Sustaining Prosperity

Alberta Party Opposition
Royalties Position Paper

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The Foundation of Alberta's Current and Future Prosperity

The oil and gas industry has been a cornerstone of Alberta for over seven decades. In that time, it has generated hundreds of billions of dollars for the people of Alberta and created tremendous prosperity in the form of high-paying jobs and the highest provincial per capita income in Canada. Its substantial tax revenues allow Albertans to enjoy high quality public services.

In reviewing the royalty framework, it is important to understand the total value Alberta receives from the exploration, production, refining and transportation of our energy assets and how that value is created. In addition to royalties, Alberta's oil and gas industry creates direct and indirect jobs for Albertans. Moreover, we receive significant benefits from government revenue generated by land sales, crown leases, landowner leases, corporate, personal and property taxes, and most recently, carbon taxes.

It is critical that Albertans receive optimal value for the energy assets we own and that we have trust in our royalty system. Done properly, a comprehensive review of the province's royalty regime should offer an opportunity to move beyond polarizing rhetoric and help educate Albertans about our energy industry, how investment decisions are made and what significant structural challenges our province faces. The better Albertans understand royalties, the better we can identify and take advantage of the opportunities that come from a strengthened and more balanced royalty regime. The overarching goal should be to help "grow the pie" by increasing investment in Alberta's oil and gas industry, which in turn creates jobs, increases public revenues and allows the government to provide the high quality services Albertans rely on.

We do this by creating policy that rewards entrepreneurial Alberta companies for innovating, creating jobs and significantly reducing the costs of hydrocarbon development and, at the same time, reducing environmental impact.

The continued expansion of Alberta's energy sector is critical to the ongoing prosperity and social wellbeing of our province. In the current low commodity price environment, and in a world seeking to reduce greenhouse gas emissions, it is fair to ask whether Alberta can — or should — continue to grow our oil and gas industry. ***Our answer is an unequivocal 'yes'.***

Although renewable energy will become an increasing part of the global energy mix, there is no viable alternative that provides the energy density or utility of oil and gas, especially for transportation. As global energy demand increases, especially in China and India, the world will need stable sources of energy supply more than ever. Renewables will play a vital role, but a recent IEA forecast shows 75% of global energy demand will still be satisfied by fossil fuels in the year 2040 (compared to 87% currently). To ensure Alberta's energy products are globally preferred, strategies must be in place that build on our advantages in the areas of industry innovation, regulation, environmental and climate leadership, and royalty regime competitiveness.

Although Albertans own most oil and gas resources in Alberta, it is investors that risk their capital to produce them. Without their investment, nothing is produced – and Albertans do not receive any benefits.

The purpose of this paper is to detail the Alberta Party Opposition's position with regard to Alberta's oil and gas industry and to communicate core principles and recommendations for action we believe are in the best interests of our province. We believe it is critical that any royalty review judiciously consider the cumulative costs of energy development and understand that increasing certain royalties, even if well-intended, may make Alberta's energy sector less competitive, reduce investment, create fewer jobs and, consequently, lower the total return to Albertans.

If the panel does consider these cumulative costs, it is incumbent on the government to apply the panel's recommendations even if those recommendations do not fit its political ideology.

The best way to maximize industry-generated returns to Albertans is by maximizing the total revenue generated by the industry. This requires achieving premium prices for our energy products, aggressively promoting Alberta's ambitious new climate policy to gain support for pipelines east, west and south. Alberta should also work with our neighbours in British Columbia to support LNG export facilities, and ensure we have adequate pipeline capacity to ship Alberta gas to the west coast and onto Asian customers.

Technology and innovation drive prosperity throughout the economy. In the context of oil and gas extraction, an effective royalty regime and a competitive overall fiscal structure will create a positive investment climate. This provides the private sector with the incentive to extract oil and gas resources based on the technology of today, but also enables investment in technology and innovation to increase recovery rates from the same reservoirs over the long term. Innovative technologies can, and will, enable the production of energy resources with a lower carbon footprint and with less impact on water, air and land. Any changes to the royalty structure must work in tandem with the recently-announced carbon plan, and appropriate incentives should be in place to encourage made-in-Alberta solutions to global environmental challenges.

