

# **Building Confidence:**

## **Improving Accountability and Transparency in Alberta's Royalty System**

March 28, 2008





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Honourable Premier Ed Stelmach  
Office of the Premier  
307 Legislature Building  
Edmonton, Alberta  
T5K 2B7

Dear Premier Stelmach:

I am pleased to submit my report *Building Confidence: Improving Accountability and Transparency in Alberta's Royalty System*. You asked me to consider three key areas: oversight of the royalty system; a review and assessment of the government's business processes and controls; and performance measurement and reporting. My findings and recommendations on each, and an action plan for implementing improvements, are contained in this report.

When I began this review, I expected to find areas in which substantial change is needed. Instead, what I found were business processes and systems at the Department of Energy that are generally well-designed, if not always well-executed. As is the case in most organizations, there is always room for improvement and my report details 13 recommendations that will help the government improve accountability and transparency in the royalty system.

I believe you have a good foundation from which to build and Albertans can be assured that the government is collecting all of the royalties properly owed to them as owners of the resource. The Department of Energy is staffed by a group of highly skilled and professional public servants who are ready to make the changes necessary to ensure Albertans are confident in the work they do to monitor and evaluate the royalty system.

I encourage you to consider adopting all of these recommendations as an important first step to restoring confidence in what is largely an effective system and would like to thank you for the opportunity to make a contribution to such an important area of public policy.

Sincerely,

(original signed by)

Peter Valentine FCA



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## Executive Summary

Overall, the Department of Energy has designed appropriate business processes and controls to support the goal of optimizing Alberta's share of resource revenue.

As long as the Department continues to apply and adhere to these business processes and controls, then I believe that Albertans can be assured the Department is collecting all amounts that can and should be collected under the royalty system. I could find no substance to support the claims made over the last year that over a billion dollars of royalties were not collected.

I also believe that the Department has established effective processes and controls to support the evaluation of the royalty system. In fact, Alberta is a leader in terms of how the royalty system is evaluated when compared to other jurisdictions. However, in my opinion, there are changes needed to the oversight which the Department provides for the royalty system.

There is a need to strengthen and formalize the review, consultation and decisions made relating to the ongoing effectiveness of the royalty system and the impact that industry development has on other goals of the government. In my opinion, the government should establish a formal process to evaluate changes to the royalty system that involves the ministries directly affected by these decisions – Alberta Finance and Enterprise, Alberta Environment and Alberta Sustainable Resource Development.

Within the Department of Energy, there is an opportunity to strengthen and formalize the management review and communication processes related to the evaluation of the royalty system. This is critical. As owners of the resource, Albertans should be able to find clear, concise information that helps them understand a complex system. The Department needs to provide greater clarity and transparency to the government's goals and the work done in the Department to manage the royalty system.

I believe that to make the necessary changes, the recently appointed Deputy Minister of Energy will need to take an active leadership role within the Department to address the recommendations in my report. To provide a road map to the Deputy Minister, I would encourage that in the first:

- 30 days he address my recommendations relating to the oversight of the royalty system
- 60 days he address my recommendations relating to the Department's business processes and controls
- 90 days he address my recommendations relating to reporting.

I recognize that to complete all that I am recommending may take longer than 90 days and will be subject to human resource, time and budget constraints. However, it is critical that the Department develops plans to make these changes, sets clear expectations and establishes accountability for when results will be achieved and then reports against those plans.

## Introduction

With the announcement of the government's New Royalty Framework in October 2007, the government initiated a process to assess and to make any improvements required in the systems, structures and resources used by the Department of Energy to support the collection, verification and reporting of provincial revenues arising from conventional oil, natural gas and oil sands.

As part of this initiative and at the request of the Premier, I was asked to review the government's systems and business processes in place to assess the performance of Alberta's non-renewable resource revenue policy and collection of royalties.

The following report provides the results of my review and includes a series of recommendations to enhance and improve upon the government's business processes and controls for Alberta's royalty system.

## Project Summary

My observations and recommendations are based on an assessment of the Department of Energy's (the "Department") systems and processes performed by KPMG LLP ("KPMG") and overseen by me.

At my request, KPMG considered the Department's business processes and controls for the collection of non-renewable resource revenue and the processes and controls for the ongoing evaluation of the royalty system. This included an assessment of processes relating to data collection, verification, error detection, controls, risk identification, monitoring and reporting.

Given that the Department deals with large public companies on a daily basis, it is important that their business processes, controls and reporting are in keeping with the most current public accounting practices. As part of the review, I asked KPMG to consider the practices at the Department of Energy in relation to the most current public accounting guidance and criteria as outlined in the following literature:

- Canadian Institute of Chartered Accountants ("CICA") Statement of Recommended Practice (SORP-2) – Public Performance Reporting, September 2006
- Committee of Sponsoring Organizations of the Treadway Commission Internal Control - Integrated System (COSO)
- Disclosure controls and procedures (DCP) guidance – Canadian Securities Multi-Instrument 52-109, National Policy 51-201, CICA guidance

In addition, KPMG conducted a cross-jurisdictional review looking at performance measurement, reporting, and responsibility for the management and oversight of the royalty systems in selected other jurisdictions. I have considered the results of KPMG's work in preparing my report and would like to thank them for conducting such a thorough review.



More information on the scope of their work is included in Appendix 1, including a list of the jurisdictions they reviewed.

I would also like to recognize the support and cooperation of the Department of Energy. Throughout this review I found their staff to be knowledgeable, competent and to have a strong understanding of their roles and responsibilities for the overall management of the royalty system.

