Alberta's New Royalty Framework
Gradually Reduce Weighting of Canadian Buy Recommendations

Summary and Recommendation

Issuing his official recommendation, Premier Ed Stelmach softened the outrageous recommendations of a provincial royalty panel in his release late yesterday (see http://www.energy.gov.ab.ca/Org/Publications/royalty_Oct25.pdf). Oil Sands royalties apparently will increase to 40% from 25%, but the full impact is several years away, if then. The positive implications of the trend to higher oil price justify our continuing buy recommendations of **Canadian Oil Sands Trust (COSWF)**, **Encana(ECA)**, **Imperial Oil (IMO)**, **Petro-Canada (PCZ)**, **Suncor (SU)** and **Penn West Energy Trust (PWE)**. Just as the investors' share of future cash flow after royalty drops by a fifth to 60% from 75%, we reduce the weightings of Canadian buy recommendations in the illustrative McDep Energy Portfolio by a fifth. There may be no urgency to act as long as oil and gas prices appreciate. In fact, we think there is a cause and effect between untrustworthy government and commodity price.

Forty Percent Royalty on Oil Sands at $120 Oil

Honest Ed recommends that beginning in 2009, royalties to the Alberta government increase from the current 25% to 40% on a sliding scale as the benchmark West Texas light sweet crude oil increases in price from $55 a barrel to $120 a barrel. The premier's position carries great weight making the recommendation almost, but not quite, final. On its face such a change would reduce present value in our current estimates tied to a $66 real price by 10%. Should oil price reach our vision of $150 in 2010, the reduction in value would be 20% from the higher level.

The Premier said he is "negotiating" with the historic producers – Suncor (wholly-owned by SU) and Syncrude (COSWF 37%, IMO 25%, PCZ 12%). He expects the Crown agreements that guarantee the old royalty through 2015 to be changed to the new proposed system. The unspecified compromise could be in the application of the new royalty to just half of cash flow that would derive from mining rather than to all of the cash from mining and upgrading. On that basis, royalties could be lower than now, even at the higher rate.

Fundamentally, we are opposed to sliding scale royalties that to us represent "double dipping". A percentage royalty already goes up in dollars as price goes up. Alberta has long had sliding scale royalties while most royalties in the U.S. are fixed in percentage terms. We think most investors expect to share proportionately in price increases, particularly since much of the increase is mere inflation. On that point, the province would gain further advantage by keying higher royalty rates to the falling U.S. dollar.

Breakeven Oil Sands Price Rises to $65 a Barrel

A few months ago, the breakeven price of oil needed for a normal return on investment in a new oils sands mine and upgrader was about $50 a barrel (see http://www.mcdep.com/mr70703.pdf). Considering the decline in the dollar since then, the number may be $55 coinciding with Honest Ed's starting point for royalty increase. Further considering that it takes a starting price of $69 to give investors the same cash flow after a 40% royalty as at $55 after a 25% royalty. Allow for a gradual increase in royalty rate and the breakeven price becomes perhaps $65 a barrel. New projects like Petro-Canada's Fort Hills will probably still go ahead because near-month oil is now $90 a barrel.

Kurt H. Wulff, CFA

Oil and Gas Producers - Rank by McDep Ratio

	Symbol/	*Rating*	*Price (US$/sh) 25-Oct 2007*	*Shares (mm)*	*Market Cap (US$mm)*	*Net Present Value (US$/sh)*	*Debt/ Present Value*	*McDep Ratio*
Imperial Oil Limited (30%)	IMO	B	50.42	282	14,220	42.00	0.08	1.18
Suncor Energy	SU	B	106.15	472	50,100	105.00	0.09	1.01
Encana Corporation	ECA	B	66.59	756	50,300	72.00	0.19	0.94
Penn West Energy Trust	PWE	B	32.74	242	7,910	36.00	0.21	0.93
Canadian Oil Sands Trust	COSWF	B	34.78	479	16,660	39.00	0.08	0.90
Petro-Canada	PCZ	B	54.76	493	27,000	65.00	0.16	0.87

B = Buy, S = Sell, H = Hold
Present Value = Shares times Net Present Value divided by (1-Debt/Present Value).
Debt = Present Value times Debt/Present Value
McDep Ratio = **M**arket **c**ap and **De**bt to **p**resent value of oil and gas and other businesses

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