



New Royalty Structure

Introduction

On October 25, 2007, the Government of Alberta (the "Government") announced sweeping changes to the royalty structure in Alberta. The Government's announcement came more than a month after the Alberta Royalty Review Panel released its long-awaited report entitled, *Our Fair Share - Report of the Alberta Royalty Review Panel*.

The Chair's letter dated September 18, 2007 to the Honourable Dr. Lyle Oberg foreshadowed the content of the Panel's recommendations and left the industry with little doubt that whatever changes were going to be implemented, they were unlikely to be minor. The Chair said:

"...Given the time constraints relative to the enormity of our mandate, I am proud to report that we, as a panel, have come together to recommend a mitigating fiscal program that the government can undertake immediately.

We say "mitigating" because our review revealed that Albertans do not receive their fair share from energy development and they have not, in fact, been receiving their fair share for quite some time. Royalty rates and formulas have not kept pace with changes in the resource base, world energy markets and conditions in other energy-rich jurisdictions. Albertans own the resources. The onus is on government to re-balance the royalty and tax system to ensure a fair share is collected both currently and as circumstances change."¹

Ultimately, the Government did not adopt all of the Panel's recommendations. In some cases, it went much further than had been recommended and, in others, the recommendations were either rejected or modified. In the result, however, the Government has announced dramatic changes to the royalty system in Alberta that have already had an impact on activity in Alberta and which are expected to have an even greater impact as the new rules are finalized and the implications fully considered by the industry.

The changes announced by the Government are projected to increase royalties by approximately \$1.4 billion in 2010 or an increase of 20 per cent over revenue forecasts by the Alberta Government for that year.

Summary Of Key Changes

Oil Sands

- The Government will introduce price-sensitive formulas, both pre- and post-payout, rather than implement an industry-wide tax on oil sands production, as recommended by the Panel.
- The base royalty rate paid before a project's capital costs are paid off -- currently 1% -- will start at the same level and increase for every dollar oil is priced above \$55 U.S. per barrel, to a maximum of 9%, when oil reaches or exceeds \$120 U.S. a barrel. There is no detail as yet as to how much the royalty percentage increases for every dollar over \$55 U.S.
- The post-payout royalty rate, currently 25%, will start at that number under the new system and increase for every dollar oil is priced above \$55 U.S. per barrel, up to 40% when crude is \$120 U.S. or higher.

¹ *Our Fair Share - Report of the Alberta Royalty Review Panel*, (www.albertaroyaltyreview.ca/panel/final_report.pdf) at p. 4.

- No grandfathering of existing oil sands projects will be granted. However, the Government announced that it will enter into negotiations with Suncor and Syncrude, which have contracts with the Government which do not expire until 2016 to transition these parties to the new royalty regime. Premier Stelmach has commented that "In the event that an agreement cannot be reached, the Government will take other measures to ensure a level playing field for all industry stakeholders". (Suncor recently announced that it had reached an agreement with the Government to transition it to the new royalty regime.)
- The Government will consider exercising its right to take its "royalty-in-kind" on oil sands projects (where raw bitumen can be delivered to the Crown operated Alberta Petroleum Marketing Commission in lieu of cash royalties and the Government, in turn, can sell it to support upgrading projects in Alberta).
- Eligible expenditures and definitions of oil sands projects that determine when a project hits pay out are going to be much more carefully defined.

Natural Gas

- Royalties will be set by a single sliding rate formula sensitive to price and production volumes. Royalty rates, currently ranging from 5% to 35%, will range from 5% to 50%, with rate caps at \$16.59 per gigajoule.
- The Government will retain an incentive program encouraging producers to drill deeper wells that come with higher drilling costs as well as low productivity wells.
- The Government will also apply lower royalty rates over a wider price range for wells with less productivity, on the premise that marginal wells create more jobs and benefit Alberta's businesses and communities.
- All "old" and "new" tiers (depending on the vintage of the gas) will be eliminated in the calculation of the royalties. The same applies for conventional oil.
- Royalties for natural gas liquids will be set at 40% for pentanes and 30% for butanes and propane.
- Deemed fees will continue to be used for gathering and compression and a facility effective royalty rate will now be used to calculate the costs associated with a processing plant for natural gas. The latter move is intended to improve the link to the costs at a particular facility.

Conventional Oil

- Royalties paid on conventional oil will be set by a sliding scale rate formula that accounts for price and production volumes. New royalty rates range from 0% to 50% with a rate cap when oil reaches \$120 per barrel. The current maximum is 30% to 35% for new and old vintages.
- The Government will simplify the royalties for conventional oil, eliminating specialty programs.
- New shallow rights reversion will be implemented to cause developers to revert to the Government shallow gas geological zones that are not being developed for reissuance.

