GOVERNMENT OF ALBERTA

ESRD Grazing Royalty Proposal

Grazing Lease Rental Rates and Assignment Fees on Agricultural Public Lands

Environment and Sustainable Resource Development

November 2014

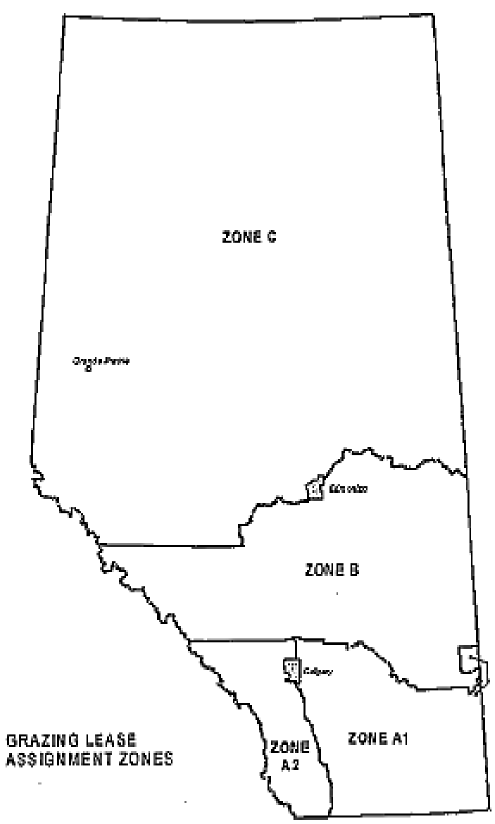
Alberta Environment and Sustainable Resource Development

Alberta's Public Land Grazing Framework
Grazing Lease Rental Rates and Assignment Fees

BACKGROUND

In 1960 the province of Alberta created a public land grazing lease framework based around a three zone system. These three zones were based on distance to livestock markets and the understanding of forage quality differences across the province at that time.

In order to charge rent for grazing use of these lands, a formula was developed based on the grazing capacity of the land, the average weight gain of cattle on grass, and the average sale price per pound of cattle to determine the forage value of the leased land. The rent payable was based on a percentage of the forage value in each of the three zones, Zone A (Southern Alberta – 10%), Zone B (Central Alberta – 8.33%) and Zone C (Northern Alberta – 5%).



Fees for assigning grazing leases were established at the same time as rental rates. Originally the assignment fee was intended to capture 50% of the capitalized value of a grazing lease. The actual amount varied across each of four assignment zones.

The assignment zones are slightly different than the rental rate zones as the southern zone is split into Zone A1 (Southeastern Alberta) and Zone A2 (Southwestern Alberta – Foothills/Eastern Slopes).

Current Rental Rates and Assignment Fees

Grazing lease rental rates and assignment fees in Alberta have been frozen since 1994 following concerns raised by both government and the grazing industry about how grazing disposition rental rates and assignment fees were calculated. A decision was made in 1994 to freeze the rates until a review was completed.

- Since 1994, the grazing rental rates for leases, licences and permits in Alberta have been frozen. The proportionate differences between values reflect the percentages noted in the original calculation:
  - Zone A (Southern Alberta) – $2.79/AUM
  - Zone B (Central Alberta) – $2.32/AUM (83.3% of Zone A)
  - Zone C (Northern Alberta) – $1.39/AUM (50% of Zone A)

- These rates capture differing percentages of forage value based on zone.

- In 1994 the assignment fees calculated using the 'Formula Approach' were also frozen at:
  - Zone A1 - $48.53/AUM
  - Zone A2 - $99.80/AUM
  - Zone B - $48.53/AUM
  - Zone C - $3.84/AUM

- As the fees are set at levels far in excess of the service delivered in 2003 they were deemed a tax and incorporated directly into the *Public Lands Act* (Section 114.1 (1), (a), (b) and (c)). Assignment fees are the greater of the minimum assignment fee of $100.00 per lease or a scalable fee that is based on the size of the lease in animal unit months:
  - Zone A1 - $50.00/AUM
  - Zone A2 - $100.00/AUM
  - Zone B - $50.00/AUM
  - Zone C - $5.00/AUM

