry—and our economy. Petro-Canada would like the panel to consider the old physicians' motto which says: "First, do no harm."

Our industry and our company is more than oil sands, and Albertans need to be sure that a balanced royalty regime is not overly weighted to one part of the industry over another. This is particularly so, where the effect of tinkering in one area can have equal and opposite impact in another.

Petro-Canada Overview

Petro-Canada is one of Canada's largest oil and gas companies, operating in both the upstream and downstream sectors of the industry in Canada and internationally. Headquartered in Calgary, Petro-Canada has more than 5,000 permanent employees. In 2006, Petro-Canada's upstream production stood at 345,000 barrels of oil equivalent per day (boe/d) from continuing operations. Production is expected to increase by 15% in 2007, to a forecasted range of 390,000 boe/d to 420,000 boe/d net.

Our upstream operations include natural gas, crude oil and natural gas liquids in Western Canada and the U.S. Rockies; offshore oil projects near Newfoundland; oil sands production in Alberta and natural gas and oil development in Europe, Africa and Latin America.

Petro-Canada is also Canada's second-largest downstream company. Our Edmonton and Montreal refineries accounted for 13% of Canada's refining capacity in 2006. That same year, our retail stations across the country accounted for about 16% of all petroleum products sold in Canada.

Western Canada Oil and Gas

Petro-Canada believes that the current royalty framework for conventional oil and natural gas is appropriate given that it meets the test of both flexibility and fairness. In particular, the current royalty rates are self-correcting because they adjust for both prices and production per well. This flexibility lends itself to continuously changing economic conditions.

The nature of the conventional resource base in the Province of Alberta is indeed changing – and it's not just about price volatility which is a normal part of the risk we assume in this business.

The Western Sedimentary Basin, from which Alberta has drawn her great prosperity, is maturing. We are conducting our conventional business in an Alberta where the amount of gas produced per day, or the productivity, of new wells has declined by a factor of three since 1995 and the total number of wells drilled has increased by a factor of four. The cost of each unit of production is increasing rapidly and significantly, pushing industry returns to the economic margin at current prices. A tangible example is the impact of recent lower gas prices and higher costs on industry drilling, which is down 25% in Alberta from last year alone.

Nonetheless, the conventional sector will continue to be the largest resource investor in the province in 2007. The industry will spend a forecasted \$28 billion and will just hold gas production flat this year. Pricing volatility, cost pressures and a maturing basin lead to Alberta's challenging well economics and a changing future outlook.

Smaller and more costly conventional opportunities have necessitated industry to look to more unconventional, more costly and more remote sources of future production, such as tight gas, deeper formations, natural gas from coal and shale gas.

And yet, conventional (i.e. non-oil sands) oil and gas is, and will be into the foreseeable future, an important part of Alberta's and Petro-Canada's total production, investment and royalties.

Petro-Canada is the seventh largest gas producer in Western Canada. In 2006, Petro-Canada's conventional oil and gas business accounted for

royalty payments of \$266 million, and Alberta income tax payments of \$106 million with the direct employment of 700 Albertans. In addition, Petro-Canada spent \$23 million in land bonus payments in Alberta last year.

Under the current royalty structure, the royalty rates for conventional oil and natural gas are based on when that oil and gas was found. The rates automatically adjust for prices and production per well – both designed to accommodate a wide range of economic conditions. However, the rates do not adjust for rising costs.

The oil and gas industry currently faces several additional costs, new government policies, and increased research and development (examples include: climate change, federal tax policy and longer regulatory processes), which will have a large impact.

The combination of the maturing Western Sedimentary Basin and rapidly increasing costs over the last few years means that future industry returns will be at the economic margin and stretched to provide a competitive return on the significant capital investment made by Petro-Canada and by industry as a whole at current prices.

As we continue to transition to higher costs and a more uncertain future conventional production base, we believe strongly that the existing royalty structure is appropriate for the oil and gas industry in Western Canada. We feel that any increase in royalties could make future investments uneconomic at current prices.

Oil Sands

The current oil sands royalty regime is part of a fiscal framework put in place in 1996 after extensive consultation between federal and provincial governments and the industry. Fairness and flexibility were critical hallmarks of the agreement that was reached:

- **Fairness** in recognizing that oil sands investors needed to be assured of a fair balance between risk and return while Albertans, as the owners of the resource, deserved to receive a fair share of the economic benefits generated by development.

