NEWSLETTER

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July 12, 2004

UNDERSTANDING FREEHOLD MINERAL TAX

Three hundred and thirty-one years ago, a group of American colonists, enraged by what they felt was an unfair tax imposed by Britain on goods sold in the English colonies, disguised themselves as Mohawk Indians, overpowered the crews of three British ships and threw forty-five tons of tea into Boston harbour. The 'Boston Tea Party' lead directly to the American Revolution.

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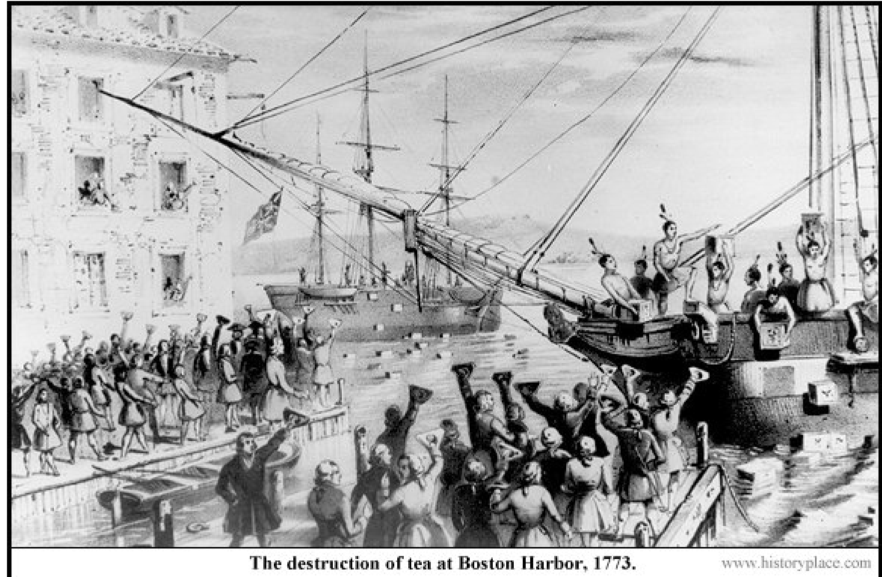

The destruction of tea at Boston Harbor, 1773. www.historyplace.com

Twenty-first century Canadians are subject to a bewildering array of taxes. The federal and provincial governments tax our employment and investment income. We pay GST on almost all of the goods and services we consume and, in all provinces but Alberta, we are subject to provincial sales tax. Specific consumption taxes are also levied on such things as tobacco, alcohol, and gambling. At the municipal government level, we pay tax on the deemed value of our property. In addition to these direct taxes, Canadians pay a host of fees, permits and licenses to all levels of government.

What these taxes or quasi-taxes have in common is that the taxpayer receives a benefit in return for his money. For example, when we pay property tax, we receive police, fire, garbage, and other municipal services. Similarly, when we pay income or consumption taxes, our monies are used by our federal and provincial governments to fund social programs such as medicare and to finance the physical infrastructure upon which we all rely. Even consumption or so-called 'sin taxes' provide some benefit to the 'sinner' in the form of government-sponsored anti-smoking, alcohol and gambling abuse programs.

This issue of your newsletter focuses on a little understood form of tax - the tax levied by provincial governments on production from freehold oil and gas rights. **The freehold owners who directly or indirectly paid more than $430,000,000 in freehold mineral tax last year had no say in how these dollars were spent and received no direct benefit whatsoever from the provincial governments who collected this tax.**

In this issue, we examine how much freehold mineral tax is collected in each province; the rationale for the tax; how the tax is calculated and collected; and, most critically, the impact of the tax on freehold owners. We also examine recent changes in the treatment of freehold mineral tax under the Income Tax Act and the effect of these changes on lease negotiation strategies.

If there was any doubt that modern-day Canadians expect and demand value for their tax dollars and a say in how for these dollars are spent just as the American patriots did three centuries ago, that doubt was laid to rest by the sponsorship scandal. Auditor General Sheila Fraser's audit of the Liberal Government's advertising and sponsorship program revealed that $100 million had been paid in fees and commissions which produced no benefit for the taxpayer. Canadians of every political persuasion were outraged and the scandal clearly impacted the outcome of the recent federal election. **The Freehold Owners Association has no objection to provincial governments taxing production from freehold mineral rights, but the time is long past for these governments to dedicate at least a tiny fraction of the tax collected to helping freeholders address the many problems we face.**

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FREEHOLD MINERAL TAX

Which Provinces Benefit:

Although privately owned (freehold) subsurface oil and gas rights exist within the boundaries of Newfoundland, Quebec, Ontario, Manitoba, Saskatchewan, Alberta and British Columbia, no material production has been established in onshore Newfoundland or Quebec.

In Ontario, modest amounts of oil and gas are produced from the southwestern part of the Province in the area of Sarnia. Almost all of the oil and gas rights in this area are freehold, but the Ontario Government does not levy a tax on production from freehold mineral rights.

Each of the four western provinces collects a tax on oil and gas production from freehold mineral rights, but the amount of tax collected varies widely depending on the oil and gas reserves of the particular province and the percentage of freehold mineral rights within the province.