Oil and gas extraction is highly capital intensive, and requires long-term investment time horizons, which, in turn, makes regulatory stability so important. The decision to alter a royalty regime has the potential to be highly disruptive, causing investment uncertainty. Investment decisions have been delayed pending the release of government's Alberta's Royalty Review, highlighting the critical importance of ensuring the new royalty structure is stable and predictable going forward.

We hope the government will consider the principles and recommendations outlined in this document as they develop their approach to Alberta's energy industry. Most of all, we hope the NDs choose to create the conditions to allow Albert to continue to be a major player in the global energy industry.

1. Recommendations for Immediate Action

Alberta faces significant challenges as a result of today's low prices for oil and gas. These challenges are compounded by the fact Alberta is located very far from major demand markets, continues to struggle to gain market access for its energy products and operates in a high-cost economic environment.

However, Alberta has high-quality energy assets, world-class technical capabilities and a highly skilled workforce. The provincial government should do everything in its power to produce optimal value from the assets thus enabling people back to work, support themselves and their families and contribute to the building of our province.

We call on the provincial government to take immediate action in the following areas:

1.1 Articulate support for growth of Alberta's energy sector, including the oil sands

The climate of uncertainty created by the Royalty Review has contributed to the substantial drop in energy investment in Alberta. The provincial government should ensure Alberta continues to be a highly attractive place to invest and remain "open for business." An active energy industry creates prosperity and social good for our province.

The Premier and Minister of Energy must remain emphatically supportive of the continued expansion of Alberta's energy industry, including the oil sands. Alberta has nothing to be embarrassed about when it comes to its oil and gas economy.

Owing to new and improving technologies, supporting Alberta's oil and gas industry is not inconsistent with the Province's efforts to address carbon emissions and climate change. In fact, Alberta's new climate change plan should be used as a platform to promote the industry at home and abroad, and gain support for export pipeline projects.

1.2 Cut the New Well Royalty Rate by 50% to match Saskatchewan, stimulate investment and create jobs

Alberta has a low 5% royalty rate applied to the first 12 months of production on new horizontal wells in order to incent drilling activity for these technically more complex and expensive horizontal wells. Though the program has been effective, the royalty rate still remains twice that of Saskatchewan's. Also, Saskatchewan's program exhibits the further strength of being based on volume, not time.

Given the dramatic drop in drilling and the associated job losses, as well as the impact on Alberta's provincial budget, reducing the NWRR by half to 2.5% and replacing the 12-month limit with a volume-based system would stimulate drilling and sends a clear signal that Alberta remains attractive for investors. It will also allow producers to optimize wells for long-term extraction rather than be compelled to produce as much as possible in the first year. We recommend the NWRR add a price component to scale up the royalty rate if prices rise. This incentive works hand-in-hand with recommendation 2.2 ("Market Access") below. The enhanced NWRR stimulates drilling activity, which in certain formations may

turn into a resource play, at which point a play-based royalty regime would kick in (see recommendation 2.3 below).

Drilling incentives like the enhanced NWRR would put Albertans back to work and result in increased revenues to the provincial government through increased personal and corporate taxes, and ultimately more royalties from increased production.

1.3 Educate Albertans about the ways oil and gas activity benefits our province, and how those benefits are achieved

The presumed goal of the Royalty Review is to ensure Albertans are getting optimal returns from our energy assets. While there is some concern this approach presumes we are not getting a fair return, the panel members have been clear they have not been guided by preconceived ideas about Alberta's royalty structure. Based on the panel's comments throughout the process we have faith that they kept an open mind and will make recommendations they believe are in the best interests of Alberta.

The governing party, on the other hand, has a strong belief that Alberta's royalties should be increased. Given their historical position on royalties, there is legitimate concern they will use the Royalty Review as an opportunity to increase royalties and/or other costs even in the face of challenging market conditions.

It is important Albertans have confidence in our royalty system, and know there are no silver bullets or simple solutions to creating a regime that delivers optimal returns in all circumstances, especially in a changing world. Any changes will have consequences, intended or not. The panel's report is an opportunity to move beyond rhetoric and create sound, resilient policy that will bring optimal benefits to Albertans.

Albertans have the right to know royalties result in a good return to the provincial treasury while not being so high as to stifle investment, because lower investment means less production and a lower return to Albertans. In today's challenging economic climate it is very likely this is already the case.

