Thinking Like An

OWNER

FACT SHEET

OVERHAULING THE ROYALTY AND TAX TREATMENT OF ALBERTA'S OIL SANDS

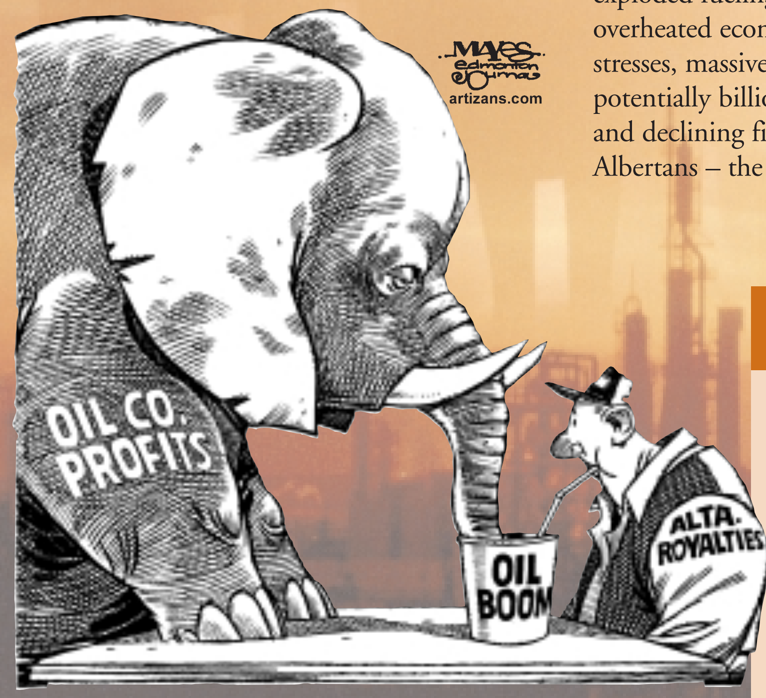
OIL BOOMS:

Royalties Down 32%, Billions in Federal Revenue Lost

Record oil prices, record oil sands production, record profits for companies, and yet Alberta's oil sands royalty return per barrel is down 32%, and the federal government has lost up to $1.65 billion to oil sands tax breaks.

How can companies make so much money off the publicly owned oil sands resource while the people of Alberta get less and the federal subsidies continue?

The answer is simple: Royalties are low and tax breaks are big.



In the mid 1990s, the sweetheart royalty deal as well as tax breaks for capital investments were meant as a shot of adrenalin for a fledgling oil sands industry. As oil prices have soared, the oil sands industry has exploded fueling "oil sands fever," an overheated economy, enormous social stresses, massive environmental damage, potentially billions in lost tax revenue and declining financial returns for Albertans – the owners of the resource.

An Outdated Scheme

It started as a scheme to overcome barriers related to high capital investments and to spur production in the fledgling oil sands industry. Oil sands companies pay a 1% royalty rate to Alberta until projects are paid for and turning a profit. After that, companies pay only 25% on the "net" revenue – less than the royalty rates for conventional oil and gas projects in Alberta.

The federal government sweetened the deal with a tax break allowing oil sands companies to write off 100% of their capital investments in the form of an accelerated capital cost allowance (ACCA) – this is four times higher than the 25% writeoff allowed for conventional oil and gas projects.

CONTINUED ON PAGE 2

Quote from former Premier Peter Lougheed:

"I was just up there on a trip, just helicoptering around, and it is just a moonscape. It is wrong in my judgment, a major wrong, and I keep trying to see who the beneficiaries are. Not the people in Red Deer, because everything they have got is costing more. It is not the people of the province, because they are not getting the royalty return that they should be getting, with $75 oil. So it is a major, major federal and provincial issue."

SOURCE: "Sounding an alarm for Alberta – an interview with Peter Lougheed" Policy Options. September 2006. p.6.

CONTINUED FROM PAGE 1

… An Outdated Scheme

Since 1997, when the current royalty regime was implemented, capital investments in oil sands projects have increased more than 300% and oil sands production has increased 88%. By 2004, production surpassed one million barrels per day – a production target that was originally set for 2020. In just one decade, the price of oil has increased 214%. While the low royalty rates and federal tax break were deemed necessary in the early days of oil sands developments, they have outlived their purpose.

The low royalty rates mean that between 1996 and 2005 royalty revenue paid to Albertans declined by 32% from $3.39 to $2.29 per barrel of oil.