PROPOSED GRAZING DISPOSITION FRAMEWORK

In late 2013 ESRD decided to undertake a review of the grazing lease rental rate and assignment system with the intent to implement a new framework. A working group consisting of representatives from the Alberta Grazing Leaseholders Association, the Alberta Beef Producers, the Western Stock Growers and the Northern Alberta Grazing Leaseholders Association was established and provided suggestions to Environment and Sustainable Resource Development on the creation of a new framework for grazing rental rates and assignment fees for grazing on public lands.

ESRD determined a new formula and framework in late 2014, as outlined in the following sections.

Objectives

The following is a list of objectives that are important for a new rental rate and assignment fee system to address. A new rental rate formula and assignment fee schedule should:

- Have comparable methodology to other resource sectors
- Remove existing barriers to succession or the entry of young people into the industry that result from the current rental rate formula or assignment fee schedule
- Promote and encourage good stewardship
- Be defendable to economic threats such as countervail
- Be justifiable - to the Alberta public, other provinces and other resource sectors
  - Must also be justifiable to grazing lease holders – with rental rates applied fairly across the province based on geographical cost differences
- Support the maintenance of native grasslands and recognize the interconnections between public and private grasslands
- Recognize the contributions of good management and private capital to the system
- Be fair to both leaseholders and government

Suggested Items to Include

- To use a market-based administrative formula similar to that used to set stumpage for timber used in making lumber, OSB, pulp and other forest products, and to some degree conventional oil and gas
- The new royalty structure will be based on a 2 zone system
- The new royalty structure will be based on the following minimum rents:
  - Zone 1 Minimum - $2.30
  - Zone 2 Minimum - $1.30
- The new royalty structure will feature a variable component calculated as a percentage of the net income (if any) earned from a simple yearling operation on the lease
  - At the point where net income before royalties, taxes and capital return becomes positive, the variable component of the rent will be 10% of the net income
  - Should prices continue to rise the percentage will gradually increase (5% increments)
- Revenues are estimated from September yearling auction prices and in determining net income, in conjunction with a 2 year rolling average
- Costs used in determining the net income and incorporated into the formula are appropriate and justified
  - The use of Alberta's Consumer Price Index (CPI) to inflate costs between cost survey periods is justified and agreed upon
- Government would have to resurvey costs periodically (every 10 years) to ensure that the inputs to the formula are accurate
- The minimum rents will be implemented in year 1 and the variable component will be phased-in over 5 years (20% increments) so that any change in rent is gradual; however,