1.4 Create an ongoing Resource Owners Report

Many organizations in both the public and private sectors produce stakeholder reports that report their activities and outcomes across economic, environmental and social measures (often referred to as the "triple bottom line").

We recommend that the government issue an annual report quantifying industry performance, direct and indirect economic benefits, royalty rates, surface land rentals and other government revenues, environmental and social impacts and benefits. Among other measures, this will better sensitize Albertans to the contributions, costs, challenges and opportunities presented by the oil and gas assets owned by Albertans.

The report should be written in simple, accessible and straightforward language, and use graphics to illustrate concepts and trends wherever possible. It would serve to increase Albertans' trust that we are receiving a fair return for our natural resources. It represents an another opportunity to ensure transparency in the operation and regulation of Alberta's energy industry.

2. Principles of an Effective Royalty Regime

An effective royalty regime balances the desire for a return to Albertans from the resource we own with the need for an attractive investment climate. Albertans own valuable resources, but we will not receive optimal returns if the private sector does not invest to extract them, and the transportation infrastructure does not exist to sell them at world prices.

We call on the provincial government to be guided by the following principles when updating Alberta's royalty structure.

2.1 Alberta's royalties should be globally competitive, simplified, predictable and encourage innovation

Alberta's royalties must be seen in the context of an uncertain global market for our oil and gas commodities, the emergence of new competition from US-based shale producers and widespread concerns about climate change. As noted above, Alberta benefits greatly from our oil and gas industry and any changes to the royalty structure must be focused on ensuring this continues. An increase to royalties, even at higher commodity price levels, will have the effect of driving away investment to the detriment of our province's economy.

The complexity itself of Alberta's royalty system increases compliance costs for industry as well as government, and can make it more difficult for Albertans to understand the return we receive from energy development. Our royalties must be predictable over the long term because timelines for resource development are long; multi-year and sometimes multi-decade. Investment decisions are made easier when there is confidence royalty rates will be predictable and fair over the long term.

Programs like the New Well Royalty Rate, the Natural Gas Deep Drilling Rate, and the Innovative Energy Technology Program (the IETP provides royalty adjustments both to pilot and demonstration projects that use innovative technologies to increase recoveries from existing reserves and to encourage responsible energy development) should be preserved and enhanced. These create stability and give investors confidence in Alberta as a great place to invest, leads to more industry activity, more jobs and higher government revenues.

2.2 Expand market access for all Alberta oil and gas

Royalties, and indeed all government income from the oil and gas industry, must take into account the challenges that come from a lack of market access for Alberta energy projects. Although most publicity has surrounded pipelines, Alberta would also benefit from access to global markets for our natural gas. This means increased gas pipeline capacity to British Columbia and support for that province's LNG projects.

The principle question behind the Royalty Review is whether Albertans are receiving optimal value for our energy products. Given market access constraints it is difficult to receive optimal value for oil, for instance, Alberta's oil is priced to a discount against premium international benchmarks. Any new royalty regime must support export pipeline

development for projects like Energy East, the TransMountain expansion and Northern Gateway. Improving international market access is a win-win-win: for Albertans, it means more jobs; for government, it means more revenues and a greater ability to deliver services; and for industry, it means an earlier payback and a greater return on investment.

2.3 Encourage the development of strategic unconventional resource plays by adopting a cash flow-based royalty structure

Alberta's shale gas and light tight oil deposits have the potential to add significant value to the province; they are geologically very similar to those basins currently attracting elevated oil and gas attention in North America (eg. the Permian, Utica, Eagle Ford and Bakken plays). Targeting emerging, strategic liquids rich resources like Alberta's Montney and Duvernay plays is even more important in the current price environment, where investors will be seeking out the lowest-risk assets.

These assets are so important, and require such significant capital investment over a long period, that a cash flow royalty similar to the one used in the oil sands is more appropriate. This means a lower royalty is payable until the initial capital costs are recovered, and a higher royalty is captured once "payout" is reached. This structure encourages investment, creates activity, jobs and tax revenues in the short term and more stable revenue at a higher royalty rate over the long term. It also has the added benefit of discouraging poor production practices to maximize early low royalty rates.

