Presentation to the Oil Sands Multi-stakeholder Committee

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Mr. Chairman and Members of the Panel:

My name is Amy Taylor and I am an economist with the Pembina Institute. The Pembina Institute is a non-profit environmental organization that focuses on energy related issues. We were born in Alberta and have been working on environmental issues both provincially and federally for over 20 years.

I thank you for the opportunity to present to you today to provide input on the provinces tax and royalty regimes related to oil and natural gas.

The Pembina Institute has been calling for a review and a reform of the province's oil and gas royalty regimes for a number of years. We are particularly concerned with the royalty regime related to the oil sands. As such, my comments in the next 10 minutes will focus mainly on the royalty regime related to the oil sands.

The Pembina Institute has a vision for oil sands in Alberta. That vision, is that:

Development of the oil sands occurs at a pace and scale that:

- *respects the capacity of regional ecosystems to be sustained,*
- *addresses global warming by achieving deep reductions in greenhouse gas emissions towards a net-zero emissions target,*
- *optimizes financial benefit to the owners of the resource, and*
- *continuously improves the quality of life of all Albertans today and for future generations.*

One of the principles needed to achieve this vision is a fair royalty regime that ensures Albertans receive maximum revenue for the development of their oil sands resource. This means a royalty regime that achieves a win-win for companies and Albertans where companies are able to retain a fair return on their investment and the balance of the value

of the resource goes to Albertans. After all, it is the people of Alberta that own the oil sands resource.[1]

Unfortunately, in the case of Alberta's oil sands, the low royalty rates currently in place mean that industry is getting more than its fair share. Instead of a win-win in which companies make a fair return on their investments and the citizens acquire maximum value for their resource, today we have a win-lose system where the interests of oil corporations are trumping those of Alberta citizens.

The current royalty regime was established to provide incentive for capital investments and to spur oil sands developments by requiring minimal royalties until all costs have been recovered as well as a return on investment. The royalty rate then increases, but only to 25% of net revenues.

The trend in capital expenditures and production since the royalty regime was introduced, demonstrates the effectiveness of this policy at overcoming barriers related to high capital investments.

Between 1997 and 2006, capital expenditure on oil sands increased over 400% and oil sands production increased 130%.

The current royalty regime has accomplished and even exceeded its objectives of spurring oil sands developments. In fact the goal of achieving 1 million barrels of oil per day by 2020 was achieved in 2004-a full 16 years ahead of schedule.

The generic royalty regime for oil sands has facilitated massive capital investments and increases in production. At the same time, technological improvements have occurred and the price for oil has increased significantly.

Oil sands developments are no longer considered a marginal resource with underlying technological and economic disadvantages. They are seen as a knowledge-based, technology driven resource of substantial quality and value. The production industry is now well established on a commercial scale.[2] Despite this shift in the oil sands industry from fledgling to mature, the provincial government has maintained the same royalty regime. The result is declining royalty revenue.

The 2007 provincial budget released on April 19th, projects a decline in resource revenues within three years, partly because of the royalty rates applied to oil sands. In fact, in a report recently made available to the public, the Department of Energy predicts that oil sands royalty revenues will be the same in 2020 as in 2004/2005. This, despite a projected tripling in production over the same time period.

To evaluate the current royalty regime related to oil sands as well as assess the impact of a number of royalty reform options, the Pembina Institute developed two "net cash flow" models; one for a typical oil sands in situ project and one for a typical oil sands mining project.

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[1] A portion of oil and gas resources are privately (rather than publicly) owned. For privately owned resources, royalties are paid to individual landlords. This research project is concerned with publicly owned oil sands resources.

[2] Yildirim, Erdal, *Oil Sands Developments in Canada,* (Edmonton, Alberta: UNITAR Centre for Heavy Crude and Tar Sands, No. 1998.227, 1998).

Taking into account current and projected economic and market conditions, these models calculate the annual flow of revenue for oil sand projects from companies to: 1) the federal government through taxes, and 2) the provincial government through taxes and royalties. The models also calculate the "Internal Rate of Return" that companies receive from oil sands projects. Most of the data used to create the models is from the National Energy Board and is the same data used in their oil sands supply cost models.

What did the models tell us about the current oil sands royalty regime? If you think of oil sands companies as resource developers working on behalf of citizens, their share of the profits can be considered a *commission* for developing Albertan's resources. Our models reveal that under the current royalty regime, resource developers are earning a 53% commission. Meanwhile, the resource owners – Albertans – only retain 32% of the revenue.