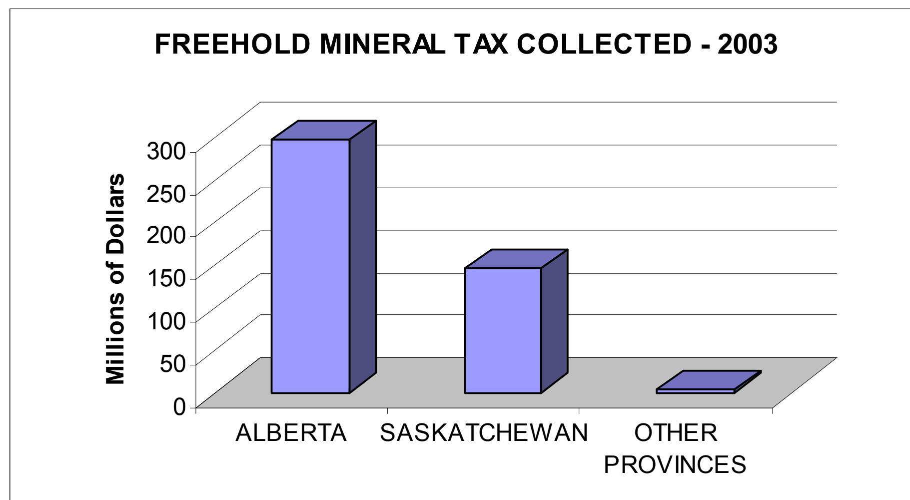
Manitoba is not blessed with the same level of oil and gas resources as the other western provinces. As a result, although 80% of the mineral rights in the productive southwestern portion of Manitoba are held by individual freeholders, the Manitoba Government collected only about $3 million in freehold mineral tax last year.

British Columbia has significantly more oil and gas resources and production than Manitoba. However most of B.C.'s current production comes from the northeastern part of the Province where there is very little freehold ownership of subsurface oil and gas. Consequently, the freehold mineral tax collected by the British Columbia Government is non-material. This may change in the future. British Columbia has vast reserves of coal and freehold ownership of subsurface oil and gas is common in areas such as Vancouver Island which are prospective for coal bed methane development.

The provinces of Alberta and Saskatchewan are the beneficiaries of the vast majority of freehold mineral tax collected in Canada.

Approximately 22% of the productive southern portion of Saskatchewan consists of freehold mineral rights. According to Saskatchewan Government officials, **last year Saskatchewan collected $146 million in tax on the production of oil and gas from these freehold rights.**

Within Alberta, roughly 12% of subsurface oil and gas rights are freehold. Most of these freehold rights are located in the southern portion of the Province which has historically provided most of Alberta's conventional oil and gas production. **Last year, Alberta collected $288 million in freehold mineral tax.**



Original Rational for Freehold Mineral Taxes:

In 1947, when Leduc No. 1 blew in and changed the economic future of Alberta, the royalty charged by the Province of Alberta on production from Crown lands was the same as the royalty rate in freehold lease agreements - 1/8th or 12 ½%. At the time, Alberta levied a very modest tax on both non-productive and productive mineral rights. In the years following the Leduc discovery, successive Alberta Governments raised the royalty rates charged on Crown lands so as to provide the citizens of Alberta with a fairer share of the proceeds of production. Premier Ernest Manning's Social Credit Government first raised the maximum Crown royalty rate to 16 2/3%. In 1972, Premier Peter Lougheed's Conservative Government eliminated this maximum. Significantly higher Crown royalty rates were imposed by the Lougheed Government in 1982. These higher royalty rates applied to all Crown lands, including Crown lands which had previously been leased to oil companies under lower royalty rates and which were producing.

The Alberta Government's retroactive royalty rate increase applied only to Crown lands. The 12 1/2% royalty rate in most existing freehold lease agreements remained the same.

The original rationale for the Alberta Government's introduction of a tax on the production of oil and gas from freehold mineral rights was to minimize the discrepancy between higher Crown and lower freehold royalty rates in order to remove any incentive the oil and gas industry might have to develop freehold rights in preference to Crown rights. Other western provinces followed Alberta's lead.

Calculation & Collection of the Tax in Alberta:

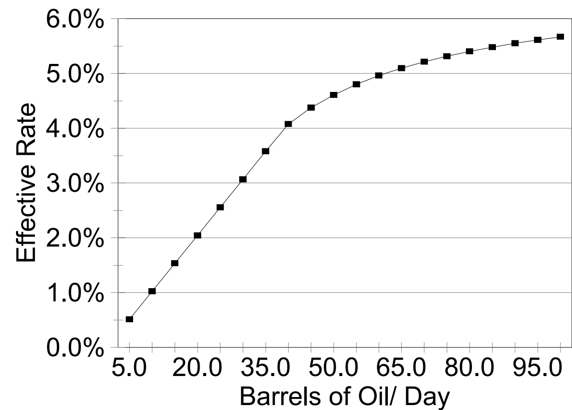
In Alberta, the method of calculating and collecting freehold mineral tax is set forth in the Freehold Mineral Tax Act Regulations. Interested readers can review this legislation by going to the Alberta Queen's Printer web site (http://www.qp.gov.ab.ca/index.cfm) and searching under "F".