## Understanding Royalties

The Oxford dictionary defines royalties as a payment made by a producer of minerals, oil, or natural gas to the owner of the site.

Generally speaking, most mineral, oil or natural gas rights are not owned by the developers or producers of the resource. In Alberta, most are Crown rights, owned by the people of the province.

Developers and producers will seek a right to develop these resources and will expect to generate sufficient revenue to cover their costs (including capital costs, operating costs, taxes and royalties) and provide for a reasonable rate of return in exchange for their investment and the risk that they take in developing the resource. The owner's goal should be to recover the maximum amount of the revenue that is available after allowing for the developer's costs and a reasonable rate of return.

## Alberta's Non-Renewable Resource Revenue

In Alberta, 81 per cent of the mineral rights<sup>1</sup> are Crown rights owned by the Province on behalf of Albertans. The remaining 19% is owned by the federal government, by First Nations and by freehold land owners where the title was originally granted to the railway companies, the Hudson's Bay Company and early settlers. The Alberta government grants the right to developers to explore for and develop its resources through a bonus bid system - a competitive sealed-bid auction process where the rights are leased to the highest bidder. Developers must also pay an annual rental fee in addition to the bonus bid for these licenses and leases. Royalties are determined and paid to the government based on a number of different factors including the type and classification of the resource, price and the productivity of the particular oil or natural gas well.

The Alberta government must ensure that Albertans, as the owners of these Crown rights, are receiving the maximum amount of revenue available to them from the oil and gas industry through bonus bids, annual rental fees, royalties and corporate taxes.

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<sup>1</sup> Minerals are defined in the *Mines and Minerals Act*. Alberta's mineral rights consist primarily of conventional oil, natural gas and oil sands.

## Alberta's Goal for the Royalty System

The royalty system, which is established through the *Mines and Minerals Act* (the "Act") and associated regulations and agreements<sup>2</sup>, is designed to ensure that Albertans' share of resource revenue is optimized.

On behalf of the owners of the resource, the Alberta government's goal, as reported in the Ministry of Energy's Business Plan and Annual Report, is to:

Optimize Albertans' resource revenue share and benefits from the development of their energy and mineral resources over the long term.

Inherent in this goal is the objective to collect 100% of royalties, bonus bids and annual rental fees that can and should be collected under the existing royalty system.

Responsibility for overseeing the development of this goal rests with the Minister of Energy who seeks input and advice from a number of sources including departmental staff, independent research and public consultation. Advisory committees and Cabinet sub-committees may also be established to provide input into the development and evaluation of the government's goal.

The Minister is also responsible for ensuring that the royalty system supports this goal. The Department implements programs and collects royalties in accordance with the Act, the associated regulations and agreements. The Department also has a responsibility to review the ongoing effectiveness of the royalty system, and to provide advice and recommendations to the Minister, including recommendations for changes to the legislative framework.

The Minister of Energy considers the advice and recommendations of the Department, together with other input such as public consultation and industry reports, in deciding whether changes to the royalty system should be considered by Cabinet. The Minister also needs to consider the impact that the royalty system may be having on these other ministry goals:

- Maintain the competitiveness of Alberta's energy and mineral resources.
- Secure future energy supply and benefits for Albertans within a growing and competitive global energy marketplace.
- Expand a value-added energy development in Alberta.

Generally, the Minister takes major changes to the royalty system to Cabinet, including contracts and agreements. This allows Cabinet to consider any amendments to the royalty system in relation to the government's overall fiscal policies and plans, the environment, and sustainable resource development. However, I noted that this is not a requirement for all changes to the royalty system. For instance, changes to agreements only require the authorization of the Minister of Energy, in consort with the Lieutenant Governor.

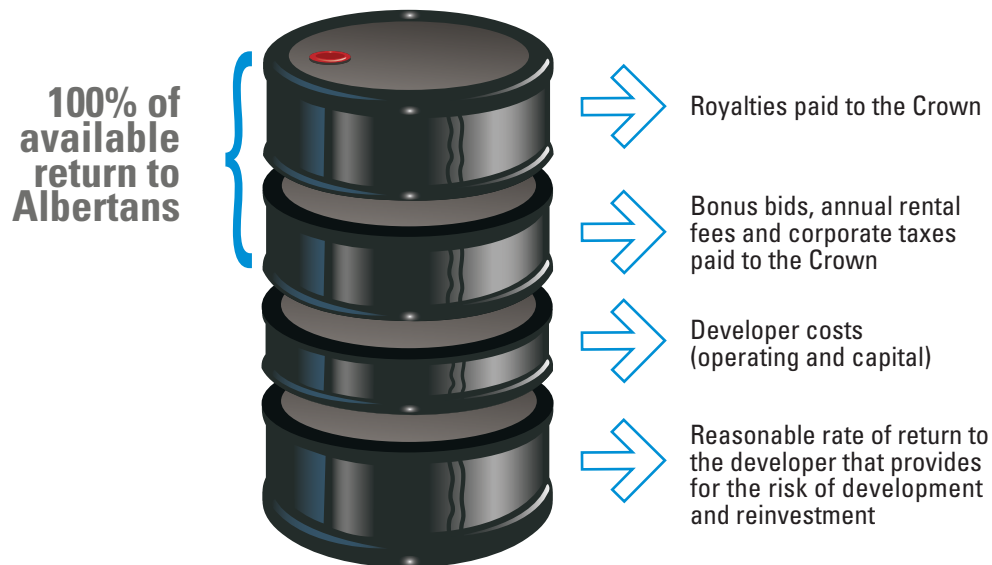
<sup>2</sup> Crown agreements are negotiated to address unique circumstances that are not covered in the Act or regulations. A primary example in the past has been Crown agreements that were negotiated with oil sands project developers.

