Intelligence MEMOS

From: Joel Balyk, Benjamin Dachis and Charles DeLand

To: Alberta Oil Royalty Regulators

Date: October 18, 2021

Re: **Alberta's Outdated Oil Sands Royalty Regime Needs A Fix**

Canada's oil sands accounted for 63 percent of oil production in Canada in 2019, and their royalties have been the source of 7.7 percent of Alberta's revenues since 2008.

The province regularly reviews the royalty regimes in place for oil and natural gas extraction, but there is some contention about the design of one particular component of the oil sands royalty: the Bitumen Valuation Methodology (BVM). The BVM introduces inequity into the royalty system and should be fixed.

The BVM is a government regulation that sets the price, and therefore influences the royalty paid, of bitumen that changes hands through non-market transactions – usually between affiliates, such as when oil sands production is sent to an upgrader owned by the same company.

Our analysis shows that the BVM leads to the payment of higher royalties than is the case for similar production not subject to the regulation. We argue that royalty price setting for all bitumen sales should be determined by market prices, not by administratively set formulas.

There is an inequity in the current system that determines how much certain oil sands projects pay in royalties because of how the government determines the value of the bitumen they produce. Alberta's BVM has consistently overvalued that production, compared with market-determined values, by between $3 and $11 per barrel in recent years, thereby increasing calculated royalties for those producers.

In our new C.D. Howe Institute E-brief, we argue that royalty price setting for all bitumen sales should be determined by market prices, not by administratively set formulas. We recommend that the BVM rely on a principle of weighted-average third-party sales prices for regionally similar products to calculate bitumen prices, backstopped by market-based benchmark prices for western Canadian oil sands-diluted bitumen (dilbit).

Facilities that produce just under half of oil sands production were subject to the BVM in some capacity during 2020. Determining the exact volume of oil sands production subject to BVM is not possible because of data limitations, thus the most appropriate comparison to make is between mines subject to the BVM and mines not subject to the BVM.

The intent of the system was to ensure that resource owners (residents of the province, through the provincial government) were collecting royalties based on the correct market value of oil sands sold in non-market transactions. If the BVM value is less than the appropriate market value, the owners are not getting the correct share; if it collects too much, producers with non-market sales, such as to their own upgraders, might not have an incentive to invest.

We find that the BVM system is failing to ensure that all types of producers pay royalties that reflect the same market value by approximating a market price for the royalty share of non-arm's-length bitumen. In essence, the goal is to resemble a market-based price had the bitumen instead been sold to a third party. This process is inherently difficult, and has resulted in projects subject to the BVM being assigned revenues different from their non-BVM counterparts, all else equal.

This means the system has consistently overvalued that production, compared with market-determined values, by between $3 and $11 per barrel in recent years, thereby increasing calculated royalties for those producers.

With well over a million barrels per day of oil sands crude oil sold at market prices, the impressive maturation of the oil sands market now provides clear price discovery. In light of this misalignment, the Alberta government should re-examine the BVM.

Specifically, it should replace the current calculation with actual third-party sales data to calculate a regional proxy by which to value non-traded products, and remove its floor-price provision, which further exacerbates potential royalty differences between BVM and non-BVM volumes.

As a backstop, the government could consider using a basket of oil sands – specific diluent blends as a price input, the prices of which are now easily available. These changes alone would not guarantee increased oil sands investment, but they would improve the fair and efficient allocation of future investment in oil sands extraction and subsequent processing and transport activities.

Joel Balyk is a former Research Assistant at the C.D. Howe Institute, where Benjamin Dachis is Director of Public Affairs and Charles DeLand is Associate Director, Research.

To send a comment or leave feedback, email us at blog@cdhowe.org.