In addition, the federal tax break is resulting in billions in foregone tax revenue. The federal Department of Finance estimates that the 100% accelerated capital cost allowance provides companies with between $5 million and $40 million in tax breaks for every $1 billion invested.[1] This means foregone tax revenue for Canadians of up to $1.65 billion between 1997 and 2005.

A study commissioned by the Canadian Association of Petroleum Producers predicts that federal income tax revenue from the oil and gas industry will be halved from $5.1 billion in 2005 to $2.4 billion in 2008, due in part to the federal government's tax break for oil sands capital investments.

Rather than subsidizing a booming industry, the royalty rates need to be increased to ensure a win-win for companies and Albertans whereby companies are able to obtain a fair return on their investment and the balance of the value of the resource goes to Albertans – the owners of the resource. And, the federal tax break for capital investments needs to be eliminated.

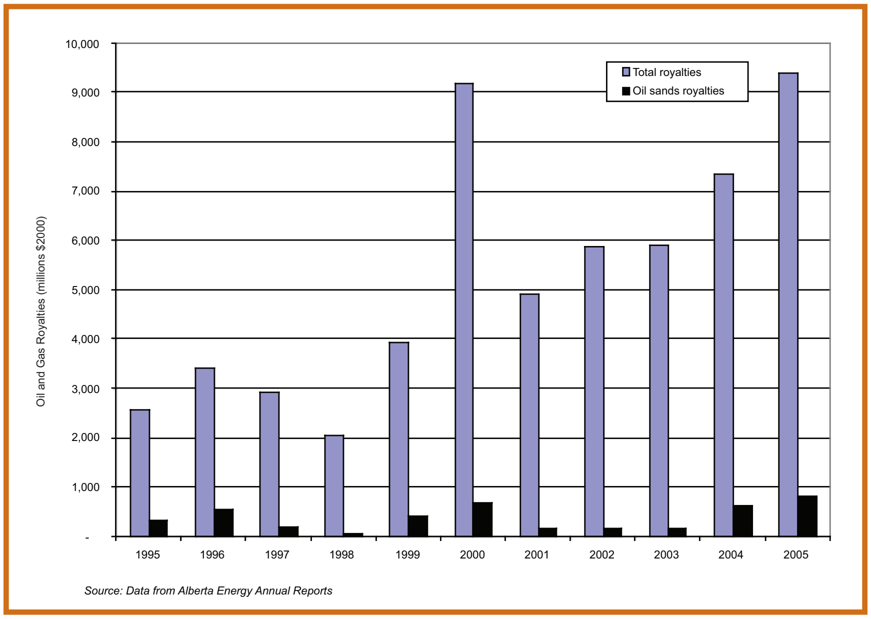


Figure 1: While total royalty revenue in Alberta (from natural gas, conventional oil and oil sands) increased by 185% between 1996 and 2005, royalty revenue from oil sands increased by only 84%. Surprisingly, oil sands royalties as a share of total royalties declined by 35% between 1996 and 2005, in spite of the fact that oil sands now make up 63% of Alberta oil production.

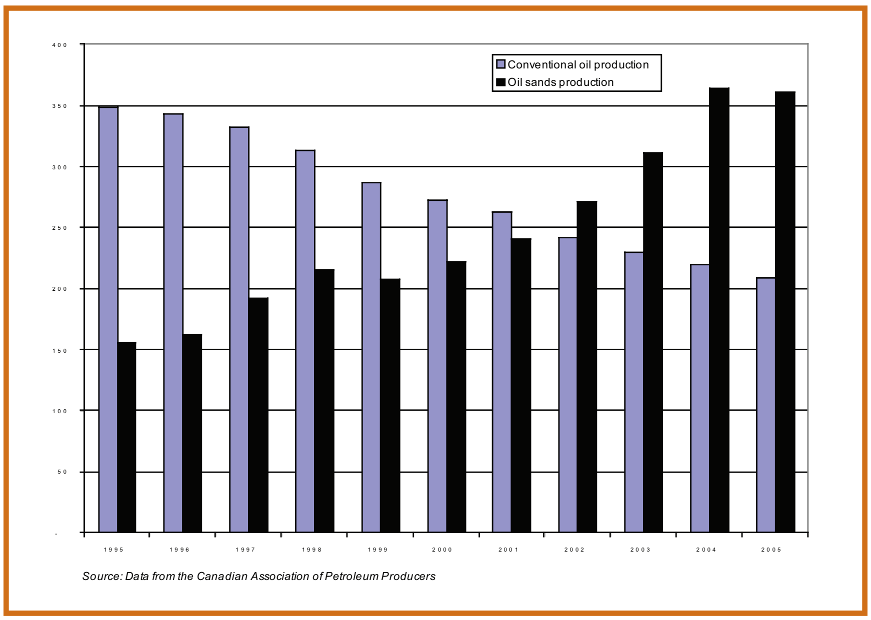


Figure 2: Oil sands production increased 123% between 1996 and 2005. As a share of total oil and oil sands production, oil sands increased from 32% in 1996 to 63% in 2005, an increase of 98%.