## Measuring Alberta's Success

To determine whether the government has achieved its goal of optimizing Albertans' share of resource revenue, the Department calculates royalties collected as a percentage of the oil and gas industry's net operating revenue.

Currently the Department estimates that it will effectively collect 100% of the available return to Albertans by collecting 20% – 25% of industry's net operating revenue through royalties with the balance of the available return collected through bonus bids, annual rental fees and corporate taxes.

The following illustration shows how the revenue from a barrel of oil is distributed between Alberta (the owner) and the oil and gas industry (the developer):



## Oversight of the Royalty System

### ORGANIZATION, ROLES AND RESPONSIBILITIES

Pursuant to the legislation, the Minister of Energy is responsible for all aspects of managing the development of Alberta's conventional oil, natural gas, and oil sands resources. To support the Minister, the Department:

- Assesses and collects royalty revenue, including interpreting royalty policy
- Measures, monitors and assesses the effectiveness of the royalty system
- Recommends changes to the royalty system to the Minister of Energy
- Reports on the collection of royalty revenue and effectiveness of the royalty system.

This work is done primarily through three business units in the Department that correspond to the three resource commodities: conventional oil, natural gas and oil sands. While these business units are organized differently, each undertakes the work necessary to support the activities listed above. Additional business units oversee and are responsible for forecasting, audit and compliance, and other corporate services.

### KEY OBSERVATIONS

Over the last year there have been reports suggesting that government had not collected a significant amount of non-renewable resource revenue. More specifically, the 2006 – 2007 Annual Report of the Auditor General ("Auditor General's Report") stated that the government could collect an additional one billion dollars or more each year without stifling industry profitability. The Auditor General's Report also referred to specific technical analysis prepared by the Department which provided estimates for uncaptured royalties.

The Department's technical analysis is designed to look forward; it forecasts the net cash flows of the full life cycle of oil and gas industry projects based on assumptions for prices, costs and industry activity into the future. The technical analysis is not designed to measure the historical or current effectiveness of the royalty system; it predicts outcomes based on future assumptions. Based on the results of this technical analysis, the Department will develop and propose recommendations for changes to the royalty system to the Minister.

The Department's technical analysis did conclude that although the royalty system worked well historically within the ranges for which it was designed, the royalty system would not capture all of the available return during periods of high resource prices. From 2000 to 2005, resource prices fluctuated widely and at certain times rose well above historical levels. Although the Department had concluded that the royalty system was not designed to optimize Albertans' return during periods of higher prices, they had not determined whether prices would remain high, or fall back to historical levels.

The Department would have evaluated the results of the technical analysis along with other information such as industry development, levels of employment, commodity prices and cost trends, and the impact on future investment. The Minister and Cabinet would have also reviewed this analysis along with other information when considering whether changes were needed to the royalty system. The conclusion of the day was that further review was needed to assess the competitiveness of Alberta's royalty system with other jurisdictions and the percentage of industry revenue that Alberta was collecting.

Currently there is no requirement for the Minister or the Department of Energy to consult or review their forecasts and conclusions with other ministries beyond the provision of the overall forecasts to Treasury Board. Further, the legislation allows the Minister to negotiate agreements without consulting other ministries or Cabinet. In my opinion, there is a need to strengthen and formalize the review and consultations on the ongoing effectiveness of the royalty system and the impact that industry development has on other government ministries including:

- Alberta Finance and Enterprise which is responsible for managing the province's financial affairs and policies in the interests of Albertans
- Alberta Environment which oversees policies and initiatives associated with air quality, water management, waste management, land reclamation and climate change
- Alberta Sustainable Resource Development which encourages balanced and responsible use of Alberta's natural resources through the application of leading practices in management, science and stewardship.

Within the Department of Energy, the absence of a formal process to oversee the evaluation of the royalty system has resulted in a varying degree of coordination between the business units depending on the specific project or activity being undertaken. Furthermore, there are no processes in place to ensure consistent, department-wide application of standards and controls for the ongoing evaluations.

Finally, although the Department staff has strong technical skills and expertise, I found that in some instances, roles and responsibilities need to be redefined to ensure there is appropriate review and oversight for all key reporting and control activities. In addition, key functions need to be assessed to ensure they have the appropriate authority, necessary skills and reporting relationships to support their mandate.

## Oversight of the Royalty System (continued)

### OTHER JURISDICTIONS

In most other relevant jurisdictions, the Ministry of Energy, or its equivalent, is responsible for policy evaluation, while the collection of royalty revenue resides with the ministry responsible for revenue and/or taxation collection. There are likely a variety of reasons why other jurisdictions have separated the responsibility for evaluating policy from the responsibility for collection of revenue. In some respects these are independent and unique functions. However, both require a thorough and detailed understanding of complex royalty policies and programs and both depend on common data and information systems. Furthermore, the separation does not necessarily ensure sufficient and appropriate debate of policy since the responsibility for ongoing policy evaluation remains within one ministry.

Across the public sector, government operates within a context of managing competing goals and serving many diverse interests. In the last several years, we have seen an increasing demand on the public service to improve efficiencies and the quality of service, in an environment of rising costs, a shrinking work force and increasing complexities.

