



Alberta Royalty Review Submission

June 19, 2007

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The Petroleum Services Association of Canada (PSAC) thanks the Alberta Royalty Review Panel for the opportunity to present this paper on behalf of its members. PSAC and its members recognize that the Royalty Review process provides the petroleum industry with a welcome opportunity to hear from those outside the industry and to enhance Albertans' understanding of the oil and gas industry and its contributions to the province and its citizens.

Canada's petroleum industry: Complex, dynamic and growing

Alberta's petroleum industry is probably the most talked about and least understood industry in the province. It is this very complexity however that makes the industry fascinating, dynamic, growing and, above all, lucrative for Albertans.

PSAC is proud to be an integral part of the petroleum industry in Canada and particularly in Alberta. PSAC is the national trade association representing the service, supply and manufacturing sectors within the upstream petroleum industry. Across Canada, the petroleum service sector generates on average \$1 million in revenue for every well drilled and completed, which in 2006 added up to more than \$23 billion. In addition, revenue is generated for ongoing service operations, including well maintenance and optimization, that occur over the lifetime of each well. PSAC members represent over 80 per cent of this business volume. For more information about PSAC and the service industry, we encourage you to visit www.psac.ca.

Petroleum services: A vital part of the industry

Petroleum service companies contract almost exclusively to oil and gas exploration and production companies, providing for them the valuable services that keep the petroleum industry operating. Many Albertans do not realize there are more than three dozen different services needed to drill, complete and maintain oil and gas wells. These services include drilling, drilling fluids, wireline, fracturing, perforating, cementing, well testing, snubbing, transportation, construction, safety and environmental services, as well as supply and manufacturing, just to name a few (see Figure 1).

Each of these services employs a great many people. Drilling a single well, for example, can require up to 75 workers, including everyone from drill bit suppliers, surveyors, truck drivers, water haulers, caterers and reclamation professionals, in addition to the rig crew itself.

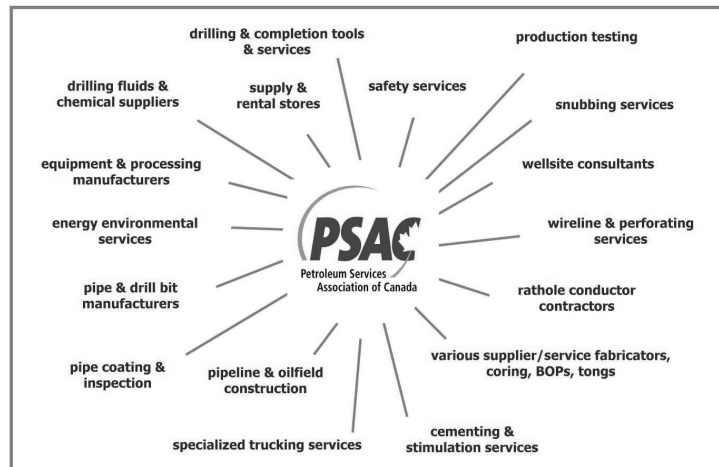


Figure 1

Sizing up the Energy

Economy for 2006¹

Figure 2 illustrates where the service sector fits into the petroleum industry, and highlights the vital role the sector plays in resource exploration, reserve additions, production growth, revenue generation and payments to government.