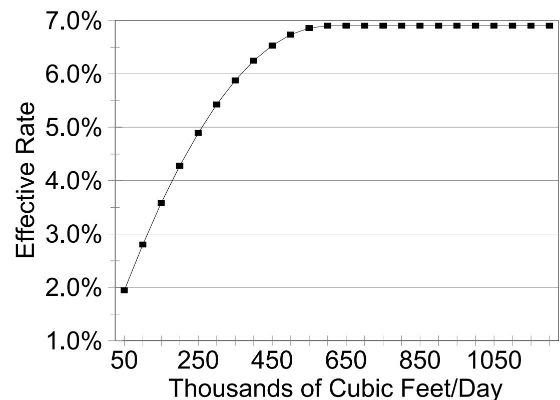
Separate freehold mineral tax rates are prescribed for oil and gas as shown in the charts to the right. The rate of tax on oil increases from 1% for a well producing at an average annual rate of 10 barrels per day to 5.7% for a well at 100 barrels per day. The rate of tax on gas is 6.9% for wells producing at an annual average of 600 thousand cubic feet of gas per day (16.9×10^3 m^3 per day) or more. A reduced mineral tax rate applies for lower average daily gas production volumes.

In the case of both oil and gas, the Alberta Government provides an exemption on the first $1600 of freehold mineral tax payable each year by a mineral title owner.

Each February, Alberta freehold owners who owe more than $20 in freehold mineral tax receive statements from Alberta Energy setting forth the freehold mineral tax due on production attributable to their mineral title in the prior year. These statements require payment of the tax on or before March 25th and invariably give rise to dozens of calls to FHOA's offices (and to the offices of Alberta Energy) from concerned and confused freeholders.

The concern and confusion arises from the structure of the Freehold Mineral Tax Act; the wording of many freehold leases; and oil and gas industry practice. Under the Act, liability for payment of the entire assessed freehold mineral tax rests with the freehold owner, and failure to pay may result in forfeiture of the mineral right to the Alberta Government. However, most existing freehold lease agreements provide for a sharing of freehold mineral tax between the oil company-lessee and the freeholder.





In most existing freehold leases, the freeholder is responsible for only his royalty share of the mineral tax. Standard practice in the oil and gas industry is for the oil company-lessee to pay 100% of the freehold mineral tax and then deduct the freehold owner's royalty share from future royalties. Oil companies do this out of self-interest. They recognize that many freeholders cannot afford to pay 100% of the tax set forth in the Alberta Energy mineral tax statements and that a freeholder's failure to pay would put the oil company's leasehold interest at risk.

Unfortunately, the taxation clauses in many existing freehold lease agreements, including the widely used CAPL 91 lease form, conflict with oil and gas industry practice. These leases require the freeholder to pay the entire mineral tax and then bill the oil company-lessee for the company's share. In its tax statements, Alberta Energy advises freeholders to contact their oil company-lessee if they are unsure as to who will pay the tax. This is good advice but unfortunately not all oil company-lessees bother to respond to inquiries from freehold owners.

It is regrettable that the oil and gas industry steadfastly refuses to adopt the CAPL 99 lease form which it approved four years ago and which provides for the oil company-lessee to pay 100% of the mineral tax and then bill the freeholder.

Calculation & Collection of the Tax in Saskatchewan:

Saskatchewan has adopted a completely different approach to calculating and collecting its tax on freehold oil and gas production.

Firstly, the liability for payment of freehold mineral tax in Saskatchewan rests with the oil company that operates the well on freehold mineral rights, not the freehold owner. Secondly, in Saskatchewan the freehold production tax is tied directly to the formula for calculating royalty on Crown mineral rights. The Government effectively requires the operator of a well on freehold lands to pay to it a tax equal to what the royalty would be if the well were on Crown lands less a 'production tax factor' (PTF) intended to account for the fact that oil company is also paying a royalty to the freehold owner.

The PTF on oil and gas production in Saskatchewan varies from 6.9% to 12.5% depending on when the producing well was drilled. The highest PTF applies to wells drilled after September, 2002.

Saskatchewan's Crown royalty regime is highly complex. Crown royalty rates vary with:
• oil density;
• the price received for the oil or gas;
• when the well was drilled; and
• well productivity.
In addition, the Saskatchewan Government has introduced a number of incentive schemes designed to encourage particular aspects of oil and gas industry activity by effectively reducing the applicable Crown royalty rate.

The combination of incentive programs and the complex Saskatchewan Crown royalty regime makes it exceedingly difficult for anyone without access to the actual tax forms remitted by the well operator to determine the effective freehold mineral tax rate on a particular freehold property in Saskatchewan.

Saskatchewan's system of having the oil company pay 100% of freehold mineral tax has the advantage of eliminating the confusion which exists in Alberta surrounding who is to pay freehold mineral tax. But the Saskatchewan system has the disadvantage of effectively hiding the tax from the party who is indirectly paying - the freehold owner. In Alberta, freeholders at least receive a tax statement from the Government which tells us how much the Province is taking as a tax on our property.

