

# Energy Tax News

## Alberta Royalty Review Report

### —Tough Decisions Ahead for the Alberta Government

On September 18, 2007, the Alberta Royalty Review Panel (the “Panel”) issued its Report on the Alberta Royalty and Tax Regime. The Report contains recommendations concerning the current royalty and income tax system in Alberta.

The Report will be reviewed by the Alberta government, which has indicated that it will respond by mid-October 2007. If fully adopted, the recommendations will have a significant effect on the oil and gas industry in Alberta and, in particular, on the economics of major oil sands projects.

### Highlights

The Report contains the following major recommendations:

#### Oil sands

- The base royalty rate of 1% for the “pre-Payout” period of an oil sands project remains unchanged. The base royalty will continue to be payable after the Payout period, and will be treated as a deduction from the net revenue royalty.
- The net revenue royalty would be increased from the current 25% rate to a new rate of 33%. The Panel considers the 25% rate to be unnecessarily low and that 33% would provide a much fairer return to Albertans as owners of the oil sands resources.
- The Oil Sands Severance Tax (OSST) would be introduced as a component of the new royalty system, with the following key characteristics:
  - OSST would be calculated based on gross revenues from bitumen production, with a floor for the bitumen price equal to 40% of the West Texas Intermediate (WTI) price in Canadian dollars;
  - the OSST rate would:
    - be zero when the WTI price is less than \$40/barrel;
    - jump to 1% at \$40/barrel;
    - increase by 0.1% for each \$1/barrel over the \$40 WTI price; and
    - be capped at 9% at a WTI price of \$120/barrel level.
- The various rental and royalty payments made in respect of oil sands production covered by the OSST would be deductible from the gross revenues base against which the OSST is applied.
- Because the new royalty regime would be primarily bitumen-based and integrated producers may no longer be allowed to choose a synthetic crude-based royalty option, the Report advocates development and implementation of a bitumen valuation methodology, which would be based on published prices for correlated surrogate commodities.
- A new Upgrader Royalty Credit would be introduced at the rate of 5% of eligible capital expenditures on additional upgrading capacity in Alberta. The primary objective would be to encourage construction of that capacity. In calculating the credit, capital expenditures related to bitumen production would be separated from those related to upgrading. Assets shared between bitumen production and upgrading would not be eligible to earn royalty credits. The credit could be used to pay royalty obligations of the builder of the upgrading capacity or sold to any bitumen producer in Alberta.

The appendix to this *Energy Tax News* provides sample calculations of the base royalty, the net revenue royalty and the OSST under different WTI prices.

## Natural gas and conventional oil

- The Panel recommends a significant simplification in the royalty regime for natural gas and conventional oil.
- The recommendations include:
  - elimination of “tiers” based on the discovery date of the reserve and of several special royalty programs,
  - introduction of a single royalty formula which would include both price and volume sensitivity, and
  - application of the new royalty formula for conventional oil to propane, butanes and pentane plus, and of the new royalty formula for natural gas to ethane, respectively, regardless of whether or not these products are stripped out of the natural gas.
- The Report also recommends that rate caps on price be increased to \$17.50/MMbtu for natural gas and to \$120 WTI/barrel for conventional oil, to reflect the new market conditions of high commodity prices.

## Other recommendations

- To ensure fair treatment to all participants, the Panel recommends against “grandfathering” any of the recommended changes.
- The Panel feels strongly that to implement and manage the new royalty regime effectively, a new administration structure is essential. Options include:
  - creation of a new sister organization to the Auditor General
  - preparation and submission to the Alberta Legislature of “effectiveness” audit reports every two years
  - a variety of annual and quarterly reports on production, technical and business data.

## Implications of the Report

- The Panel believes that if the entire set of recommendations contained in the Report were implemented, the Alberta Government would receive approximately \$1.8 billion of additional annual royalties in 2010 and \$2 billion in 2016, representing increases of 26% and 37% respectively, from the current projected royalty revenues for those years.
- The recommendations will affect every company in the energy sector in Alberta, not just the oil sands players.