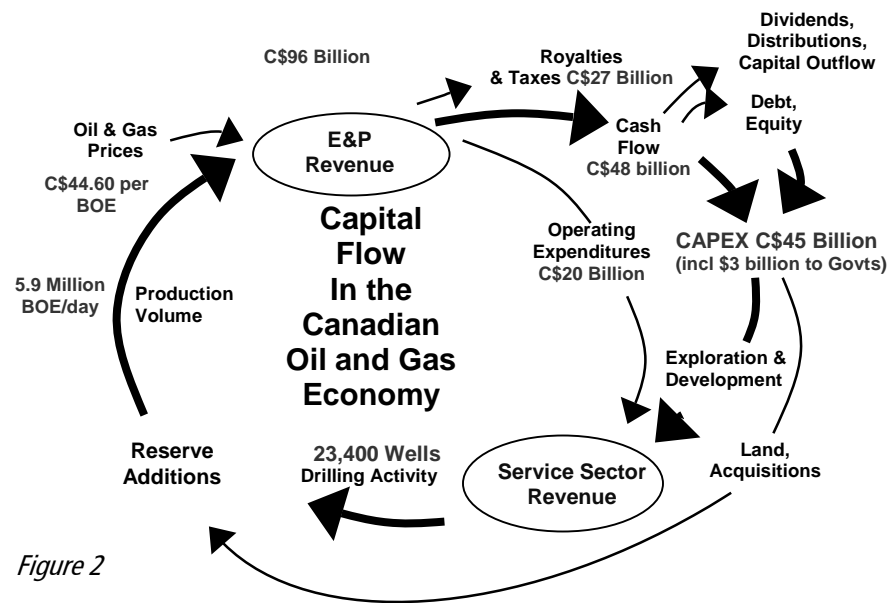


Figure 2

Petroleum service companies operate in and between virtually every community in the province, from Rainbow Lake to Medicine Hat, Lloydminster to Grande Prairie. Wherever there is oil and gas activity in Alberta, there are petroleum service companies, owners and employees. In fact, PSAC estimates that more than 80 per cent of the service sector’s employees live and work outside of Calgary.

Currently, 258 (more than 95 per cent) of PSAC’s member companies are Alberta-based. Together, PSAC members employ 68,000 people, primarily Albertans. Those people live and work in small towns and cities in every corner of the province. They pay taxes; they vote; and they spend their disposable income here.

Those 68,000 people are about half of all those working in the service and supply sector across Canada. They and their families are living proof that the western Canadian oil and gas industry isn’t just about “big oil” corporations – it’s about people, ordinary people. As a result, any decisions made that affect Alberta’s petroleum industry – like changes to the royalty structure – must be made with people, not corporations, in mind.

This paper, submitted by PSAC on behalf of its members and the entire service sector, looks at the royalty system and describes how changes to it could adversely affect the many thousands of Albertans working and investing in the industry, and the millions of citizens benefiting indirectly from it.

¹ ARC Financial & Canadian Association of Petroleum Producers (CAPP)

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Oil and gas: Alberta's economic driver

We'll start by identifying the benefits derived from the petroleum industry. Alberta counts on non-renewable resource revenue to fund its many programs and services. This revenue comes directly from royalties, land leases, fees and corporate taxes paid by companies in the petroleum industry. Although the productivity of Alberta's conventional resources has fallen, revenues from royalties and lease sales have risen significantly over the past decade because of commodity price increases, record levels of drilling and high demand for land.

The provincial revenue numbers are impressive. In the 2007-2008 fiscal year, non-renewable resource revenue is projected to reach \$10.2 billion, 29 per cent of the province's total revenue stream² and equivalent to Alberta's health care expenditures. In 2006-2007, non-renewable resource revenue reached \$11.7 billion, including \$9.3 billion in royalties.³ In 2005-2006, following the industry's record year, non-renewable resource revenue topped out at \$14.3 billion.⁴

Further, the industry is responsible for creating and sustaining thousands of well-paying jobs in this province and country. According to a recent study by Statistics Canada, employment in the Canadian upstream petroleum industry increased 65 per cent over the past 10 years, more than three times the average employment growth in the country.⁵ Of the 177,000 people directly employed in the upstream petroleum industry, 75 per cent live in Alberta.⁶ The people working in this industry earn about \$30 an hour, on average 80 per cent more than the average worker across Canada.⁷ In Alberta, the average oil and gas worker earns closer to \$38 an hour.⁸ Further, an additional 98,000 people work in jobs that support the industry, an increase of 88 per cent from 10 years earlier.⁹

Because of strong employment and high wages, the total government share of the oil and gas industry is boosted through income taxes. The province receives hundreds of millions of dollars in personal income taxes every year, paid by the many thousands of Albertans who work directly or indirectly for the petroleum industry. Because of the petroleum industry, people are operating and working in hotels and restaurants; car and truck dealerships; coffee shops and retail stores; technology, construction and communication companies; banks and finance companies; law, accounting, safety and environmental service firms; and many more services. And all of these people are paying their fair share of provincial income taxes.