Timing

Changes to the royalty structure will take effect on January 1, 2009. Accordingly, we expect that all necessary legislation will be passed and have received Royal Assent before the end of 2008 so that the target implementation of January 1, 2009 may be met. Certain elements of the new royalty structure are, however, set to be implemented sooner. In the case of the generic "bitumen valuation methodology" which will provide a common price index for the oil sands sector, the *New Royalty Framework* publication issued by the Government indicates that it will be implemented by June 30, 2008 after Government

consultation with stakeholders and independent advisors², and in the case of the as yet undefined "accountability measures", those are slated to be implemented beginning in May 2008³.

The Impact

There has been no shortage of commentary and criticism from industry and non-industry alike on the proposed royalty revamp. Positions are polarized with many in industry crying foul, and non-industry demanding more action, convinced the changes are not deep enough. ARC Energy Trust, one of Canada's top conventional oil and gas trusts, discussed the anticipated impact of the royalty changes on its portfolio in its results announcement for Q3 2007.⁴ ARC Energy Trust concluded that its "total corporate royalties payable will increase by approximately 10 per cent in 2009. ... The royalty change in 2009 on a property by property basis is highly variable with decreased royalties on some properties, primarily shallow gas wells, and a doubling of royalties on Alberta high rate oil production properties".⁵

In an ominous statement now being heard repeatedly in Alberta, ARC Energy Trust continued in its Q3 Report and stated:

"The New Alberta Royalty Framework will impact future drilling decisions in order for the Trust to maintain acceptable rates of return on its capital deployed.

The Trust reviews all of its capital expenditures on a project by project basis; with higher royalties in the Province of Alberta, projects previously deemed economic may no longer meet the Trust's investment objectives. Already, the Trust has cancelled a \$4 million investment in northern Alberta, re-allocating the money to British Columbia where it believes it can get a better return on its investment. The Trust will be reviewing the proposals in detail in order to assess the full impact to the Trust's future cash flows and investment opportunities and determine ways in which it can mitigate the negative impact."⁶

Canadian Oil Sands Trust ("COS") which holds a 36.74 per cent working interest in the Syncrude Joint Venture also commented on the changes to the royalty structure in its Q3 report⁷, and in particular, on the mandated negotiations with the Government. While the Government has set a 90 day timeline for negotiations, it appears evident that the vested interests of Syncrude and Suncor are unlikely to be yielded without sufficient compensation from the Government. COS, discussing its existing contractual arrangements, said:

"The Syncrude joint venture owners have a legal contract with the Alberta government that codifies today's royalty rates for Syncrude through to the end of 2015. The government has established a 90-day period to renegotiate the terms of this contract. Canadian Oil Sands and the other Syncrude owners are willing to discuss fair and equitable amendments but any transition to the new royalty terms must recognize and preserve our legal rights to the embedded value in our contract. In the absence of a renegotiated agreement with the government, the Syncrude owners fully expect that this contract and all of its terms will continue until the December 31, 2015 expiry date, maintaining the

² Government of Alberta, *New Royalty Framework*, October 25, 2007 at p. 3.

³ Government of Alberta, *New Royalty Framework*, October 25, 2007 at p. 14

⁴ ARC Energy Trust, Management Discussion and Analysis, filed November 14, 2007 on SEDAR (www.sedar.com).

⁵ *Ibid.* at p. 9.

⁶ *Ibid.*

⁷ Canadian Oil Sands Trust, Third Quarter Report, filed October 31, 2007 on SEDAR (www.sedar.com).

current royalty rate and allowing Syncrude to convert to a bitumen-based royalty."⁸

President and Chief Executive Officer of COS, Marcel Coutu, was quoted as saying: "We are confident that we can have a productive discussion with the Alberta government that provides a value for value exchange in revising the terms of our legal agreement because the government guides itself by principles of law, which is fundamental to the 'Alberta Advantage'."⁹

COS, like ARC Energy Trust, also raised a cautionary note stating in its Q3 Report:

"Canadian Oil Sands believes the royalty regime changes announced by the government likely will result in reducing oil sands development activity and thereby have a significant negative impact on Alberta and Canada's economy. Some projects may not proceed over their planned timeframe, if at all, and some of the lower grade oil sand resource, which form part of every project, may never be recovered due to a now higher economic threshold. The future success of the oil sands industry depends on its ability to continually attract major investment capital. The development of the oil sands has unique challenges: multi-billion dollar capital construction costs, multi-year lead times before costs are recovered and a profit can be realized, and higher operating costs compared to conventional crude oil production. As such, a stable fiscal regime that does not add incremental risks, while providing a rate of return that is competitive with other regimes around the world is critical to attracting and retaining investment capital."¹⁰