For the Alberta government to place the functions of royalty system policy evaluation and royalty collection in two separate departments would be a significant and costly undertaking which, in my opinion, would only provide limited benefit. I believe that the processes of planning, measuring, monitoring and assessing, collecting and reporting on performance are closely linked. When managed appropriately, these processes generate the information needed for both public reporting on performance and internal decision making and managing for results.

## RECOMMENDATIONS

### Organization review

1. The Deputy Minister of Energy should initiate a department-wide review to identify changes to the current organizational structure which will better align the Department's core businesses (collection of royalty revenue and ongoing evaluation) with the government's goals; clearly define responsibilities and reporting relationships between business units; and, develop an inventory of critical human resource skills and capabilities required.

### Inter-ministry royalty system committee

2. The government should establish a formal inter-ministry committee, chaired by Alberta Energy, with representatives from Alberta Finance and Enterprise, Alberta Environment and Alberta Sustainable Resource Development. This committee will provide a mechanism for the Ministry of Energy to consult with other key ministries on the impact of the royalty system. The committee's role, mandate and reporting relationships will need to be defined clearly.

### Cabinet approval

3. The Minister of Energy should consult with Cabinet on major royalty system policy changes and the principles which underlie the negotiation of Crown agreements.

## Business Processes and Controls

Overall, the Department of Energy's business processes and controls provide reasonable assurance that the Department is collecting all amounts that can and should be collected under the royalty system. In my opinion, however, there are opportunities for improvement in the following areas:

### MANAGEMENT REVIEW

Many of the Department's business processes which support the collection of non-renewable resource revenue, as well as the ongoing evaluation of the royalty system, rely on management review of key reports and other key controls. However, there is no standard which defines what would constitute appropriate and sufficient management review. Given the complexity of the royalty system, and the need for Albertans to have confidence in the information presented to them, the Department needs to have processes and controls in place that work.

Of specific note is the Department's use of economic models which are complex and involve significant data input. The Department does not have standard procedures which require analysts to validate data input into the economic models and as such there is a risk of data entry errors affecting the results of the technical analysis. While this risk needs to be balanced with the time and effort to validate and review all data entered, it is mitigated somewhat through the independent review of the results by the commodity business unit leaders and the Scenarios and Forecasting business unit. I also noted that there is no requirement to produce evidence that management has reviewed the results of the technical analysis or other key reports.

### INTERNAL COMMUNICATIONS

The importance of an effective internal communications process in a department dealing with complex technical issues cannot be overstated. Staff involved in the royalty system need to be aware of policy changes and of the linkages between the work they do and the Department's core businesses.

In general, the Department believes that royalty system policy changes or interpretations are accurately communicated to the business units most affected, including the Audit and Compliance group, the three commodity business units, and the Scenarios and Forecasting group.

However, in my opinion, the process of communicating this information is not well defined. There is a risk that Department staff may not be working with the most current information due to the lack of formal processes and clear accountability for communicating decisions and their impact within the Department.



## AD HOC REPORTING

I also considered the business processes and controls the Department uses to provide information relating to the royalty system in response to specific one-time requests. This type of reporting generally falls into two categories: external requests for information such as those from industry, media, or individuals and requests from the Minister's office. While this is a regular part of the Department's business, there is risk involved since these requests are often urgent. With limited time to formulate the response, the Department will often need to reference a number of source systems with varying levels of data validation.

The Department's systems do not readily facilitate these ad hoc requests and the normal reporting relationships and management review may be bypassed to address urgent requests for information.

## AUDIT AND COMPLIANCE

The Audit and Compliance group prepares annual plans to audit business units and industry submissions. Although there is a well defined process for audit planning and involvement of the business unit leaders, it was not clear how the Audit and Compliance group prioritizes key risks and activities and whether the current functional reporting structure is the most effective.

I also noted that this group has been challenged to both meet its annual audit plan and to complete oil sands audits on a timely basis. In some instances, oil sands audits are being planned and completed four years after the costs have been submitted to the Department. This situation will likely become even more pronounced as increased oil sands development results in the need for more audits. The Department attributes the lag in completing audits to staff shortages. In my opinion, this lag presents a significant risk given the critical role Audit and Compliance plays in ensuring the Department is collecting 100% of what can and should be collected from industry.

**Business Processes and Controls (continued)****RECOMMENDATIONS****Management review**

4. The Department should establish standards which define what is expected from management when reviewing and signing-off technical analysis, control activities and key operating reports which support the royalty system. The standards should be sufficiently detailed and communicated in such a way that there is a consistent understanding by management as to what constitutes sufficient management review. The Department should also implement policies which require management to provide evidence that this review has been completed.

**Internal communications**

5. The Department should implement a formal internal communications process to ensure that all policy decisions are documented and communicated to all affected staff.

**Ad hoc reporting**

6. The Department should develop policies which clearly establish the procedures and approvals required before any information is distributed. The Department should also assess the risk associated with the various systems used to prepare these reports and identify additional checks or balances for data sources which are assessed as being of higher risk. For example, free-standing economic models will be subject to a higher risk of error than will a system generated report. Where there is a risk that reporting will be subject to error based on current systems and complexity of the information request, the Department should communicate the specific risks or challenges associated with the reports being provided.

Over the longer term, the Department should review and identify modifications to its information systems to improve the ability to quickly access and validate information.