Compare this with Norway — considered a leader in managing oil and gas development on behalf of its citizens — where companies retain 22% of available revenue and 78% of net revenues are captured for Norweigans, the owners of the resource.

Albertans expect their government to do a better job of managing the oil sands on their behalf. In a recent poll, 90% of respondents indicated that Alberta should be a leader in maximizing resource value for its citizens.[3]

The Pembina Institute's analysis suggests that a commission rate of around 30% would be more appropriate. At this level, the internal rate of return for oil sands projects continues to be attractive for resource developers under a variety of different royalty structures.[4]

The Pembina Institute investigated three ways to deliver a fair share of oil sands revenues to Albertans, the resource owners. Each option strikes an important balance between ensuring a reasonable return for companies and maximizing earnings to Albertans for the one-time development of their non-renewable resource. I will briefly review each reform option. Full details of the reforms and their impacts are available in a report, released today by the Pembina Institute titled *Royalty Reform Solutions: Options for Delivering a Fair Share of Oil Sands Revenues to Albertans and Resource Developers.*

The first option is to raise the post-payout royalty rate on net revenue from 25% to 55%. Note that in this case – as in all the others I will present – the pre-payout royalty remains as it is now at 1% of gross revenue.

Under this reform option, the Alberta government would receive approximately 59% of the available revenues and the federal government would receive 9%. Companies would still receive a 32% commission.

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[3] Pembina Institute. *Albertan's Perception of Oil Sands Development: Poll, Part 2: A Fair Share for Albertans* (Calgary, Alberta: The Pembina Institute, 2007).

[4] 12% was selected as the floor for acceptable IRR ranges based on the an Alberta Department of Energy assessment of the oil sands royalty regime identifying an IRR of 12.2% as representing breakeven economics in the oil sands. (Source: Alberta Department of Energy. *Technical Royalty Report, OS#1: Alberta's Oil Sands Fiscal System — Historical Context and System Performance* (Edmonton, Alberta: Department of Energy, 2007).) A 25% to 30% commission was identified as the lowest target that maintains IRR above 12% for all three royalty structures evaluated in this paper. This rate also compares favourably with the Norwegian best-practice standard. Note, however, that because IRR is sensitive to the precise structure of royalty systems, an IRR exceeding 12% is easily obtained for in situ projects and may also be obtained for mining projects, even when commissions are lower than 25-30%.

The second option is to implement a 3-tiered royalty structure. In this case, resource developers would pay a 1% royalty on gross revenue until they recover all of their costs plus the existing return allowance. Post-payout, the royalty rate would increase to 30% of net revenue. A higher royalty rate would kick in when a company recovers all of its costs and the basic return allowance as well as achieving an additional return of 10%. This third tier rate would be set at 60% of net revenue.

With a three-tiered royalty, Albertans' net revenue share would increase from 32% to approximately 63% — while still delivering a commission of 29% to companies for developing the resource.

The third option for royalty reform examined by the Pembina Institute combines increased royalties with an environmental levy based on the polluter pays principle. Under this option, companies pay an environmental levy of $40 per tonne of carbon dioxide emissions in addition a post-payout royalty set at 40% of net revenue.

In this scenario, Alberta receives approximately 47% of available revenue while the federal government receives 15% through taxes. Companies would retain approximately 38% of the available revenues.

In these scenarios, companies' rates of return range from 12 to 16 percent for mining projects and from 23 to 26 percent for in situ projects. These results show that a win-win royalty regime is possible, As such, **the Pembina Institute recommends that retaining 70% of available revenue through taxes and royalties be set as a minimum criteria for royalty reform.** New royalty terms should apply to new projects, including those undergoing approval, immediately and be phased in rapidly for existing projects. **The Pembina Institute also recommends that at least 50% of resource revenues from the oil sands be set aside in a dedicated long term fund** that would be used to invest in economic diversification, to cushion the Alberta economy from boom and bust cycles, to store wealth for future generations and to facilitate a transition to a sustainable energy future for Alberta.

The current oil sands royalty regime, given its explicit goal of increasing oil sands investments, is no longer appropriate. It needs to change. It needs to guarantee Albertans maximum value today and in the future.

The royalty review process as designed, has made it difficult for the average Albertan to become engaged on this issue. This means that a great deal of weight rests on your shoulders to make a recommendation for royalty reform that gets a better deal for Albertans. I encourage you to "think like owners" and recommend significant, decisive and fair reform to the oil sands royalty regime.

The only regime that will pass muster with Albertans and withstand the test of time is one that provides a fair commission to companies undertaking oil sands development while maximizing Albertans' share of the returns.

Thank you.