- **Flexibility** in recognizing that oil sands development was an entirely new kind of energy play—technology-driven, capital-intensive and with a huge lag time between investment and actual production and revenues.

These two principles are reflected in the current royalty structure. But for oil sands, it led to a royalty regime that sees developers pay a 1% levy on gross revenues until capital costs are recovered—and then pay the full 25% royalty rate on net revenue over the decades-long life of these mega-projects.

The result was exactly as intended. We can draw a straight line from the decisions taken a decade ago to the \$100 billion in planned or existing oil sands development—and the jobs, government revenues and general economic growth this is generating.

Much is made of the fact that world oil prices in 1996 stood at about \$20 per barrel, whereas today they are on average triple that. There is a growing perception that industry is benefiting unduly from higher prices while governments' revenue is shrinking. Given the high-cost environment in which new oil sands projects are being built, the business economics have improved less than many realize. We feel this is certainly a situation where perception does not equal reality.

Petro-Canada's oil sands interests come from a long-standing 12% stake in Syncrude, the world's largest oil sands mining operation. But our entry as a major oil sands player really began with the development of our MacKay River *in-situ* leases, which we own outright.

The MacKay River facility opened in 2002 and helped pioneer the steam assisted gravity drainage technology that has revolutionized this industry by allowing us to recover oil buried too deep to be mined. We are currently in the planning phase of a multi-billion dollar expansion to the MacKay River project.

The next big step was in 2005 when Petro-Canada acquired a 55% interest in the Fort Hills mining project. This partnership, together with UTS Energy Corporation and Teck Cominco, will mine one of the largest remaining undeveloped oil sands leases in the Athabasca region.

Together, Petro-Canada's *in-situ* and mining leases represent a significant recoverable oil sands resource. We estimate we will be able to recover 10 billion barrels of dirt. And, it's some of the best dirt in the world which means that it will take less energy and is easier to recover and get to market.

Petro-Canada has plans in place to triple current levels of oil sands production to 190,000 barrels per day by 2013. This would be followed by further *in-situ* and mining expansions to take us ultimately to 350,000 barrels per day.

But Petro-Canada is not content to simply extract this resource. Our goal is to see all of this oil upgraded to sweet synthetic crude or finished refined products.

We intend to capture the full value of this oil sands resource—from extraction to the Petro-Canada gas pump. To that end, the company is completing a \$2 billion conversion of its existing Edmonton refinery to upgrade and refine oil sands feedstock exclusively. We are also seeking regulatory approval to build a new multi-billion dollar upgrader near Edmonton to handle the flow from the Fort Hills project.

We believe this “wells-to-wheels” approach is in-synch with the stated aims of the provincial government—namely to keep as much of the added value from the oil sands as possible right here in Alberta, producing economic benefits for generations to come. We project, based on a plan of upgrading 350,000 barrels per day in the province, that such an investment would add \$30-\$50 billion to Alberta's GDP over the next 15 years, and create a spin-off economic benefit of \$3-\$5 billion every year thereafter.

It is clear oil sands is a key element of Petro-Canada's future - as it is for Alberta, and for Canada as an energy super power in the making.

This is not the time to change royalties that discourage investment in the very projects that could fuel Alberta's economic future. We should not be hampered in our shared goal of generating added value to the oil sands or our search and development of oil and gas in a conventional environment that is moving to non-conventional.

Challenging Economics

Despite relatively high world oil prices, the economics of all oil and gas development remain as challenging as they were a decade ago— perhaps even more so.

Oil sands is risky business. Oil sands projects are long-term, capital-intensive propositions that require an extraordinary level of sustained investor confidence to pull off. In the case of our Fort Hills mine, for example, Petro-Canada and its partners will have invested more than a decade of planning and development, and billions of dollars, before we produce a single drop of oil. It is even riskier and more difficult to build upgraders here in Alberta, with escalating costs and challenging environmental and operating conditions.

While it's true that average world oil prices are three times higher than a decade ago, it's equally true that industry's costs—for labour, materials and equipment—have increased at least 300% in the last five years alone.