² Alberta Finance – Revenue http://www.finance.gov.ab.ca/publications/budget/budget2007/fiscal_tables_charts.html#revenue

³ Ibid

⁴ Ibid

⁵ Statistics Canada – Fuelling the Economy <http://www.statcan.ca/english/freepub/75-001-XIE/10507/high-2.htm>

⁶ Ibid

⁷ Ibid

⁸ ARC Financial – Weekly Energy Charts http://www.arcfinancial.com/index.php?option=com_content&task=view&id=38&Itemid=47

⁹ Statistics Canada – Fuelling the Economy <http://www.statcan.ca/english/freepub/75-001-XIE/10507/high-2.htm>

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Petroleum: Source of the “Alberta Advantage”

For many Albertans, the financial benefits that come from the petroleum industry are virtually invisible. They know the province is well off because of oil and gas, but many do not realize the far-reaching impacts the industry has on the province and its citizens.

The fact is, the “Alberta Advantage” is the direct result of years of oil and gas activity in the province. The most obvious advantage for Albertans is living in the only province in the country without a provincial sales tax. In fact, Alberta boasts the lowest combined provincial and municipal tax load, at 54.8 per cent of the national average.¹⁰ The Canadian Association of Petroleum Producers (CAPP) estimates that without the annual revenues realized from the oil and gas industry, Alberta would need a 16 per cent sales tax to maintain the level of services citizens currently enjoy.¹¹

Further, Albertans have the highest personal income and the highest disposable income per capita in Canada. Our living standards are 45 per cent above the national standard and our unemployment level is consistently the lowest in the country.¹²

Canadians are flocking to Alberta from every province and territory in order to capture their own piece of the Alberta Advantage. They want to live in a province that is debt-free; a province whose economy grew by 7.0 per cent last year; a province that has created approximately 465,600 new jobs in the last 10 years; a province that boasts “world-class infrastructure to support business, including transportation, telecommunications, and utilities, as well as excellent hospitals, schools, and post-secondary institutions”.¹³

There are bigger picture benefits as well. Energy makes up more than 28 per cent of the province’s gross domestic product. In 2006, Alberta businesses exported \$90.1 billion worth of goods and services to world markets, an increase of about 149 per cent over 1996. Crude oil and natural gas made up \$31.2 billion of those exports.¹⁴

Viewed from any angle, the industry and the system that it works within are clearly working. The oil and gas industry is operating fully in the province, employing thousands of people and paying billions to the government. In turn, the government is using its substantial annual non-renewable resource revenues and other tax revenues to fund programs and infrastructure that benefit all Albertans.

¹⁰ Alberta Government – Alberta Advantage <http://www.alberta-canada.com>

¹¹ CAPP – Oil Sands <http://www.capp.ca/raw.asp?x=1&e=PDF&dt=NTV&dn=121342>

¹² Alberta Government – Alberta Advantage <http://www.alberta-canada.com>

¹³ Ibid

¹⁴ Ibid

Even so, some still say it's not enough. Some say the government's share – specifically from royalties – should be higher.

Vibrant industry – challenging conditions

Before we discuss royalties specifically, let's take a closer look at Canada's current petroleum industry and Alberta's leading role in it. Worldwide, Canada has 19 per cent of the market share in drilling for oil and gas¹⁵, and Alberta is home to about 75 per cent of Canada's drilling activity. For 2007, PSAC forecasts¹⁶ that approximately 19,200 wells will be drilled across Canada. More than 14,000 of those wells will be in Alberta. This graph shows that strong drilling levels have been sustained in Canada for the past five years, despite the challenges the industry faces operating in a volatile commodity pricing market.

But there's no denying this is a cyclical industry that is extremely sensitive to market and fiscal conditions. This is illustrated by the difference in Canadian drilling activity between 1988-1992 (Figure 3) and the last five years (Figure 4).