- However, the largest percentage shift in the revenue “sharing” between Albertans and the energy industry will occur in the oil sands sector, where the Albertans’ share would increase from 47% to 64% upon full implementation of the Report’s recommendations. The percentages would increase from 58% to 63% in the natural gas sector, and from 44% to 49% in the conventional oil sector.
- Provincial royalties are fully deductible for federal income tax purposes, so the new regime would significantly reduce federal income tax revenues from the oil sector. This would create a situation similar to the early 1970s, when increases in provincial royalty rates led to the introduction of the federal resource allowance system, which was designed to mitigate the resulting loss of federal revenues. Ironically, the phase-out of the resource allowance system became fully effective on January 1, 2007. This raises the question of how the federal government will react should the Alberta government introduce the proposed changes.

With a weaker U.S. dollar, which has hurt the balance sheets of Canadian oil and gas producers, and increasing production costs in the energy sector, especially in the oil sands area, how would the implementation of the proposed changes affect the level of investment in the energy sector of Alberta? The Panel believes that, while the changes will slow the pace of the oil sands investments, the new system will remain competitive internationally and will not result in an overall loss of investment to competing jurisdictions with lower government takes of the resource revenues. As the industry reviews and analyzes the effect of the proposed changes and make its views known, it will be interesting to see whether the Alberta government will adopt some or all of the Panel’s recommendations.

## For more information

For help understanding the implications of the new rules, please contact any of the individuals listed below:

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## Appendix

### Example of royalty and OSST calculation

	Current royalty system			Proposed royalty system		
	40	80	120	40	80	120
<b>Pre-Payout</b>						
WTI Price per barrel (Cdn \$)	40	80	120	40	80	120
Bitumen production (barrels)	100,000	100,000	100,000	100,000	100,000	100,000
Gross revenue (50% of WTI)	2,000,000	4,000,000	6,000,000	2,000,000	4,000,000	6,000,000
Base royalty (1%)	20,000	40,000	60,000	20,000	40,000	60,000
Pre-Payout OSST	-			19,800	198,000	534,600
<b>Total Pre-Payout amount payable to Alberta</b>	<b>20,000</b>	<b>40,000</b>	<b>60,000</b>	<b>39,800</b>	<b>238,000</b>	<b>594,600</b>
Rate of OSST				1%	5%	9%
<b>Post-Payout</b>						
Gross revenues	2,000,000	4,000,000	6,000,000	2,000,000	4,000,000	6,000,000
Operating expense	(1,500,000)	(1,500,000)	(1,500,000)	(1,500,000)	(1,500,000)	(1,500,000)
Capital expenditures	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)
Other allowable costs	(90,000)	(90,000)	(90,000)	(90,000)	(90,000)	(90,000)
Return allowance	(79,500)	(79,500)	(79,500)	(79,500)	(79,500)	(79,500)
Net	230,500	2,230,500	4,230,500	230,500	2,230,500	4,230,500
Base royalty				(20,000)	(40,000)	(60,000)
Base for net royalty	230,500	2,230,500	4,230,500	210,500	2,190,500	4,170,500
Net royalty (25% current; 33% new)	57,625	557,625	1,057,625	69,465	722,865	1,376,265
Post-Payout OSST				19,105	161,857	410,736
Base royalty				20,000	40,000	60,000
<b>Total Post-Payout amount payable to Alberta</b>	<b>57,625</b>	<b>557,625</b>	<b>1,057,625</b>	<b>108,570</b>	<b>924,722</b>	<b>1,847,001</b>
Rate of OSST				1%	5%	9%

#### Assumptions:

- The actual sales price realized on the sale of bitumen is 50% of the WTI for crude.
- The royalty point is the bitumen processing facilities. We have assumed no upgrader and therefore the upgrader royalty credit is not available.
- Expenses remain constant as shown above, but WTI increases from \$40 to \$120.
- Operating expenses are assumed to be \$15/barrel.
- A LIBOR rate of 5% was used for purposes of the Return Allowance calculation.

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