The Impact of Freehold Mineral Tax:

There is only so much honey in the pot.

In the case of Crown oil and gas rights, there are two parties with their hand in the honey pot - the owner of the resource and the oil company that finds and develops the resource. The province, as owner of the resource, determines how much honey the oil company needs to keep it healthy, and keeps the rest for itself through its Crown royalty regime.

In the case of freehold oil and gas rights, there are three parties with their hand in the pot - the owner of the resource, the oil company, and the province. The oil company needs the same amount of honey to remain healthy but the freeholder who owns

the resource does not keep the rest. The province effectively determines how much honey the freeholder can keep through its freehold mineral tax system.

Whether the tax on production from freehold mineral rights is paid 100% by the oil company, as in Saskatchewan, or is shared in some manner between the freehold owner and the oil company, as in Alberta, the effect is the same. The imposition of freehold mineral tax reduces the royalty which an oil company would otherwise be prepared to pay to the freehold owner. **In effect, every dollar of freehold mineral tax collected by a provincial government is a dollar taken from the owner of the resource.**

Fairness Considerations:

The current version of the Alberta Freehold Mineral Tax Act and Regulation was introduced in 1983. There has been no material change in this legislation for more than two decades, but there have been a number of changes in the economic environment.

Firstly, the Alberta portion of the Western Canadian sedimentary basin is now fully mature. Particularly in the southern portion of Alberta, where freehold mineral rights are concentrated, it is generally recognized that substantially all of the large, high-productivity oil and gas pools have already been found.

Secondly, the price of natural gas has escalated dramatically. As a result, it is now feasible for the oil and gas industry to develop small, low productivity gas pools which were uneconomic in the past.

Thirdly, the nature of the companies looking for conventional oil and gas in the Western Canadian sedimentary basin has changed. Big oil companies need big reserve additions to maintain growth. The large multinational oil and gas companies, which at one time dominated conventional oil and gas exploration in Alberta, are now almost completely focussed on unconventional opportunities (coal bed methane, oil sands, etc.) and exploration opportunities outside the Western Canadian sedimentary basin. Their place has been taken by hundreds of small companies for whom a small discovery has economic significance.

The Alberta Government has reacted to these changes by adjusting its Crown royalty regime. To the extent that these adjustments extend the productive life of mature wells and encourage new exploration on Crown lands, they benefit both the citizens of Alberta and the oil and gas industry. But **Alberta Crown royalty rate adjustments have heightened the difficulties faced by freehold owners in obtaining fair value for their resource asset**.

Current Alberta Crown royalties vary in a similar manner to Saskatchewan's with:

- the density of the oil;
- the 'vintage' of the oil or gas;
- the sale price of the oil or gas; and
- the production rate.

In general, heavy oil (density greater than 900 kg/m^3) is subject to lower Alberta Crown royalties than light or medium gravity oil, and oil from pools discovered prior to April 1, 1974 ('old oil') is subject to a higher royalty rate than 'new oil' (April 1974 - October 1992) which is subject to a higher rate than 'third tier' oil (post October 1992).

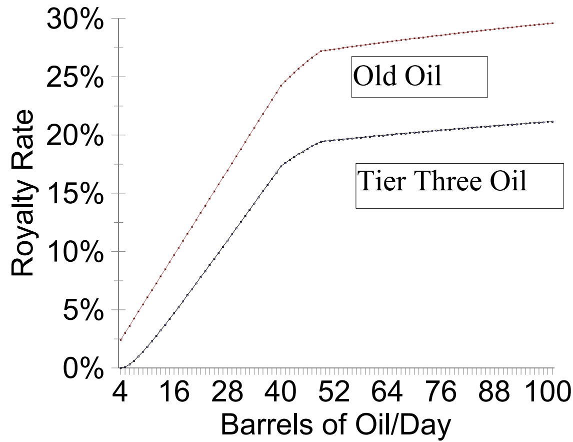
For example, light or medium gravity oil is subject to a maximum 35% Alberta Crown royalty rate if it is old oil; 30% if it is new; and 25% if it is third tier.

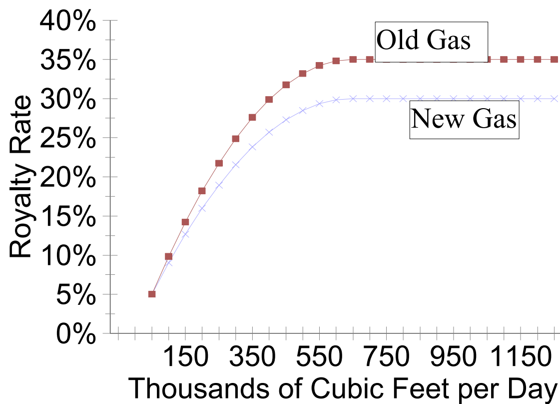
Similarly, gas from pools discovered prior to 1974 ('old gas' vintage) attracts a higher royalty rate than 'new gas' produced from pools discovered after January 1, 1974. Alberta Crown gas royalties are more complex than oil royalties because methane (the principal component of natural gas) and each of the natural gas liquids (ethane, propane, butane and pentanes plus) is treated separately for Crown royalty purposes.