**Review of Audit and Compliance group**

7. The Department should conduct a review of the Audit and Compliance group to assess reporting relationships and authority within the Department and the adequacy of resources and skill sets. In addition, a review of the current audit planning process should be completed. This would include a comprehensive review of the audit plan to ensure that all key risk areas are being adequately addressed, as well as developing specific strategies to address current challenges faced in the timing of audits and in completing audit plans.

# Department of Energy: External Reporting

## KEY PERFORMANCE REPORTS

The Department's key performance reports include the Ministry's Business Plan and Annual Report which are produced in accordance with the Government of Alberta guidelines. In addition, the Department publishes a number of technical papers and statistics on its website and maintains a library of related documents and industry information that is available to the public.

At my request, KPMG reviewed the Ministry's Business Plan and Annual Report content against performance reporting guidelines published by the Public Sector Accounting Board ("PSAB"), a division of the Canadian Institute of Chartered Accountants ("CICA"). It is important to note that the PSAB guidelines are reasonably new and although the government's goal is to follow the guidance provided by PSAB, performance reporting develops over time. As such, I would not have expected the Department's reporting to fully meet all of the PSAB criteria.

Overall, it appears that the Department is partially meeting most of the PSAB criteria. However, the Ministry's Business Plan and Annual Report could be improved in the following areas:

- The reports should be easy to understand
- The Department should focus on a few critical aspects of performance rather than on a broad range of indicators
- There should be more information to help compare the Alberta experience to other jurisdictions.

In my opinion, the current public performance reporting does not explain clearly the government's goals for the royalty system. In particular, the government's goal to collect 100% of royalties that are properly owed to Albertans is not clearly stated and the current measures are not sufficient to communicate the government's effectiveness in meeting this goal.

Unless this is addressed, there will be room for speculation as to whether Albertans are receiving what is due to them as owners of the resource.

**Department of Energy: External Reporting (continued)****RECOMMENDATIONS**

In my opinion, the Ministry's Business Plan and Annual Report should continue to be the primary vehicles by which the government reports on its goals for the royalty system. However, given the complexity and significance of the oil and gas industry to Alberta, the Department should consider whether there are other ways to help Albertans find the information they need to understand the royalty system.

**Improve communication of the government's goals**

8. To improve the clarity and understanding of the government's goals with respect to the royalty system, the Ministry's Business Plan and Annual Report need to better explain how:
  - Alberta's share of industry revenue (i.e. 20% - 25%) equates to optimizing Alberta's share of resource revenue
  - The percentage of industry revenue that equates to optimizing Alberta's share of resource revenue will change over time as other factors change such as:
    - Commodity prices and industry costs including changes in the tax rates
    - Risks associated with the development of the resource including both economic and political risks
    - The maturity of the basin

The Department needs to improve the communication of its goal to maximize the collection of non-renewable resource revenue within the approved system which includes royalties, bonus bids, and annual rental fees. In addition, the Department needs to clarify and communicate that the objective of the royalty system is not to manage and monitor the pace of industry development.

Specific recommendations to improve the Ministry's Business Plan and Annual Report have been provided to the Department and are included in Appendix 2.

## Develop new information products

9. The Department should develop new products designed to help Albertans find the information they need to understand the royalty system such as:
  - Quarterly and annual industry statistics (including comparative statistics from other jurisdictions)
  - Construction starts and operational start ups including information on land available, reserves, permits and wells drilled
  - Policy and program changes
  - A technical review and policy planning document which explains the Department's planning and monitoring processes and outlines the key factors such as price, production and costs which the Department uses to ensure all revenues are collected and to monitor the effectiveness of the royalty system
  - An overview of the technical review process including the scope of these reviews, key factors which are continually monitored and any resulting policy changes.

## Communications audit

10. To facilitate the recommendations dealing with external reporting, the Communications Branch, in conjunction with the Business and Strategic Planning business unit, should conduct an audit of all royalty system information provided publicly through the Department's website and publications. This audit should include an assessment of whether the information is relevant to the intended audience, understandable, accurate and consistent.

## Royalty System: Benchmarking and Performance Measures

Benchmarking is essentially any type of comparative analysis and can be internal or external. Comparative information can include a trend analysis where the actual results for the current period are compared against the actual results for prior periods. This information allows users to assess plans, relate current achievements to long-term goals and assess progress over time. Trend analysis should cover a period longer than two years and the information should be prepared in a consistent manner over time.

Where possible, comparisons should also be made against the results of other similar organizations or industry benchmarks and significant differences in measures, data definitions and/or circumstances should be included as part of the organization's performance reporting.

I was asked to establish benchmarks that would be useful for evaluating and reporting on the royalty system. To do so I assessed the Department's current measures and reporting against other jurisdictions and considered the reviews conducted over the last year.

While I have already stated that the Department needs to improve communication of Alberta's goals, I believe the measures, which report on Alberta's share of resource revenue and Alberta's competitiveness, are appropriate benchmarks. At the same time, I believe there is an opportunity to make improvements and I have provided the Department with some specific recommendations which can be found in Appendix 3.

In my opinion, Alberta is a leader in reporting on the effectiveness of its royalty system. Looking outside of Alberta, it appears that only Saskatchewan reports on a measure that is similar to Alberta's. Furthermore, I found no jurisdiction that benchmarked its royalty system against other jurisdictions as part of its annual performance reporting. However, in my opinion, additional benchmarks are needed to more fully report on the royalty system.

## RECOMMENDATIONS

### Distribution of industry revenue benchmark

11. The Department should report a year-over-year comparison on the distribution of industry revenue between royalties, bonus bids, annual rental fees, corporate taxes, and industry costs and return on investment. This analysis should be reported for at least the last three years.