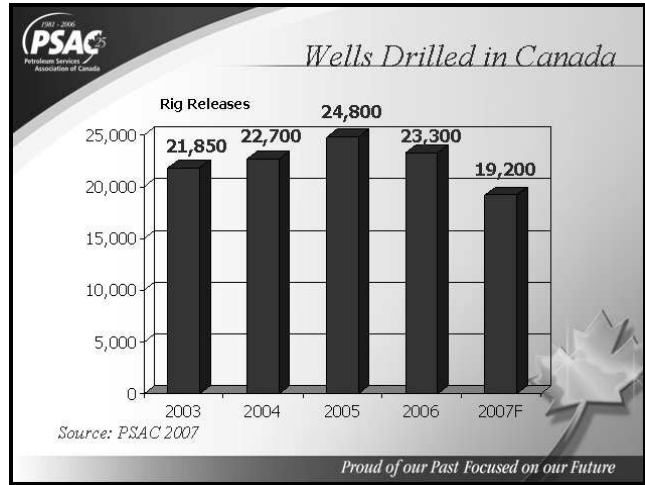


Figure 3

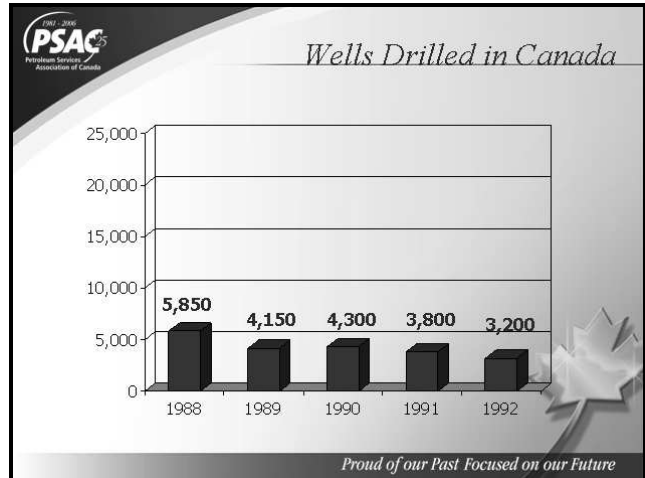


Figure 4

In addition to the volatility that affects the oil and gas industry wherever it operates around the world, the people and companies working in Alberta's conventional oil and gas industry face even more challenges.

¹⁵ World Oil – Outlook 2007 Worldwide Drilling
http://www.worldoil.com/magazine/MAGAZINE_DETAIL.asp?ART_ID=3117&MONTH_YEAR=Feb-2007

¹⁶ Petroleum Services Association of Canada Canadian Drilling Activity Forecast 2007
http://www.psac.ca/media_centre/pdf/20070426.pdf

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First, Alberta has long been recognized as a relatively high cost area, for a number of reasons. The Western Canadian Sedimentary Basin (WCSB), which underlies almost all of the province, is a mature basin with depleting resources. That means that the crude oil and natural gas still to be discovered are in smaller quantities, in more remote or difficult to access locations. These remaining resources also flow at a lower rate and require more innovative and expensive technology to extract. In short, Alberta's "cheap oil and gas" is long gone.

At the same time, demand for the province's energy resources is growing. To meet that demand, more and more wells must be drilled every year, since each successful well produces only a fraction of the "elephant" wells discovered here many decades ago.

Further, the oil and gas industry in Alberta is operating within increasingly stringent regulations in the areas of safety, environment, taxation and corporate governance, particularly when compared to many other locations around the globe. And the recent extended stretch of strong demand, combined with changing demographics, has strained the industry's human resources just when more people, not less, are needed to keep the industry vibrant.

Because of this combination of factors, average finding and development costs – a fundamental indicator of any petroleum location's cost – have risen dramatically over the past few years. Yet, Albertans and others continue to see value in the province's petroleum industry. They remain committed to investing in the province and developing innovative ways to extend the life of the resource all citizens have come to rely on.

Impact of increased royalties: Eroding jobs, investment and certainty

With that background, let's look closer at royalties. On the surface, raising royalty rates seems easy: increasing royalties is a simple process that will grow the government take and only impact the big oil and gas companies that can pay for the increase from their profits. But it's not that straightforward. Seemingly small changes, like royalty increases, can have large unintended consequences. For example, producing companies faced with increased royalties would have to adjust their capital expenditures, programs and activities to accommodate those extra fees, so they could remain profitable and able to make a return to their investors.

Even just the possibility of increased royalties can slow industry activity because of fiscal uncertainty. When companies are unsure of their future financial picture, they rein in. That may seem okay, but any resulting reduction in activity from the producer side could easily force service sector company closures and staff reductions. So what affects "big oil" doesn't just stop there. It travels right down the pipe and impacts the owners and employees of service, supply and manufacturing companies in Alberta.