It appears that the new royalty structure will have a disproportionate impact on the deep well gas producers and the junior sector. In an article published in the Calgary Herald on November 6, 2007, Gary Leach, executive director of the Small Explorers and Producers Association of Canada, commented that some of the biggest impact is being felt by the "star exploration companies".¹¹ He said that there is "a major disincentive in the way the royalty structure is going to impact them to make it less economically rewarding to go after some of the high-impact exploration that we still need in the province".¹² Many smaller producers have made public statements that they expect cash flow to be cut significantly as a result of the royalty changes, with some expecting declines of up to 30%. These types of producers are very concerned that the royalty changes will produce a number of anomalous and discriminatory results for companies undertaking high-risk oil exploration.¹³

Peter Tertzakian, chief energy economist for ARC Financial Corp. discussed the disproportionate market valuation being applied to the smaller companies in the Alberta oil patch, in a Calgary Herald article dated November 16, 2007¹⁴. In that article, he stated that: "The small caps are trading at a 40 per cent discount to the big caps when you look at valuations in the context of a unit of production".¹⁵ Foreshadowing events to come in 2008, Mr. Tertzakian believes that a wave of consolidation is pending. He was quoted as saying: "it's cheaper to buy than to explore and that's why the next six months will be characterized by a wave of consolidation as companies fight to survive through the current business cycle".¹⁶

⁸ *Ibid.* at p. 3

⁹ *Ibid.*

¹⁰ *Ibid.* at p. 25.

¹¹ Gary Leach, as quoted by Lisa Schmidt in, "Royalty changes worry junior sector", The Calgary Herald (November 6, 2007) p. D4.

¹² *Ibid.*

¹³ "Minnows will bear the brunt", Upstream (November 2, 2007) p. 10.

¹⁴ Deborah Yedlin, "Brace for the year of the merger", The Calgary Herald (November 16, 2007) p. D1.

¹⁵ Peter Tertzakian, as quoted by Deborah Yedlin in, "Brace for the year of the merger", The Calgary Herald (November 16, 2007) p. D1.

¹⁶ *Ibid.*

Also quoted in that article, was Tristone Capital Inc.'s George Gosbee, who discussed the early move towards consolidation in the industry, though apparently somewhat circumspect moves thus far. He noted that "there are a lot of 'soft shops' going on around town. Companies are going out to their list of, say, top ten prospects, and gauging the level of interest, but no one is launching a full-sale effort."¹⁷

Ultimately however, the changes may not be as harsh as predicted. A November 2, 2007 Upstream article noted that Energy Minister Mel Knight has conceded that the royalty changes may have a very negative effect on some oil and gas producers and also mentioned that the Government intends to have some further discussions with those companies.¹⁸ More recently Premier Ed Stelmach suggested that it may be open to "tweaking" its new system though the royalty changes will go ahead.¹⁹ Premier Stelmach said "If there are unintended consequences as a result of the framework next year, then we need to discuss them and address them. ... We heard the concerns being raised by small producers, for example, and I want to assure industry and those Albertans who work for these companies that we'll listen closely to your concerns."²⁰ The announcement comes after a major producer, Canadian Natural Resources Ltd. announced a 33% spending cut for 2008 which it says stems largely from the new Alberta Royalty structure.

Looking Forward

It is our view that the industry will be in transition mode for the immediate future. Consolidation of the various players continues to be likely, and those with more marginal projects, particularly on the deep gas side, may not proceed with their projects or they will be delayed until the economic climate becomes more favourable. Alberta is, however, likely to retain its competitive edge as it remains an essentially pro business climate with a stable fiscal regime and a significant resource base.

The failure to grandfather existing projects was an unwelcome surprise to many in the industry and may make future investment more cautious, but having become a regressive fiscal regime, we suspect that many in the industry had known that the changes would ultimately come.

What is clear is that the next year will be a period of adjustment in the industry and, until the final legislation has been enacted, the Alberta oil patch will be a much more uncertain place. We are likely to see a significant shake-up as the players determine what position they wish to take going forward. Additional capital will come in and some capital will leave, but the indication thus far is that strong projects and strong companies will have no difficulty weathering the suddenly stormy seas.

¹⁷ George Gosbee, as quoted by Deborah Yedlin in, "Brace for the year of the merger", The Calgary Herald (November 16, 2007) p. D1.

¹⁸ "Minnows will bear the brunt", Upstream (November 2, 2007) p. 10.

¹⁹ Jason Markusoff and Tony Seskus, "Premier willing to tweak royalty scheme; Alberta Energy to consult with industry", The Calgary Herald (November 28, 2007) p. A1.

²⁰ The Honourable Premier Ed Stelmach as quoted by Jason Markusoff and Tony Seskus in "Premier willing to tweak royalty scheme; Alberta Energy to consult with industry", The Calgary Herald (November 28, 2007) p. A1.