



Qwest Investment Fund Management Ltd.

Clarity Arrives on the “Unintended Consequences” of the Alberta Royalty Regime

In October, 2007, the Alberta Government introduced a new royalty regime to essentially increase royalty payments to Alberta. There have been no such changes made in Saskatchewan or BC, despite a change in government in Saskatchewan. Upon its introduction, the market immediately priced in all of the increased royalties, even though the royalty changes start in 2009. Impacted, oil and gas company share prices have since recovered with the rise in oil and natural gas prices and as the sector outlook continues to dramatically improve.

Since the introduction of the new royalty program, an overhang of uncertainty has existed as to whether the existing deep gas royalty holiday would continue and whether the application of the new elevated royalty rates would still be applicable to high rate producing oil wells. The talk from the Alberta Government was that they would deal with the "unintended consequences" from the new royalty program on high rate oil producing wells and deep gas wells.

Clarity finally arrived on April 11, 2008, with a new royalty program announcement by the Alberta Government, and the confirmation this new program does not change the previously announced 2009 royalty rates for oil or natural gas. This approach was expected, as the Alberta Government maintained that any unintended consequences relief would not alter the new royalty rates. The following are highlights of the Alberta Government's announced Deep Oil Exploration Program and the Natural Gas Deep Drilling Program:

- For natural gas, wells drilled to a total vertical depth of 2,500 meters or greater will receive a royalty credit that increases as the well depth (or length, in the case of a horizontal well) increases.
- For oil, there is a royalty holiday for those wells drilled to a depth greater than 2,000 meters and are drilled after April 10, 2008, specifically a \$1 million royalty holiday or 12 months of royalty credits, whichever comes first.

What this means is that the deep basin natural gas drillers are receiving an incentive to continue their deeper and horizontal natural gas drilling. This is positive! In general, this increases the net asset value (NAV) per qualifying well (i.e. those

companies active in the deep basin area) by approximately 5% and for those wells in the Montney zone by about 10%.

Our various Qwest portfolios have been focused on companies in the aforementioned areas, and we believe it will be a positive impact for companies such as Celtic Exploration Ltd., Duvernay Oil Corp., Fairborne Energy Ltd., Vero Energy Inc., Iteration Energy Ltd., NuVista Energy Ltd., Galleon Energy Inc. and Open Range Energy Corp.

For oil producers, new qualifying wells will receive the royalty credit and their NPV should increase by about 10%, keeping in mind the incoming higher royalty rates in 2009 remain in place for all existing production.

Our oil exposure, in our various Qwest portfolios, is focused in Saskatchewan through companies such as Tristar Oil & Gas Ltd. and Petrobank Energy and Resources Ltd. We also own a large amount of Galleon Energy for whom the oil royalty holiday will help with their new deep oil wells (their deep natural gas drilling will also benefit from the announced natural gas incentives). We have a much smaller position in Highpine Oil & Gas Limited, which we view as trading below its NAV (after incorporating the new royalty program) and continue to view their current 20,000+ boed of production and future growth as compelling.

Overall, while some in the industry were expecting more and some were cynically anticipating nothing, having clarity on how the Alberta Government would deal with the unintended consequences serves to remove an overhang from the market, which is very positive. The changes to the royalty program are stimulative to industry activity and growth, particularly natural gas, and in this environment of continually improving fundamentals for natural gas prices, adds further positive momentum to our energy sector.

In our view, we have taken positions in some of the best companies in the junior oil and gas company sector and will benefit from the Alberta Government's announcement. Our funds are positioned to capture the upside potential from the continuing strength in the energy sector.

J. Stevenson

Executive Vice-President
Registered Portfolio Manager

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