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Oilpatch Response To Royalty Review Still Grim

By James Mahony

Three days after Alberta's Royalty Review Panel delivered a report to Finance Minister **Lyle Oberg**, negative reaction from all parts of the Canadian oil and gas industry continues to grow.

After a few senior producers and their association responded earlier this week, a couple of smaller producers and the oilfield service sector added their views, rejecting the panel's recommendations.

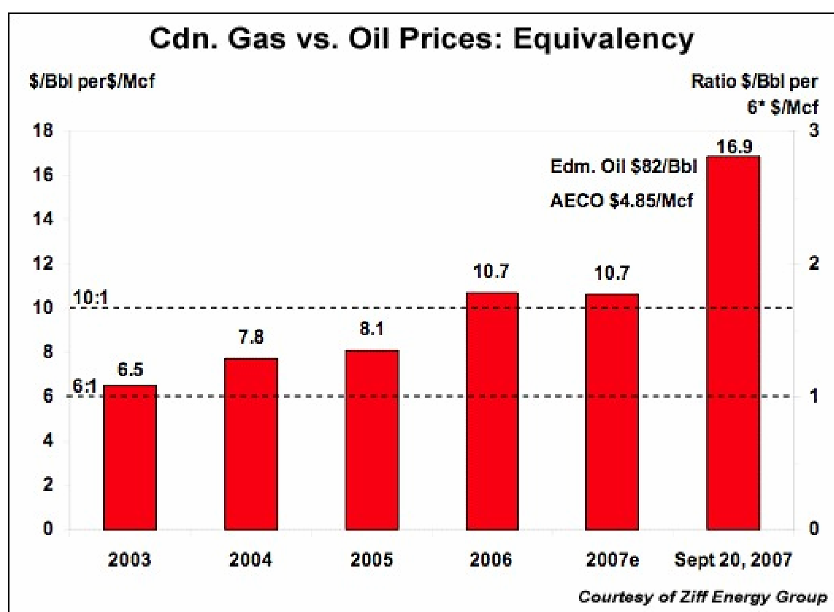
Oilfield service companies are concerned that the panel's recommendations would take the conventional industry, including natural gas producers, down the wrong road, worsening an industry slowdown that is already deepening.

The board of directors of the **Petroleum Services Association of Canada** (PSAC) issued a statement Thursday saying it is "gravely concerned that adoption of the recommendations will cause irreparable damage to PSAC's member companies and their 68,000 employees through further erosion of activity levels."

PSAC is now surveying its members to determine what the impact might be on employment levels. The service sector has already seen significant layoffs due to the downturn in gas prices.

Roger Soucy, president of the association, questioned how the provincial government would differentiate between low and high-productivity wells and how it would adjust the applicable royalty, especially on low-productivity wells.

"What's the definition (of low-productivity) going to be? I've heard some people indicate it will be high enough that 90% of the wells would not qualify. If so, then it doesn't mean anything for us, and it's an excuse for taking (revenue) out of one end of the industry, and saying you're giving back on the other side."



Already, Alberta's service industry has seen a 25% drop in activity this year, and Soucy said things don't look any better for 2008, and may be much the same as this year.

"That's without this (report). You take $2 billion out of cash flow from producers, who would spend most of that in the conventional industry where our members are, and we may have even less business this coming year."

"We're asking the Premier to be careful on how he moves forward in adopting any recommendations that are coming out of this study."

The royalty review panel's report called for Alberta's government take in the conventional crude oil sector to increase to 49% from 44%, while its share of natural gas would rise 63% from 58%.

The panel recommended that lower royalties apply to lower-productivity wells, while increased royalties would apply to higher-productivity wells. Under the new regime, the report said nearly two-thirds of Alberta's conventional oil wells would pay lower royalties, while 82% of gas wells would pay less. Still, it was not clear how low-productivity wells would be define under the new regime.

"I think it was quick and harsh," said **Doug Bartole** when asked about the recommended changes, "and any sort of harsh changes are never good. You don't know all the consequences when you make them and it takes some time to figure them out."