1 *Commissioner of the Environment and Sustainable Development, Report of the Commissioner of the Environment and Sustainable Development, (Ottawa, Ontario: Government of Canada, 2000).*

Cost Over-Runs Are Costing Albertans and Canadians Money!

It's bad enough that oil sands royalties are declining as oil sands production goes up and oil companies reap windfall profits. Now cost over-runs for the construction of new oil sands projects, brought on by an economy that has been overheated by the pace of development, are further reducing royalties and taxes that Alberta and the federal government should be receiving.

Cost over-runs mean oil companies stay at the 1% royalty rate longer before jumping to the 25% rate, which means Albertans get less revenue today.

Even when companies do get to the 25% rate, it is based on their net income so higher expenses means even less revenue for the resource owners, the public.

Cost over-runs also cost Canadians money. This is because federal taxes are reduced or deferred because of the sweetheart deal that enables oil sands companies to write off 100% of their capital costs.

This means taxpayers subsidize not only the start-up of the oil sands industry but continue to subsidize project expansions too. And now that the industry is getting too big, too quickly, Canadian taxpayers are also on the hook for cost over-runs resulting from an overheated economy.

The Syncrude (left) and Suncor (right) oil sands upgraders and Syncrude's mine (left) north of Fort McMurray, Alberta. The public resource owners deserve a fair share of revenues.

PHOTOS: DAVID DODGE & CHRIS EVANS, THE PEMBINA INSTITUTE

Tax and Royalty Regimes CAN Change...

Support for a pubic review of the oil sands royalty regime is growing. Peter Lougheed, a former premier of Alberta, told Albertans that they need to think like owners and get more for the development of their oil sands resource.

"The provincial royalty scheme cheats Albertans... Albertans own the resources... and they should get more faster,"[2] Lougheed told *The Globe and Mail*. In fact, Lougheed called for a moratorium on oil sands projects saying that public hearings should be held during the moratorium to give Albertans the opportunity to decide what kind of development they want, and at what pace.[3]

The citizens of Alberta are also becoming increasingly uncertain that they are getting the best deal for their resources. A recent poll revealed that 63% of Albertans feel they are not getting maximum revenue from oil sands developments, and 84% of Albertans support a public review of the royalty regime.[4]

It is irresponsible for the governments of Alberta and Canada, as the people's representatives, to keep tax and royalty regimes stagnant in the face of increasing oil prices, technological improvements and massive capital investments, Government leniency is shortchanging Albertans and Canadians and benefiting oil companies.

The low royalties and tax breaks were established to kick-start an industry and not to subsidize highly profitable oil companies. And now the public is losing out on a fair return for their own resources, and Canadian taxpayers are subsidizing a highly profitable industry.

The tax and royalty regimes need to be adjusted to ensure a win-win for companies and citizens and not a win-lose where the interests of the corporations take precedence, and the citizens are short-changed for the depletion of the publicly owned resource.

Government leaders need to take a long-term approach to resource development and recognize that despite threats by oil companies to reduce investments in the oil sands if fiscal policies are changed, they are unlikely to walk away from the second largest oil deposit in the world in one of the most stable, secure democracies in which to do business. The alternative is to invest in oil production in places like the Middle East, Nigeria or Venezuela.

Getting to Win-Win

The royalty and tax structure must change to balance the benefits between oil companies and Albertans and Canadians.

To allow companies to adjust to new royalty and tax regimes, changes should be announced in advance of implementation and undertaken in a time-specific manner. Changes should be made for all new projects immediately, and changes to old projects should be phased in over a period of time with the details understood in advance of implementation.

The states of Alaska and Montana recently adjusted tax and royalty regimes as did Britain in the North Sea. It was also done in Alberta when Peter Lougheed adjusted the regime for conventional oil in the mid-1970s. It has been done before and must be done again.