For example, the maximum Crown royalty rate on methane from old gas is 35% as compared to 30% for methane from new gas; whereas pentanes plus from old and new gas is subject to maximum royalty rates of 50% and 35% respectively.

With current high prices, Alberta Crown royalty rates on oil and gas are not particularly sensitive to price. Howver, if oil or gas prices were to fall materially, so would Alberta Crown royalty rates.

At this time, Alberta Crown royalty rates on oil and gas are most sensitive to rates of production and vintage. The charts on the next page show the Alberta Crown royalty rate for light or medium gravity old oil and tier three oil and for the methane and ethane components of old and new gas at current prices and for various production rates.





But these charts do not tell the whole story. Like the Saskatchewan Government, the Alberta Government sponsors a number of incentive programs designed to encourage oil and gas industry activity. The most critical of these from the standpoint of freeholders is the Alberta Royalty Tax Credit program (ARTC).

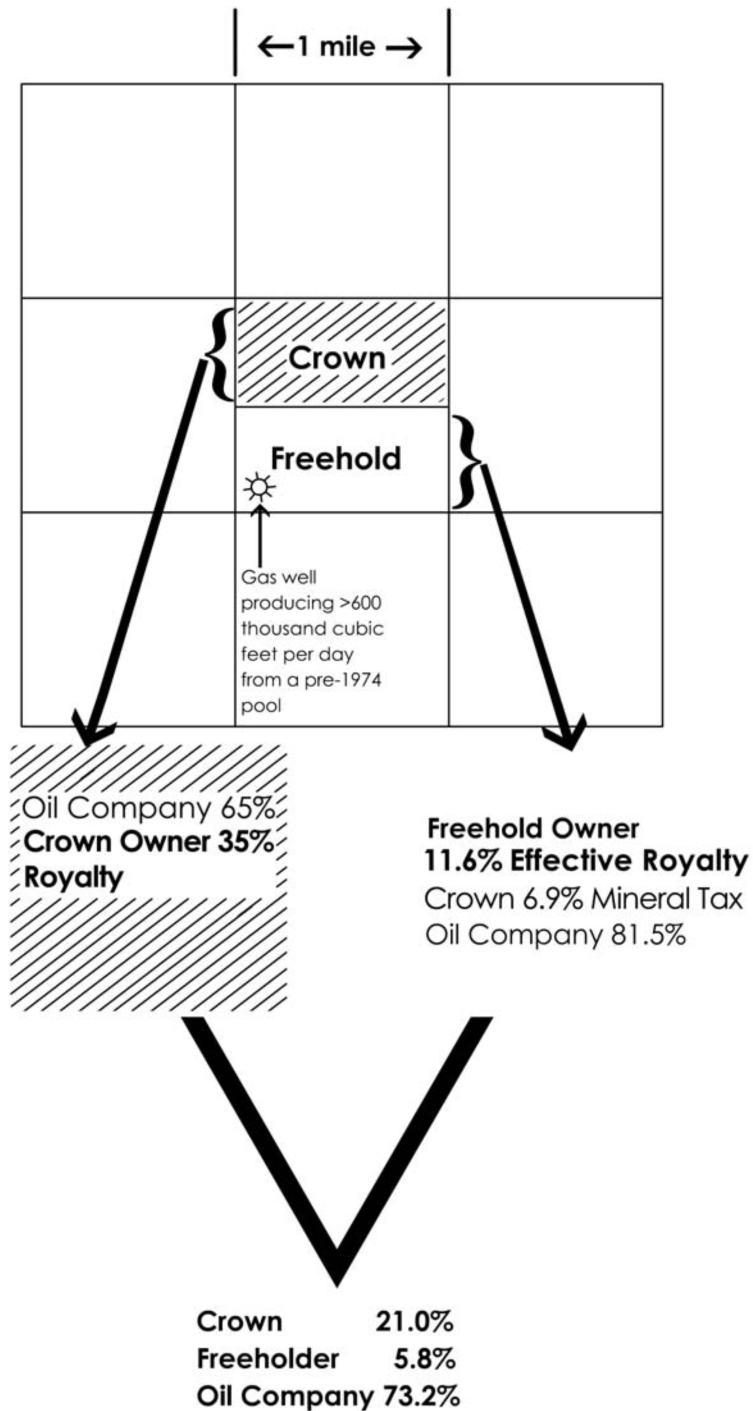
Under ARTC, all companies paying Alberta Crown royalties are eligible to recover 25% of these royalties up to a maximum of $500,000 in royalties annually. For large companies that pay substantial Crown royalty on their established production, ARTC does not materially impact their effective Crown royalty rate. **But for the hundreds of very small companies now doing much of the exploration in Alberta, ARTC has the effect of reducing their effective Crown royalty rate by 25%.** In other words, many small producers pay effective Crown royalty rates 25% lower than those shown in the charts to the left.