### Effectiveness of collection of royalty revenue benchmark

12. The Department should provide an additional internal benchmark on the effectiveness of the collection of royalty revenue. Options which should be evaluated by the Department include:
  - audit costs as percentage of revenue
  - revenue by source (royalty, bonus bids, annual rental fees, commodity type)
  - percentage of royalties collected without adjustment
  - percentage of overdue amounts collected
  - percentage of total royalties audited to total royalties paid.

### Comparison to other jurisdictions

13. To benchmark Alberta's royalty system against other jurisdictions, the Department should plan and conduct a review, including external input, which evaluates and reports publicly on:
  - The continued appropriateness of the 20% - 25% target range for Alberta's share of industry revenue
  - Comparison of Alberta's share of industry revenue to other jurisdictions
  - Industry investment and competitiveness.

In my opinion, this review should take place every three to five years; however, the Department should have some flexibility to adjust this time period to recognize significant events in the sector.

## In Conclusion

I was asked to review the government's systems and processes in place to assess the performance of Alberta's non-renewable resource revenue regime and collection of royalties.

As I have reported, the Department has largely designed adequate processes and systems to support the royalty system. The Department's employees are knowledgeable and understand their responsibility for managing the royalty system on behalf of Albertans. However, there are changes which should be made to enhance the government's overall management of the royalty system.

To make the necessary changes, in my opinion, the Deputy Minister will need to very quickly take an active leadership role within the Department. To this end he will need to:

- engage the Department's staff in building a strong vision of the Department's strategic goals
- build a strong, agile team culture
- realign the organization to better leverage the Department's intellectual capital.

To provide a road map to the Deputy Minister, I would encourage that in the first:

- 30 days he address my recommendations relating to the oversight for the royalty system
- 60 days he address my recommendations relating to the Department's processes and controls
- 90 days he address my recommendations relating to reporting.

I recognize that to complete all that I am recommending may take longer than 90 days and will be subject to human resource, time and budget constraints. However, it is critical that the Department develops plans to make these changes, sets clear expectations and establishes accountability for when results will be achieved and then reports against those plans.



## LIST OF RECOMMENDATIONS

### Organization review

1. The Deputy Minister of Energy should initiate a department-wide review to identify changes to the current organizational structure which will better align the Department's core businesses (collection of royalty revenue and ongoing evaluation) with the government's goals; clearly define responsibilities and reporting relationships between business units; and, develop an inventory of critical human resource skills and capabilities required.

### Inter-ministry royalty system committee

2. The government should establish a formal inter-ministry committee, chaired by Alberta Energy, with representatives from Alberta Finance and Enterprise, Alberta Environment and Alberta Sustainable Resource Development. This committee will provide a mechanism for the Ministry of Energy to consult with other key ministries on the impact of the royalty system. The committee's role, mandate and reporting relationships will need to be defined clearly.

### Cabinet approval

3. The Minister of Energy should consult with Cabinet on major royalty system policy changes and the principles which underlie the negotiation of Crown agreements.

### Management review

4. The Department should establish standards which define what is expected from management when reviewing and signing-off technical analysis, control activities and key operating reports which support the royalty system. The standards should be sufficiently detailed and communicated in such a way that there is a consistent understanding by management as to what constitutes sufficient management review. The Department should also implement policies which require management to provide evidence that this review has been completed.

## Internal communications

5. The Department should implement a formal internal communications process to ensure that all policy decisions are documented and communicated to all affected staff.

## Ad hoc reporting

6. The Department should develop policies which clearly establish the procedures and approvals required before any information is distributed. The Department should also assess the risk associated with the various systems used to prepare these reports and identify additional checks or balances for data sources which are assessed as being of higher risk. For example, free-standing economic models will be subject to a higher risk of error than will a system generated report. Where there is a risk that reporting will be subject to error based on current systems and complexity of the information request, the Department should communicate the specific risks or challenges associated with the reports being provided.

Over the longer term, the Department should review and identify modifications to its information systems to improve the ability to quickly access and validate information.

## Review of Audit and Compliance group

7. The Department should conduct a review of the Audit and Compliance group to assess reporting relationships and authority within the Department and the adequacy of resources and skill sets. In addition, a review of the current audit planning process should be completed. This would include a comprehensive review of the audit plan to ensure that all key risk areas are being adequately addressed, as well as developing specific strategies to address current challenges faced in the timing of audits and in completing audit plans.

## Improve communication of the government's goals

8. To improve the clarity and understanding of the government's goals with respect to the royalty system, the Ministry's Business Plan and Annual Report need to better explain how:
  - Alberta's share of industry revenue (i.e. 20% - 25%) equates to optimizing Alberta's share of resource revenue
  - The percentage of industry revenue that equates to optimizing Alberta's share of resource revenue will change over time as other factors change such as:
    - Commodity prices and industry costs including changes in the tax rates
    - Risks associated with the development of the resource including both economic and political risks
    - The maturity of the basin

The Department needs to improve the communication of its goal to maximize the collection of non-renewable resource revenue within the approved system which includes royalties, bonus bids, and annual rental fees. In addition, the Department needs to clarify and communicate that the objective of the royalty system is not to manage and monitor the pace of industry development.

Specific recommendations to improve the Ministry's Business Plan and Annual Report have been provided to the Department and are included in Appendix 2.