We envision this system working hand-in-hand with the enhanced New Well Royalty Rate referenced in Recommendation 1.2 which provides incentives for drilling. Producers would chose one of the two program, but not both simultaneously.

2.4 Create incentives to maximize the long-term development of Alberta's resources, encourage enhanced oil recovery and enhanced gas recovery

Many of the known oil and gas fields in Alberta have significant remaining hydrocarbons to be recovered; however, many of these partially depleted fields require significant investments in facilities, infrastructure and drilling as part of an enhanced oil and gas recovery schemes.

Enhanced oil recovery (EOR) projects have a proven history of optimizing the total recoveries of oil and gas from reservoirs. Virtually all enhanced oil recovery projects require significant up-front capital investments that can result in long-term production and higher recoveries of oil and gas than drilling alone. In turn, the province would collect significantly greater royalties.

A technology that is not as established, enhanced gas recovery projects may be applied to natural gas reservoirs in Alberta. Again, a suitable regulatory framework and innovation funding may allow industry to further gas recoveries. In Enhanced Gas Recovery schemes, Nitrogen (N_2) or Carbon Dioxide (CO_2) are injected into natural gas reservoirs to artificially increase pressure – which results in increased gas recoveries from the well.

An added benefit is that includes re-using existing infrastructure and re-starting abandoned vertical wells by tying them together with new horizontal wells to produce hydrocarbon using enhanced oil recovery (EOR) techniques including water- or gas-floods.

The current royalty regime discourages these types of projects. Alberta would be well served by the industry pursuing investments in enhanced oil recovery schemes to increase oil and gas production from older, depleted fields and thus increase royalties payable. Pursuing this policy would have the added benefit of reducing the number of abandoned wells because some would be put back into use as part of EOR programs. Further, if CO_2 is the gas injected for EOR or EOG projects, this is an effective means of carbon sequestration and storage (CSS).

2.5 Maintain the fundamental structure for oil sands royalties, narrow eligible write-offs against initial capital costs

In contrast to conventional production, royalties for oil sands projects are calculated on a cash flow basis, meaning lower royalty rates are paid until both the project's full cost and the financing costs have been recouped. Afterwards, a much higher royalty rate comes into effect. This arrangement provides an incentive for investors to take the risks required to invest in such capital-intensive and long-term projects.

The Alberta Party Opposition believes the cash flow model is appropriate for oil sands projects and should be maintained at current rates. However, eligible write-offs against initial capital costs should be narrowed and the Province should maintain vigilance to ensure only costs directly related to a specific project are included in pre-payout calculations. This will allow oil sands projects to reach payout sooner, and begin generating higher royalties earlier.

2.6 Modify and phase-in the implementation of the Shallow Rights Reversion (SSR) policy

The Shallow Rights Reversion (SSR) was introduced in 2007 with the New Royalty Framework. It was met with mixed support, mainly related to administrative burden it would put on the regulatory bodies (now the AER and Ministry of Energy), and was indefinitely put on hold in 2010.

The Shallow Rights Reversion (SRR) means that oil and gas rights above the top of the shallowest productive zone in an agreement are removed from the lease and put back out to bid. This has been the case for deep rights (below the lowest point of a productive zone) for some time, but shallow rights have been excluded. In simple terms, it is a "use it or lose it" policy that requires rights holders to drill or give up the portion of the formation they are not drilling.

The objective of SRR is to stimulate activity and increase production. This will also create opportunities for smaller producers to drill because often the producers who own these rights do not find it economic to produce in shallower formations, where smaller producers might.

It is important that these changes are phased in over several years to ensure surface access concerns are addressed and that a fair and transparent contracting process is put in place.

Our recommendation is to reinstate these policies with one fundamental modification. The shallow rights would only be caused to expire through application from another operator, through much the same process as posting land for public land sale. This assures there is another party with the intent to develop or explore on the shallower rights.

2.7 Consider total benefit beyond just royalties; align royalties with the new carbon tax

Alberta's new government has significantly increased corporate taxes and implemented a new carbon tax. Along with increasing property taxes, land sales and leases, fees and other operating costs, these create a challenging climate for energy producers, especially in a low price environment.