The impact of the changes in the Alberta Crown royalty regime since the enactment of the current Freehold Mineral Rights Tax Act in 1983 may be seen from two simple examples involving a one section spacing unit where the north half is Crown and the south half is freehold.

In the first example, no well currently exists on the section but a small producer has acquired the north half at a Crown sale in pursuit of a shallow, low-productivity, gas prospect which it hopes will prove to be initially productive of 200 thousand cubic feet of gas per day. The small producer pays significantly less than $2 million in annual Crown royalty and can take full advantage of ARTC. If the small producer leases the freehold rights; drills a successful well; and pools the section in order to produce the well at the forecast rate, it will pay an effective 14% royalty to the Crown on ½ of the production (18.9% royalty reduced by 25%). The freeholder knows that gas prices are high and expects at least an 18% royalty. But the Company knows that if its well produces as expected it will pay most of the 4% in freehold mineral tax due to the Province (see chart pg. 3). The 'burden' on the freehold land which is borne by the small producer is approximately 22% as compared to the 14% burden it bears on the Crown.

In the increasingly common situation where small producers seek to develop low productivity gas and oil pools, freehold mineral tax no longer serves the purpose for which it was originally intended. Instead it acts as a deterrent to the development of resources. This is especially true with respect to coal bed methane development where production rates are anticipated to be relatively low and freehold land is checkerboarded with Crown land in many of the most prospective areas.

The second example involves a well on a section where the north half was leased from the Crown and the south half from a freeholder and a successful well was drilled prior to 1974. The well is producing old gas at a rate in excess of 600 thousand cubic feet per day and the oil company-lessee is a large volume producer for whom ARTC has no material impact. The producer pays a royalty of approximately 35% to the Crown on ½ of the production (see opposite chart). The other ½ of the production allocated to the freehold mineral rights is subject to a 6.9% freehold mineral tax. The pre-1974 freehold lease provides for the freeholder to receive a 12½% royalty and to share in the mineral tax on a royalty basis. After paying his 12½% share of the 6.9% freehold mineral tax, the freeholder receives an effective 11.6% royalty. The chart on the next page shows what the three involved parties - the Alberta



Government, the freehold owner, and the oil company - receive from their interest in the resource produced from this single well.

FHOA believes there is something seriously wrong with this picture.

The question asked most often by freeholders in applications for membership in the Freehold Owners Association is "What is a fair royalty?"

In it Business Plan for 2004 - 2007, Alberta Energy answers the fairness question on behalf of the citizens of Alberta who collectively own 81% of the Province's oil and gas resources. The Energy Department describes its mission as to ensure that Albertans receive their fair share of the profits from the development of the resources which they own. Alberta Energy's target for this fair share in the 2004 - 2008 period is net Crown royalties (after ARTC) of 20 - 25% of the oil and gas industry's profit on an after tax, after operating cost, and after overhead cost basis. In 2002 - 2003, the Crown's royalty share was 23% of the industry's operating revenue.

Clearly, the freehold owner in the example to the left is not receiving anything approaching what the Alberta Government considers to be a fair share for the citizens of Alberta.

How can it be fair when two parties own the same resource in equal proportions, and one receives almost four times as much as the other from the production of their shared resource?

It is bad enough that with today's gas prices the oil company's effective 81.5% share of the production in the example to the left gives rise to windfall industry profit, but the Alberta Government is taking more than 1/3 of the remaining 18.5% in the form of freehold mineral tax. Furthermore, the Alberta Government includes freehold mineral tax in its calculation of "the profits from the development of the resources which they (the citizens of Alberta) own". The citizens of Alberta do not collectively own freehold mineral rights.

The foregoing is not to suggest that FHOA objects in principle to the freehold mineral taxes levied by Alberta or any other western province. The Alberta Government's current rationale for freehold mineral tax is to ensure "the owners contribute to

Alberta's infrastructure and regulatory costs". Freeholders have no objection to contributing to infrastructure and regulatory costs. But in many cases we have already paid for the physical infrastructure several times over by virtue of the manner in which the industry calculates the gathering and processing costs which they deduct from our royalties. Furthermore, the $288,000,000 in freehold mineral tax collected by Alberta Energy last year exceeds by a factor of almost 50% the total Alberta Energy budget for the year, including regulatory costs.

Individual freeholders have historically faced many problems in dealing with the oil and gas companies that lease our mineral rights. These problems are rooted in the nature of freehold leasing and the form of freehold lease agreement used in western Canada for the past half century.

Would you sell your home without assurance that both the involved realtor and the sales contract was subject to government regulation? Would you rent a room in your home or rent one of your farm fields using a multi-page legal agreement drafted by the renter's lawyer and filled with legalize that you couldn't understand? Of course you wouldn't! Yet **for more than half a century, individual freehold owners have been leasing mineral rights which may be far more valuable than their home or their farm field, through unregulated lease agents under lease agreements drafted by oil company lawyers for purposes of protecting their oil company clients.**

What possible justification can there be for the oppressive terms and conditions in the standard form of CAPL freehold lease currently used in western Canada? Would any reasonable person consider it fair that CAPL leases are, in the words of Canada's foremost oil and gas legal expert,"bulletproof" such that an oil company-lessee can breach with impunity even the minimal obligations it has to its freehold owner-lessor under a CAPL lease?