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It was mentioned earlier that PSAC's membership represents 258 companies in Alberta, but it is estimated that there are upwards of 3,000 service companies operating all over the province, including hundreds of small "mom and pop" operations. To survive, these entrepreneurial operations rely on a vibrant local petroleum industry and a stable fiscal framework. Increased royalties and their resulting impacts on the industry's activity levels would have a negative – and potentially disastrous – effect on the people working in the service sector in this province.

We can compare the potential effects of increased royalties by looking at a similar situation from the past. Whether they were here or not in the early 1980s, most Albertans know of the devastation wrought by the National Energy Program (NEP). With the collapse of the industry resulting from the NEP's policies, hundreds of companies folded and thousands of people lost their jobs. Many talented employees left the industry, the province and even the country, never to return, leaving an enormous skills gap from which the industry is still trying to recover. So even though that government intervention in the petroleum industry was more than 25 years ago, its effects are still being felt today.

We know from the NEP how sensitive the petroleum industry is to government changes, particularly when activity levels are precarious due to rising costs. Already this year, we have seen a dramatic slowdown in conventional industry activity. In fact, PSAC is predicting a 20 per cent drop in wells drilled in Alberta this year from 2006 levels (Figure 5). Other organizations are expecting an even bigger drop in activity this year. The Canadian Association of Oilwell Drilling Contractors¹⁷ and ARC Financial Corporation¹⁸ recently released predications of 27 to 30 per cent drilling decreases in 2007 over 2006. Activity is already down 28 per cent this year over 2006.¹⁹

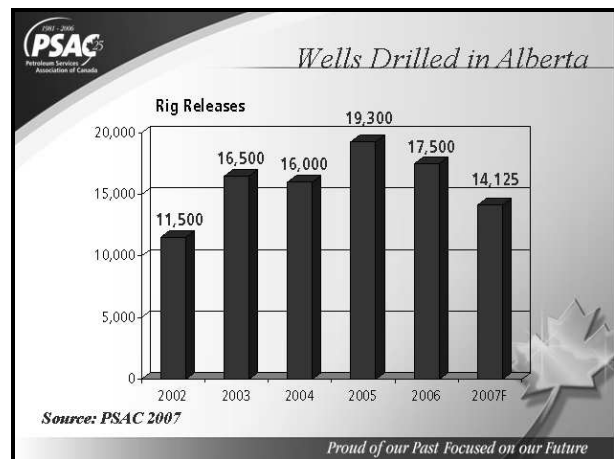


Figure 5

Today, at the tail end of an extended period of record activity levels, commodity prices and revenues, the question of royalty percentages is being asked again. But making a long-term change to the royalty regime based on the industry's recent short-term "boom" doesn't make sense, given our knowledge of the many repercussions from such a change. And even if the plan is to cash in on the boom, it's already too late.

¹⁷ CAODC – Revised Forecast for 2007 <http://www.caodc.ca/PDF/2007%20Forecast%20-%20May.pdf>

¹⁸ ARC Financial Corporation – Weekly Energy Charts
http://www.arcfinancial.com/index.php?option=com_content&task=view&id=38&Itemid=47

¹⁹ Ibid

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Further, there's the issue of costs. The current royalty structure adjusts for price and productivity – and that's good. But it does not adjust for costs. Operating costs in Alberta have skyrocketed over the past few years, which has had companies scrambling to meet program commitments and corporate growth plans, while staying on budget. Fuel, construction, material and especially labour cost increases have significantly impacted the industry over the past few years. ARC Financial reported recently that the average operating cost per barrel of oil equivalent at year end 2006 were 23 per cent higher than two years prior.²⁰ In addition, weekly average earnings of oil and gas workers have increased 25 per cent over the past five years.²¹

The combination of high costs and reduced activity is deadly for the service sector. Just recently, one petroleum services company, Leader Energy Services Ltd., had to cut its staff by 30 per cent and send 20 pieces of equipment south to work in the US, where the company is looking to generate higher margins on its services.²² Uncertainty about industry metrics, low natural gas prices, overcapacity and a drop in gas well activity forced the company to take this drastic step. Unfortunately, other companies are sure to follow their lead.