It is essential that the Royalty Review considers the cumulative impact of all of these costs, economic and social; and that it ensures that investment continues to flow into Alberta. Raising royalties too far will stifle flow of investment and lead to lower activity, fewer jobs and lower government revenue.

Further, it is important the full impact of the carbon tax is considered in royalty calculations. For example, many producers use their own gas to power compressors. With the new carbon tax the cost of this gas will increase substantially, altering project economics to the point where a significant number of wells are no longer economic. This and other (likely unintended) consequences of the carbon tax must be taken into account in royalty calculations going forward.

2.8 Take a market-based approach to "value-added"; avoid direct government participation; be cautious about regulations that require upgrading

It is important to understand the integrated nature of North American energy sector, where raw product is produced wherever it is found (in Alberta's case a long way from major population centres), and it is shipped and refined closer to the point of consumption. This is why pipelines are so important to the economic viability of Alberta's oil sands and conventional and unconventional energy producers.

Projects like the North West Upgrader (now called the Sturgeon Refinery) provide a cautionary tale for government investment in so-called "value added". The Alberta Party Opposition believes that private enterprise is better suited to evaluate the risks and rewards associated with refining projects. It is noteworthy that the only new refinery built in Alberta in the past three decades required substantial government support and exposed Alberta taxpayers at significant financial risk.

While the government may have ideological reasons for using tax dollars (or bitumen royalty-in-kind) to finance the refining in Alberta, it is geography and economics – and not government policy, that have allowed the industry to develop the way it has.

Additionally, barriers to smaller scale cogeneration of electricity from natural gas need to be reduced. Natural gas is a reasonable bridge fuel from coal to greener renewables. Other derivatives of natural gas (methanol and other petrochemical products) can be produced in Alberta and shipped to other markets with established transportation networks.

The argument that Alberta is "shipping jobs down the pipe" doesn't hold, since it implies what we are doing today does not add value to our province. The hundreds of thousands of Albertans whose livelihoods rely on the oil and gas industry as well as and skilled labour shortages prevailing as recently as one year ago, will attest to the fact that when Alberta's energy industry is operating at capacity it does indeed add significant value.

There are opportunities to implement well-designed and targeted incentives to encourage the production of synthetic crude, partially upgraded bitumen and petrochemicals (especially given the abundance of natural gas and propane in Alberta), but these do not necessitate direct government participation. The core principle must be maintained that any incentives schemes allow the market decide which projects are built based on its assessment of risk and return.

2.9 Evaluate Alberta's overall position on an ongoing basis to ensure we remain competitive

The capital required to finance energy projects easily moves between jurisdictions seeking the highest return. A competitive fiscal regime that takes into account all aspects of a project, from political stability and the scale of the resource to the total cost of doing business — including corporate taxes, royalties, fees, property taxes, land leases etc. — is vital to ensuring the long-term viability of an energy-producing region.

As the landscape for energy production changes over time it is important that Alberta review its fiscal structure on a regular basis. Although stability is equally important, scheduling transparent reviews will mean Alberta's royalty structure continues to keep Alberta competitive and ensure Albertans receive an optimal return from our resources by ensuring activity is maintained.

2.10 Phase in any royalty changes to protect investments made in good faith

Substantial investment has been made based on the existing royalty regime and it is vital that Alberta continue to be seen as a stable and reliable place to do business. Any royalty regime changes should be phased in to minimize any adverse impacts on the economic basis of existing investment.

We recommend that producers are given the option to adopt the new structure immediately or stay on the old structure for up to five years. This will protect existing investments while maintaining flexibility.

3. Additional Considerations – Orphan Wells

There are several challenges with the current orphan well system. While it is vital that orphaned or abandoned wells are cleaned up in a timely and comprehensive manner, smaller producers in particular find it challenging to comply with the new rules because in many cases the rules have shifted project economics significantly. There are also issues with abandonment obligations and orphan wells delaying asset sales or bankruptcy proceedings.

The Alberta Party Opposition recommends the government undertake a comprehensive review of the Orphan Levy, the Licensee Liability Rating (LLR) program, the Licensee Liability Management (LLM) program and the Oilfield Waste Liability (OWL) program to ensure all are meeting the needs of Albertans to ensure orphan wells are remediated while still allowing for drilling activity and asset sales.