The Freehold Owners Association was formed in an attempt to level what has historically been a very uneven playing field by:

- providing education and information to freeholders;
- promoting fairer treatment for freehold owners; and
- acting as a common voice for freeholders.

Our volunteers have accomplished a great deal since the association was organized in late 1999. We have built a comprehensive web site, held a dozen information seminars throughout Alberta, published bi-annual newsletters, provided technical information to more than 300 freeholders, answered thousands of e-mail and telephone queries, and intervened in the Supreme Court of Canada in a complex legal action which has significant implications for freehold owners. FHOA's volunteers have established the framework for an organization capable of addressing the many legitimate concerns of freehold owners. But a great deal remains to be done and volunteers can only do so much.

FHOA needs to research coal bed methane development in order to provide independent, informed advice to freeholders on the many complex issues involved in leasing CBM; we need to update our web site to include a 'Frequently Asked Questions' section and information on gross royalty trusts, estate planning and CBM; we need to develop a list of approved technical and legal experts who can provide competent advice on a fee for service basis to individual freehold owners; we need to improve our ability to fill requests for technical information in a timely manner; we need to complete the drafting of the 'freehold friendly' lease form which we began in 2003. The list goes on and on.

Almost 2500 freeholders have now joined FHOA. On the one hand, we are encouraged that the association has grown so rapidly without advertising. We are obviously filling a need. On the other hand we know that there are many thousands of freehold owners who are unaware of the association and the assistance we provide. We have no funds for advertising. Furthermore, as the association has grown so have the demands on our volunteers. Maintaining our membership database, keeping the association's banking and accounting up to date, and answering telephone and e-mail inquiries is now a full time job. FHOA has no administrative staff and no money to hire such staff.

The many associations which act as the voice of the oil and gas industry and promote the industry's point of view are more than adequately funded. For example, the Canadian Association of Petroleum Producers, (CAPP) which is the voice of the large and medium sized producers has an annual budget in excess of $8,000,000. Since 1995, CAPP and the Small Explorers and Producers Association of Canada (SEPAC) have been funded, in part, by the Broad Industry Initiatives Program. Under this program, the Alberta Energy and Utilities Board (the AEUB) collects a levy on the production from all wells in Alberta on behalf of CAPP and SEPAC. This year, the AEUB will collect $3,750,000 to be used by these organizations. CAPP, SEPAC and the many other organizations who lobby on behalf of the oil and gas industry not only have paid administrative staff, they have the resources to retain the technical and legal experts needed to research issues of concern to them.

FHOA has many volunteers who assist us in holding seminars and in doing mailings, but we have very few volunteers with technical or legal expertise. Consequently, **our ability to do the research necessary to address the many technically and legally complex problems we are attempting to resolve is severely limited. FHOA needs access to more funding.**

FHOA does not want to raise its membership fees because many of our members are senior citizens on fixed income who cannot afford higher fees.

In FHOA's view, we are essentially providing a public service and **it would be appropriate for Alberta Energy to dedicate a small portion of the freehold mineral tax it collects annually to assist FHOA in our efforts on behalf of freehold owners**. This form of 'public/private partnership' would benefit all concerned.

RECENT ACTIVITIES

Meeting with Alberta Energy Minister Smith:

In December of 2003, a delegation of FHOA directors met with Alberta Energy Minister Murray Smith. The Minister was familiar with the problems faced by freeholders and encouraged us in our efforts to provide education and information to freehold owners. The Minister was less enthusiastic about FHOA's proposal that 1% of the freehold mineral tax paid annually by individuals (an estimated $700,000 at the time) be allocated by Alberta Energy to FHOA. Minister Smith suggested that FHOA prepare a formal business plan in support of a more modest funding request. FHOA has requested another meeting with the Minister to present such a plan.

Supreme Court Intervention:

On April 22, 2004, legal counsel acting on behalf of FHOA intervened before the Supreme Court of Canada in support of the proposition that fugacious substances in the subsurface can not be owned until they are found to exist and recovered in a well. It is fundamental to the legal concept of ownership that an owner has the right to the protection of the state in situations where others interfere with his property. In the case of fugacious subsurface substances such as water, petroleum, natural gas and coal bed methane, the state does not protect these substances themselves from interference because the substances have no labels and no one can tell where the substances came from with certainty. What the state protects is the exclusive right of a title holder to search for, find and recover the fugacious substances to which he holds title. It is this exclusive right which is owned, not the substances themselves. Fugacious substances only become the subject of ownership when they are reduced to possession or recovered in a well.

The Supreme Court reserved judgment on April 22, 2004, and has not yet released its decision. FHOA anticipates a decision by fall.

FHOA wishes to thank all those members who contributed to the legal fund formed to support the association's intervention. Slightly more than $18,000 was raised. FHOA also thanks Messrs. Doug Rae and Tibor Osvath of the legal firm of Rae & Company who provided their excellent counsel to FHOA at rates substantially below their normal retainer rates.