## Develop new information products

9. The Department should develop new products designed to help Albertans find the information they need to understand the royalty system such as:
  - Quarterly and annual industry statistics (including comparative statistics from other jurisdictions)
  - Construction starts and operational start ups including information on land available, reserves, permits and wells drilled
  - Policy and program changes
  - A technical review and policy planning document which explains the Department's planning and monitoring processes and outlines the key factors such as price, production and costs which the Department uses to ensure all revenues are collected and to monitor the effectiveness of the royalty system
  - An overview of the technical review process including the scope of these reviews, key factors which are continually monitored and any resulting policy changes.

## Communications audit

10. To facilitate the recommendations dealing with external reporting, the Communications Branch, in conjunction with the Business and Strategic Planning business unit, should conduct an audit of all royalty system information provided publicly through the Department's website and publications. This audit should include an assessment of whether the information is relevant to the intended audience, understandable, accurate and consistent.

## Distribution of industry revenue benchmark

11. The Department should report a year-over-year comparison on the distribution of industry revenue between royalties, bonus bids, annual rental fees, corporate taxes, and industry costs and return on investment. This analysis should be reported for at least the last three years.

## Effectiveness of collection of royalty revenue benchmark

12. The Department should provide an additional internal benchmark on the effectiveness of the collection of royalty revenue. Options which should be evaluated by the Department include:
  - audit costs as percentage of revenue
  - revenue by source (royalty, bonus bids, annual rental fees, commodity type)
  - percentage of royalties collected without adjustment
  - percentage of overdue amounts collected
  - percentage of total royalties audited to total royalties paid.

## Comparison to other jurisdictions

13. To benchmark Alberta's royalty system against other jurisdictions, the Department should plan and conduct a review, including external input, which evaluates and reports publicly on:
  - The continued appropriateness of the 20% - 25% target range for Alberta's share of industry revenue
  - Comparison of Alberta's share of industry revenue to other jurisdictions
  - Industry investment and competitiveness.

In my opinion, this review should take place every three to five years; however, the Department should have some flexibility to adjust this time period to recognize significant events in the sector.

# Appendices



KPMG Project Scope

Detailed Recommendations on the Department  
of Energy's External Reporting

Detailed Recommendations on the Department  
of Energy's Performance Measures

# KPMG PROJECT SCOPE

## THE SCOPE OF KPMG'S WORK INCLUDED THE DOCUMENTATION, REVIEW AND ANALYSIS OF:

- The Department of Energy's business processes, controls and supporting information technology systems for planning, measuring and monitoring, and reporting on the conventional oil, natural gas and oil sands resources including revenue from bonus bids, annual rental fees, royalties and corporate taxes.
- Source and nature of assurance the Department has over the accuracy and completeness of industry and/or other external data.
- Processes established by the Department to collect external data and information used to assess the performance of Alberta's non-renewable resource revenue policy and collection of royalties.
- Jurisdictional scan to identify practices for reporting on the performance of royalty systems.
- Delineation of roles and responsibilities for the overall management of Alberta's royalty system.

## THE SCOPE OF KPMG'S WORK SPECIFICALLY EXCLUDED:

- Review and analysis of royalty programs that will be eliminated as a result of the new royalty framework which takes effect in January 2009.
- Public and/or industry consultation.
- Establishing royalty system goals and targets.
- Detailed process maps, internal control and information technology systems documentation.
- Review of calculations, data input, reporting, and verification processes and controls that take place outside of the Department, for instance in oil and gas companies and the Energy Resources Conservation Board (the "ERCB").
- Testing of royalty processes, controls or information technology systems.
- Identification of detailed processes, controls and/or information technology system changes or re-design to meet recommendations made during the course of this project, or to address changing royalty calculations and/or programs.
- Implementation of recommendations identified through the course of this project.

KPMG's analysis was based on a series of workshops, interviews and review of documentation with the three commodity business units and members of the Department's management team. As part of their work, KPMG assessed the overall control environment and completed high to medium level process maps documenting the business processes and key control points for each of the following areas:

- Conventional Oil
- Natural Gas
- Oil Sands
- Performance measurement, forecasting, planning and reporting

KPMG conducted a cross-jurisdictional review looking at performance measurement, reporting, and responsibility for the management and oversight of the royalty systems in place in 24 other jurisdictions. There are very few jurisdictions that are comparable to Alberta with regards to the contribution that non-renewable resources make to the economy and government revenue. The notable exceptions were Norway and Alaska. As a result most other jurisdictions provided very limited public reporting. Jurisdictions which were determined to be of some relevance included Alaska, Louisiana, California, Oklahoma, Norway, New South Wales, Western Australia, British Columbia and Saskatchewan.

# DETAILED RECOMMENDATIONS ON THE DEPARTMENT OF ENERGY'S EXTERNAL REPORTING

The following specific recommendations have been provided to the Department of Energy to help improve the clarity and understandability of both the Business Plan and the Annual Report.

## BUSINESS PLAN

While the Ministry's Business Plan provides a road map for the Department's activities, additional contextual information should be provided to help readers understand the goals and strategies and to help Department staff see the linkages between their work and the plan itself. The following information should be included:

- Information on the resources in Alberta
- An explanation of who owns the resources
- What the Department does to manage the resources
- A description of the royalty regime
- The benefits Albertans receive from resource development
- Government context; i.e. federal and provincial fiscal policies
- Key factors that may influence performance outcomes such as price, cost, production or inflation
- Further information on opportunities and challenges
- Risk identification and mitigation strategies
- Department capacity to execute its Business Plan through an explanation of the link between human and financial resources
- Information on how Alberta compares to other jurisdictions which could be done through excerpts from third party reports such as Wood MacKenzie which reference Alberta's competitive position, production, and percentage of industry revenue due as royalties
- Additional contextual information on performance measures such as breakdown of revenues and percentage of industry revenue due to government as royalties
- Contact information for the Department's Communications Branch.