This year, it is expected that capital expenditure in the conventional oil and gas industry will reach \$28 billion across Canada.²³ That level of investment would provide enormous opportunities for Canadians and substantial benefit to the economies of Canada and Alberta. But everyone knows that Alberta is not the only game in town for the petroleum industry. This industry is extremely global, mobile and sensitive to changes in local market economics.

Given the uncertainty and cost pressures already facing this industry, companies that are willing to invest in and operate in Alberta under its current fiscal regime may simply go elsewhere in the world should increased royalties make more of their operations here uneconomic. And the hundreds of small petroleum service companies in Alberta could not follow them, nor remain viable in the vacuum that would be left.

The oil and gas industry has never been considered a stable industry. In the WCSB, because of its mature basin and high cost environment, the industry is even more fragile. However, with personal and corporate perseverance, supported by a stable fiscal regime in Alberta, in recent years the petroleum industry has been able to build the certainty it needs to attract companies, workers and investors. Alberta has become known internationally as a good place to do business, a good place to work and live, and a good place to make an investment. An increase in

²⁰ ARC Financial Corporation – Weekly Energy Charts
http://www.arcfinancial.com/index.php?option=com_content&task=view&id=38&Itemid=47

²¹ Ibid

²² Nickle's Daily Oil Bulletin, May 29, 2007 <http://www.dailyoilbulletin.com>

²³ Canadian Association of Petroleum Producers – Alberta Statistics http://www.capp.ca/default.asp?V_DOC_ID=675

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royalties has the potential to erode that certainty, literally scaring away potential investors, entrepreneurs and employees.

Royalties and industry activity: Learning from our past

Royalties in Alberta increased through early 1970s, but were originally hidden by high oil prices. By the 1980s, however, the industry was crippled by a combination of high royalties and low oil prices. The government of Alberta recognized it had to cut royalties to spur the industry and it did so in the early 1990s.²⁴

By 1993, industry economics had improved dramatically. That set the stage for the dramatic growth in industry activity and non-renewable resource revenue that we are all benefiting from today. The results since then – measured in government revenues, economic growth, industry activity and employment – have been nothing short of spectacular, which proves the regime is working.

When the WCSB's higher costs are considered along with higher commodity prices, it becomes apparent that the current royalty regime in Alberta is fair and competitive.

Royalties: One size does not fit all

Regardless of the evidence from Alberta's past, and the forecast for the future, many people think we should ignore what we know. They think we should change our proven royalty system because other jurisdictions, like Norway and Alaska, seem to function well with a higher royalty-type structure. But that's not comparing apples to apples. Alberta's mature, low-productivity basin is a completely different operating environment from Norway or Alaska, where average well production is two to three hundred times as big.

A recent study found that the average well in Alberta produces 18 barrels of oil per day²⁵. Even well-recognized, large producing companies like EnCana Corporation produce just 15 to 18 barrels of oil equivalent per well per day.²⁶ In Norway, by comparison, average production per well is 6,000 barrels per day and in Alaska, it's 600 barrels per day.²⁷ In Saudi Arabia, average production per well is more than 5,100 barrels per day²⁸ and more than half of that country's oil reserves are located in just eight fields.²⁹

²⁴ Alberta Energy – About Royalties <http://www.energy.gov.ab.ca/docs/aboutus/pdfs/InfoSeries-Report3-Formulas.pdf>

²⁵ John S. Herold Inc. – 2006 Global Upstream Performance Review http://www.hargrove.co.uk/hlc_presentations.asp

²⁶ FirstEnergy Capital – Finding, Development & Acquisition 2007 Webcast <http://firstenergy.com/home.php>

²⁷ John S. Herold Inc. – 2006 Global Upstream Performance Review http://www.hargrove.co.uk/hlc_presentations.asp

²⁸ The Oil Drum – Just the Facts <http://www.theoil drum.com/classic/2005/05/just-facts-maam-or-checking-oil.html>

²⁹ US Energy Information Administration – Saudi Arabia <http://www.eia.doe.gov/emeu/cabs/saudi.html>

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Just as the petroleum basins around the world are unique, their royalty structures cannot be one-size-fits-all. Here in Alberta, the royalty regime must be carefully structured to support the ongoing recovery of resources from an increasingly mature basin overlain with challenging climate and accessibility issues.