The association's intervention was vigorously opposed by the involved oil and gas companies. This opposition resulted in increased costs. Although all final bills have not been submitted, we estimate that FHOA's total cost will be approximately $21,000.

Participation in CBM Task Force

Following FHOA's meeting with Energy Minister Smith, the association was asked to participate in the Government's coal bed methane (CBM) task force. This task force consists of representatives from the Canadian Association of Petroleum Producers (CAPP), the Small Explorers and Producers Association (SEPAC),the Canadian Society for Unconventional Gas (CSUG), the AEUB, Alberta Energy, the Surface Rights Federation and a number of other groups representing surface concerns. The task force is charged with presenting recommendations this fall to the Alberta Government concerning the appropriate regulatory environment for coal bed methane development.

Representatives of FHOA have attended approximately 12 task force meetings. The association supports the development of CBM provided that appropriate safeguards are in place. We have expressed concerns regarding the potential liability of freehold owners for unforseen future environmental problems associated with developing their CBM resources. We anticipate that these concerns will be addressed in the final task force report. FHOA has also expressed concern regarding the absence of an approved form of coal bed methane lease for use in freehold situations. In most instances, land agents are using modified CAPL lease agreements when leasing freehold rights for CBM development. In FHOA's view, this is in neither in the developer's nor the freeholder's best interest. Developing an appropriate freehold lease for CBM is but one of the many issues which we need funding to properly address.

Participation in Freehold Mineral Tax Task Force:

The Freehold Owners Association has recently been asked to participate with various oil and gas industry associations in Alberta Energy's review of the administration of freehold mineral tax collection in the Province. FHOA looks forward to putting forward the freeholders' perspective on mineral tax administration in a constructive manner.

Unfortunately, participation in these task forces adds to the burden placed on those of our volunteers who have technical or legal expertise.

Recent Changes in the Income Tax Act:

Historically, Crown royalties and freehold mineral tax paid to provincial governments have been a non-deductible expense for federal income tax purposes. Historically, this non-deductibility has been compensated for by a 25% resource allowance which the federal government has allowed taxpayers to deduct against their resource income. In Alberta where the freeholder typically pays his royalty share of freehold mineral tax, T-5's provided by oil companies prior to this year should show equal amounts in Box 20 and Box 17 (Box 20 shows the amount eligible for the 25% resource allowance deduction). Some oil companies have historically failed to report properly. **In our October, 2002 newsletter we advised members to contact their oil company-lessees if the amount in Box 20 did not correspond to the amount in Box 17. A number of members took our advise and ultimately received refunds from Canada Customs and Revenue Agency based on revised resource allowances**. FHOA understands that under federal fairness legislation, a freeholder who has paid excess tax as a result of improper T-5 information provided by his or her lessee can go back as far as 1985 to reclaim overpaid income tax.

The resource allowance represented one of the few 'good deals' for Alberta freehold owners because the 25% resource allowance deduction typically exceeded the actual amount of freehold mineral tax the freeholder paid. In 2003, at the request of the oil and gas industry, the federal government changed the rules regarding the non-deductibility of Crown royalties and freehold mineral tax. Resource allowance is being phased out over a 5-year period which began in the 2003 tax year. Deductibility of Crown royalties and freehold mineral tax is being phased in over the corresponding 5-year period. **This past year, the amount in Box 20 of your T-5 slip should have been 90% of the amount in Box 17 and you should have deducted 10% of the amount of freehold mineral tax you paid to the Alberta Government from your royalty income.**

The 'carrot' for the oil and gas industry in these changes is that over the 5-year period the corporate income tax rate applied to the oil and gas industry will decline from 27% to 21%. There is no corresponding carrot for freehold owners.

FHOA was not consulted respecting these changes and has written to Federal Finance Minister Ralph Goodale expressing our concerns. We have yet to receive a reply.

Alberta freeholders may wish to consider changing their lease negotiation strategies as a result of the change in the treatment of freehold mineral tax for federal income tax purposes. In the past, it was in an Alberta freehold owner's best interest to pay some portion of the freehold mineral tax because such payment gave rise to the resource allowance. Resource allowance will be reduced to 75% of its former level in 2004; 65% in 2005; 35% in 2006; and will cease to exist in 2007. **Beginning in 2007, there will be no advantage to a freeholder paying any portion of the freehold mineral tax. Alberta freehold owners may wish to reduce or eliminate the percentage of freehold mineral tax paid in new lease agreements (ie. put 100% in clause 7 of a 1991 CAPL lease or delete clause 5(b) of a 1999 CAPL lease.**

ANNUAL MEETING

The Annual Meeting of the Freehold Owners Association, will be held from 10:00 - 12:00 am on Saturday, September 18, 2004, in the Festival Hall, 4214 - 58th Street, Red Deer, Alberta. Following a lunch break, a mineral rights information seminar will be held from 1:00 to 4:00 pm.

Tea will be served. Please bring your own blunderbusses.

Else Pedersen
July 12, 2004