2 Jeffrey Simpson, "Call a halt Albertans," Globe and Mail, July 7, 2006.

3 Jeffrey Simpson, "Call a halt Albertans," Globe and Mail, July 7, 2006.

4 "Albertans Perceptions of Oil Sands Development Poll, Part 1: Economic Issues" (Calgary, Alberta: Pembina Institute, May 30, 2006, http://www.oilsandswatch.org/pubs-poll.php).

What Needs to Happen Now?

1 The **Alberta Minister of Energy needs to increase the royalty rates** applicable to the extremely profitable oil sands industry. The current royalty regime is not a good deal for Albertans. The 25% royalty rate is less than the rate applied to conventional oil and natural gas in Alberta. This is not acceptable.

2 The new **rates should be determined through a comprehensive and public review** of the current rates, in particular the 25% royalty on net revenue. At the end of the review, a rebalancing of the fiscal regime is required to ensure a win-win for companies and Albertans, based on a fair return on their investment and maximum compensation to citizens for their non-renewable resource.

3 Changes to the **royalty rates should be applied to new projects immediately** and older projects over time according to a defined and well communicated timeline.

4 **Alberta Energy should suspend new tenure allocations and the Energy and Utilities Board and Alberta Environment should suspend new project approvals** until the royalty review has been completed, and the royalty rates have been increased to ensure that they apply to all new projects.

5 The federal **Minister of Finance should eliminate the 100% accelerated capital cost allowance (ACCA)** for oil sands and put oil sands on a level playing field with conventional oil and natural gas. Money saved from eliminating preferential tax treatments should be invested in facilitating a transition to a sustainable energy future by supporting the wide-scale development of renewable energy and energy efficiency.

PHOTOS: DAVID DODGE, THE PEMBINA INSTITUTE

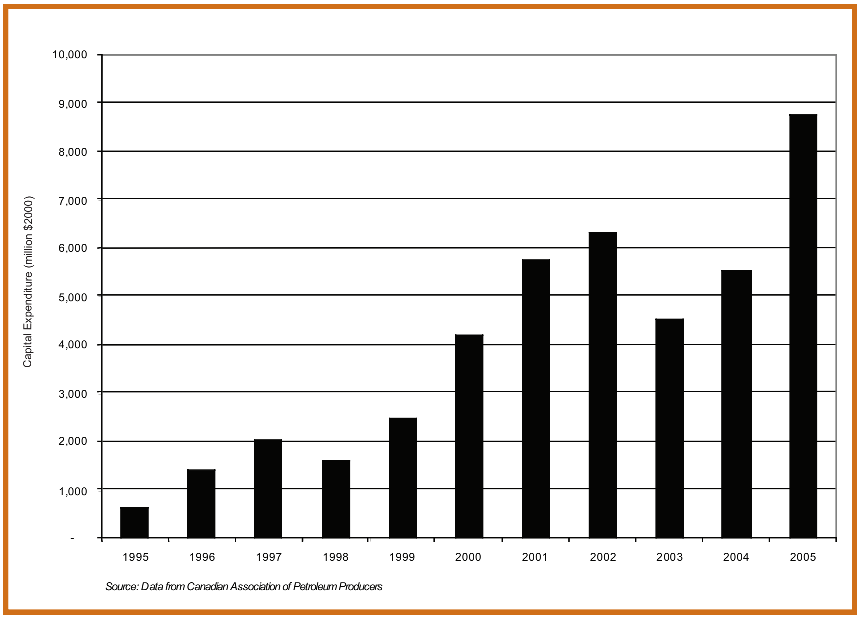


Figure 3: Capital investment in oil sands may be soaring, but substantial cost over-runs such as those that have been observed in the oil sands mean that Albertans are getting lower royalties. They also mean that royalty payments are being deferred as companies are staying at the 1% royalty rate for a longer time. Cost over-runs are resulting from the rapid pace of oil sands development, facilitated by low royalties and tax breaks, that is over-heating the Alberta economy.

Want more information?

For more information and a complete list of recommendations, download our full report ***Thinking Like An Owner: Overhauling the Royalty and Tax Treatment of Alberta's Oil Sands****. It is available from* ***www.oilsandswatch.org****. There you will also find other titles in our Oil Sands Issue Paper series, photos and videos. For related papers including* ***Government Spending on Canada's Oil and Gas Industry: Undermining Canada's Kyoto Commitment****, visit* ***www.pembina.org****.*

This report was prepared by Amy Taylor, staff economist and Director of Ecological Fiscal Reform, and Marlo Raynolds, Executive Director of the Pembina Institute, ***www.pembina.org****.*

the PEMBINA institute

Sustainable Energy Solutions

PRINTED ON RECYCLED PAPER