President and chief executive officer of **VERO Energy Inc**., Bartole said the short-term effect on his company's cash flow would be very negative. VERO is active in the Deep Basin, where its gas plays in the Rock Creek formation require deeper, more expensive wells. If the price of gas recovers, it would help the economics of the Rock Creek play. On the other hand, with higher gas prices, royalties also increase, he said.

As for the impact on U.S. independents now working in Alberta, Bartole thought some might leave, "but others will reduce capital spending, and that's the big thing."

Yesterday, a report by **FirstEnergy Capital Corp**. said the changes to conventional royalties, if adopted, would reduce cash flows for Alberta's conventional producers by roughly five per cent. Yet, the firm said producers with a higher proportion of low-productivity wells would be less affected by the changes.

Also yesterday, another oilpatch executive was blunt about the panel's recommendations to change the conventional royalty regime.

"It's clearly a grab for more cash," said **Fred Woods**, president and chief executive officer **Midnight Oil Exploration Ltd**. He had little patience with the panel's rationale for increasing royalties on higher-productivity wells while dropping them on lower-productivity wells.

"They're not selling (the proposals) on the basis that it's an improvement for producers, but on the basis that it's a formula that the provincial government has found (will) take more money," he said.

Despite operating in a very high-cost basin, Alberta's oil and gas industry attracts investment by having set rules and regulations that are well-understood by all the parties, with rules that are not subject to random changes and whims, he said. The upshot is that, if adopted, the panel's recommendations would increase uncertainty for investors, who will demand higher returns before they invest.

"That's not an environment for stable investment," he said. "You're talking about multi-billion dollar investments, where you need the entire world to feel safe and secure to put money in Alberta, and that just doesn't do it."

Without referring to Alberta Premier **Ed Stelmach** by name, Woods implicitly compared him to former Premier **Ralph Klein**. "Ralph knew not to do that. You just don't do that. There's no reason to. The business is thinly-margined. We're not making that much money."

While most of the public is focused on record high oil prices and the oilsands story, most of the producers and service and supply companies working in the oilfield derive the majority of their income from the natural gas sector which has been struggling since the spring of 2006. While oil prices were setting new highs last year and again this year, gas prices have fallen as storage inventories in North America have climbed to record levels. As a result, the price gap between oil and gas had widened dramatically (see graph, provided by **Ziff Energy Group**).

In its report, the review panel also called for simplification of the current royalty regime for gas, which it said had become overly complex as programs and exemptions were added over the years to compensate for what panel members described as "basic problems" that emerged over time, due to the maturing of the resource base.

The recommendations also stipulate that no grandfathering would be allowed, so that all producers would be equally affected by the changes.

In addition, the panel recommended that special royalty programs be eliminated, on the grounds that these will no longer be needed if the Stelmach government adopts the panel's proposal for a simpler, single formula for calculating the royalty. The new formula would combine price-sensitive and volume-sensitive components in one equation. Under the formula, the maximum royalty payable on gas or conventional oil wells would be 50%, while a minimum two per cent royalty would apply to gas wells.

The panel report also recommended that the government-determined gas reference price be the only price used to determine royalties, meaning the current situation, in which producers may choose to apply their own corporate average gas price in calculations, would be eliminated. Maturing North American gas markets have rendered the provisions unnecessary, the panel said.

As well, panel members proposed that the option, currently available to some producers, to elect that the "oil sands" administrative status for primary or "cold- flow" oil sands wells be eliminated. The provision applied to producing conventional heavy oil wells in Alberta's township 53, which has long been classified as oil sands for administrative purposes.

The panel also recommended that the Alberta government deem a fee for processing that would apply to all gas-processing facilities in the province, with adjustments for different kinds of plants relative to the nature of the gas being produced, whether dry or wet, sweet or sour.

As well, the report recommended that the royalty formula for conventional oil apply to propane, butanes and pentanes-plus, whether or not the products are stripped of gas. As well, the group proposed that the recommended royalty formula for natural gas also apply to ethane, regardless of whether or not it has been stripped out of the gas.

The Stelmach government has indicated it will respond to the report of the Royalty Review Panel within sometime in the next four weeks.

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