Alberta has long recognized the unique nature of its petroleum resource. The government, to its credit, worked hard to develop a customized royalty structure that provided a fair return for Albertans, while supporting the long-term viability of the industry. The Alberta Royalty Review background document summarizes the goals of the royalty program as such:

“The overall objective of Alberta’s royalty system is to provide a fair return to Albertans as owners of the province’s energy resources. Within the context of providing a fair return, Alberta’s current royalty system is designed with three other objectives in mind:

- *To extend the life of mature oil and natural gas pools to maximize recovery*
- *To promote the development of new and more efficient technologies*
- *To promote the exploration and development of new reserves.*³⁰

We believe that, under the current royalty regime, all of these goals are being met.

Going forward: Three key elements

In this paper, we looked at the intricacies of Alberta’s unique petroleum industry and royalty regime. We discussed the close business partnership between the industry and the government, and saw what happens when the rules of engagement get changed by one of the partners. We would like to close by summarizing the most important elements to be considered in the government’s decision about a change in the province’s royalty program.

But first, a healthy reminder. We live and work in an area with vast resource potential. The Western Canadian Sedimentary Basin is mature, it’s true. But it is estimated that up to 70 per cent of the original discovered crude oil and 50 per cent of the natural gas still lie under Alberta. That, along with new discoveries, are enough to keep the industry and the province going strong for another century, if not longer. But the government must uphold its end of this proven business partnership, by structuring a royalty regime that takes into account three key elements: fairness, certainty and people.

³⁰ Alberta Royalty Review – Background Document http://www.albertaroyaltyreview.ca/more_info/background.pdf

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Fairness. The industry must be able to operate within a fair fiscal framework – a framework that supports the industry's ongoing investments in innovation and people, and manages the resources sustainably for today's Albertans and the generations to come. The current royalty regime does just that. It provides the appropriate balance between the province's citizens – who are the greatest beneficiaries of the industry's success – and the companies taking the financial risks by investing billions of dollars to develop those resources.

This risk-return equation cannot be ignored. Without the petroleum industry taking the financial risks necessary to develop Alberta's oil and gas resources, Albertans would not receive a single penny of benefits. Just having oil and gas underground doesn't provide benefits. Only when dedicated people using innovative technology bring Alberta's resources to the surface, and turn them into marketable commodities, can the province benefit.

Certainty. Since we cannot control the volatility of commodity prices, demand, weather or other factors, continued investment in and growth of the petroleum industry in Alberta requires stability in the areas we can control, like royalties. The current royalty regime provides the level of certainty the petroleum industry needs to remain committed to working here. With stability in royalties, investors can remain optimistic about supplying the billions of dollars in financing needed for industry investment; employees and entrepreneurs can continue to see Alberta's petroleum industry as a great career opportunity; and citizens in every community in the province can continue to reap the huge benefits afforded them from annual non-renewable resource revenues.

People. PSAC knows from experience that any changes to fiscal regimes will quickly be felt by the hard-working Albertans working in the petroleum service sector, and will ultimately affect all Albertans. The theory may be that increased royalties will just affect big oil and gas producers. But in reality, additional funds taken from the industry in royalties will come right out of the pockets of the industry's employees, entrepreneurs and investors. Gains in royalties will simply be offset by shrinking activity and employment; reduced revenues from taxes, land leases and fees; and finally slowing economic growth and reductions in investment. Eventually every citizen will feel the impact.

Alberta's royalty regime: Working for the future

With a royalty structure based on fairness and certainty, and one that takes into account the most important asset this province has – its people, the petroleum industry will be willing and more than able to recover Alberta's huge energy resources for decades to come. In doing so, the industry will continue to employ a great number of Albertans, provide investment opportunities for many others, and contribute revenues to the government that will pay for valuable services that benefit all citizens.

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The existing Alberta royalty regime is working – in fact working extremely well – for the province and its people. PSAC, on behalf of the entire petroleum service, supply and manufacturing sector, commends the government on creating and managing a complex but fair system, and urges the province to let the royalty structure continue to do the job it has been doing so well.

The Petroleum Services Association of Canada is the national trade association representing the service, supply and manufacturing sectors within the upstream petroleum industry. PSAC represents a diverse range of close to 270 member companies, employing more than 68,000 people and contracting almost exclusively to oil and gas exploration and production companies. PSAC member companies represent over 80 per cent of the business volume generated in the petroleum services industry.

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