Take our MacKay River facility as an example. It was completed at a cost of \$300 million during a time when world oil prices had again dipped to about \$20 per barrel. To build the same facility today, in a \$60 per barrel environment, would cost about \$1 billion—more than triple.

Petro-Canada plans to spend tens of billions of dollars to build and operate our new oil sands projects. For Albertans and Canadians, the good news is: that's a lot of money our company will be injecting into the economy. The reality, though, is that we have to go to the market and raise that cash before any of this can happen.

Our industry is reliant upon investors in a similar way that governments rely upon those who pay taxes – and royalties.

Recent developments have deepened the investment challenge for Petro-Canada and Alberta. The Canadian Loonie is almost at par with the American dollar. This means industry's revenue decreases because oil is priced in U.S. dollars. And this reduced revenue will in turn result in reduced royalties and corporate taxes for the province.

Add to this the federal government's decision to claw back another key element of the 1996 fiscal framework—the accelerated capital cost allowance or the ACCA. The ACCA phase-out particularly hits companies, like Petro-Canada, which are investing in value-added upgrading. We are concerned because it singles out just the oil sands industry—other Canadian mining sectors remain untouched.

Yet another cost pressure for our industry comes from the new greenhouse gas emission targets set by both the Alberta and federal governments. Petro-Canada has already invested significantly to reduce its CO₂ emissions—and we are committed to meeting these new targets through further technological improvements. We recognize the importance of reducing greenhouse gas emissions, but it will not come cheaply.

Taken together, these factors—much higher capital and operating costs, the ACCA claw back and the costs of reducing GHG emissions—mean that the return margins on oil sands mega-projects are, if anything, even slimmer than they were when the current royalty regime was established.

The question remains: why proceed with development at all?

Because, once the up-front costs of developing these oil sands mega-projects is covered, they represent a long-term, stable source of production and profit for our shareholders; jobs for Albertans; and substantial tax revenues for governments at all levels. Under the current royalty regime, cost recovery is the point where companies start paying out the biggest dividends to the owners of the resource, Albertans.

When oil prices are relatively high, as they are today, this happens sooner rather than later. Take the example of Syncrude's recently completed Stage 3 expansion. Because of higher oil prices, revenues from Syncrude's base operations allowed the company to pay out the cost of expansion at the same time the project was completed. As a result, Syncrude has been paying the 25% royalty rate.

But even in the advent of lower oil prices, the long-term pay-off for Albertans is significant. For example, based on our current growth strategy and a benchmark oil price of \$45 per barrel, Petro-Canada's royalties are projected to increase from \$40 million a year before royalty payout to \$600

million annually after payout. Over the same period, corporate income taxes (federal and provincial) would grow from \$850 million to \$1.3 billion annually.

Petro-Canada's total payments to governments from oil sands are estimated to reach \$900 million per year by 2020 and \$1.9 billion by 2030.

Those numbers do not account for the billions of dollars Petro-Canada's oil sands division would generate in terms of personal, consumption, business and property taxes.

We believe it is critical to leave the current royalty regime unchanged to sustain investor confidence over the long term and bring these projects to fruition. This will allow Petro-Canada's oil sands operations to contribute significantly to the prosperity of all Albertans and all Canadians for generations to come.

Preserving the Alberta Advantage

We often hear and talk about the Alberta Advantage. It's all about the quality of life that we've built here through a combination of fiscal prudence, entrepreneurship and respect for the environment. Petro-Canada wants to see the Alberta Advantage preserved.

Investors need stability and predictability. They don't like uncertainty. The ACCA claw back and the additional costs associated with climate change are already rocking the investment boat. This is not the time to abandon a royalty regime that has done so much to fuel the Alberta Advantage.

Premier Stelmach has said that Albertans can "...be confident that the royalty structure will meet the needs of the province as we work together to build a stronger Alberta." And Minister Oberg stated when charging this panel, "We need to be certain that the royalty regime is providing Albertans with a fair return on the province's natural resources while maintaining an internationally competitive system that allows the Alberta economy to continue to prosper."

Given the tremendous momentum this industry has already demonstrated, and the potential that exists to promote economic growth for decades to

come, Petro-Canada is confident the existing royalty structure provides the necessary certainty so that our economy will continue to prosper.