The Business Plan should clearly identify strategies and activities that are being implemented to respond to any areas in which performance fell short of the Department's targets in the previous year.

### ANNUAL REPORT

The Annual Report should be written for Albertans who are interested in finding out more about the province's resources. Anyone requiring more detailed information should be directed to additional sources.

The Annual Report should "tell a story" about Alberta's non renewable resources and the Department's activities in managing the royalty system. This could include:

- Information on Alberta's non-renewable resources
- The role of the Department in managing these resources
- Explanation of applicable policy, legislation and regulations
- Identification of key stakeholders such as Albertans, industry and other government entities
- Risks faced and mitigation strategies undertaken
- The Department's people and financial resources
- A summary of performance targets and results in a one page table
- A detailed discussion on performance targets and results, including calculation methodology, rationale for choosing the measure and key factors influencing performance results
- A comparison of Alberta's royalty regime and key performance indicators to other jurisdictions
- Financial results including discussion of assurance obtained over results
- Sources of additional information or detailed industry statistics in an appendix.

In the report, the Department should describe the factors contributing to performance which either exceeds, or falls short, of the ministry's goals. This should reference the ongoing technical review which evaluates current and future effectiveness of the royalty system.



## DETAILED RECOMMENDATIONS ON THE DEPARTMENT OF ENERGY'S PERFORMANCE MEASURES

The Department has four performance measures which fall within the scope of this review. Each measure was assessed against the following criteria:

- Reliability
- Validity
- Relevance
- Fairness
- Comparability
- Consistency
- Understandability

The following observations and recommendations have been provided to the Department of Energy on each relevant performance measure. In addition, the Department should consider publishing its performance measure working papers to provide better understanding on data input and sources used in the measurements.

### Goal 1: Optimize Albertans' resource revenue share and benefits from the development of their energy and mineral resources over the long term.

#### Performance Measure 1: Sharing the Profits from Resource Development

##### Key Observations:

- The measure provides a high level indicator as to how effective the royalty system has been.
- The measure is not well understood in terms of how it equates to optimizing Alberta's share of resource revenue, particularly as it relates to other jurisdictions, nor is it understood that the target range may change as conditions change.
- There are few royalty regimes in other jurisdictions that are structured in the same way as Alberta's and as such it is difficult to benchmark this measure against other jurisdictions.
- Only Saskatchewan reports a similar measure.

##### Recommendations:

- The description of the measure should be reviewed and clarified.
- Additional information on the nature of the measure should be provided which explains that it is a historical measure and does not measure the effectiveness of the system into the future.
- The target of 20% - 25% should be re-evaluated every three to five years or when there has been a sustained change in factors impacting the effectiveness of the royalty system.
- As part of the re-evaluation of the target range, the Department should also benchmark Alberta's share of industry revenue against other jurisdictions. The reasons for differences between Alberta's percentage of industry revenue as compared to other jurisdictions should be explained such as industry costs, political and country risk, type of resource and basin maturity.

#### Performance Measure 2: Audit Adjustments to Industry Filing and Reporting

##### Key Observations:

- The measure appears to be a proxy for "did we collect everything owed to us?"
- The measure is not well understood and is difficult to interpret.
- The measure does not adequately measure the Department's effectiveness in managing the royalty system.
- Other jurisdictions report percentage of overdue amounts collected or percentage of total royalties audited to total royalties paid.

**Recommendations:**

- The description of the measure should be reviewed and clarified.
- Add a measure that directly reports on the effectiveness of the Department in collecting royalties due.
- Include supplemental information to give the reader confidence that all royalties due under the current system have been collected.

### Goal 2: Maintain the competitiveness of Alberta's energy and mineral resources.

#### Performance Measure 3: Resource Development

**Key Observations:**

- This is a measure of industry investment.
- The measure is relevant, easily understood and provides useful information to compare results over time within Alberta.
- This is a commonly reported measure; however, there does not appear to be a consistent method across jurisdictions or in industry reports as to how it is calculated.
- As a result there are inherent challenges in benchmarking this measure against other jurisdictions.

**Recommendations:**

- The Department should conduct a comparative analysis of industry investment in other jurisdictions every three to five years to benchmark levels of industry investment in Alberta against other comparable jurisdictions.
- The measure should be indexed for general or industry-specific inflation.
- Consideration should be given to either develop a competitiveness index, or use an existing one, to measure Alberta's investment attractiveness against other comparable jurisdictions. This index should take into account the rate of return and risk factors.

### Goal 3: Secure future energy supply and benefits for Albertans within a growing and competitive global energy marketplace.

#### Performance Measure 4: Energy Resource Portfolio Diversification

**Key Observations:**

- This measure is intended to demonstrate the Department's success in influencing industry to extend production from conventional energy resources and to develop non-conventional energy resources.
- There may be an indirect relationship to the government's goal to optimize Alberta's share of resource revenue.
- The relevance of the measure is not clear and the description is highly technical.
- This measure is rarely reported by other jurisdictions.

**Recommendations:**

- The description of the measure should be reviewed and clarified.
- The Department should report at a high level on the "specific royalty features" in place to encourage development of new sources of energy or new technologies to enhance production.
- The Department should simplify the discussion of the results of this measure.