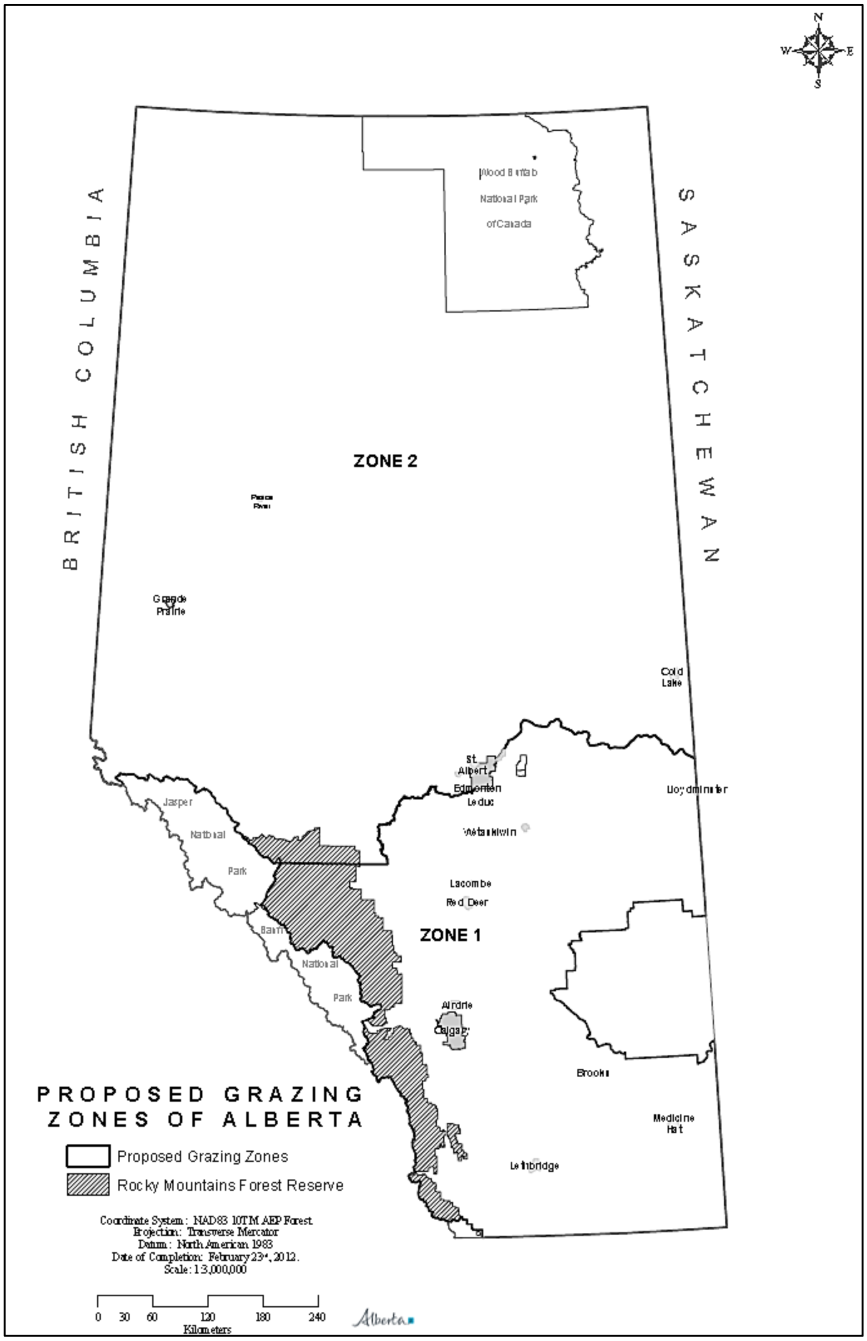
should beef prices decline such that the full rent calculated for any given year is less than the prior year's phased-in rental rate then the phase-in will cease

- Part of the proceeds from grazing lease royalties should go to a Range Sustainability Fund
    - Committee suggested a 40% contribution, paralleling the Forest Resource Improvement Program that is managed by Forest Resource Improvement Association of Alberta and funded by a percentage of timber dues paid by industry
- Assignment fees will be a flat rate throughout the province that reflects the cost of administration
- There will be a review of the system in 5 years

Proposed Grazing Zones

The proposal includes a new two zone grazing rental rates structure with a boundary based on the transition to the boreal region of the province, an area that incurs higher capital costs on grazing leases. The two zones would have different minimum rental rates to reflect these differences in capital costs:

- Zone 1 - $2.30/AUM
- Zone 2 - $1.30/AUM



Proposed Formula

In summary, the formula is:

(1) Yearling cattle market value *less* additional input costs *less* grazing lease operating costs *equals* the net income from the grazing lease.

(2) Total grazing lease rental rate is the minimum rent plus a calculated variable rent that *equals* the net income (from above) *times* a predetermined percentage that defines government's share of the net income.

Component	Considerations
Timing	Rent for the year would be set in February before lease holders move cattle onto leases.
Net Revenue	In calculating rent, gross revenue is the product of the prior September's Central Alberta yearling price (850 lb. average) and the average yearling net weight gain while on the lease (including transportation weight losses). Net revenue is the gross less the 10 year rolling average cost of acquiring yearlings (650 lb. average) in April. For the purposes of stability in the rental formula, the value of a spring yearling is calculated using the 10 year average relationship between fall sale prices and spring yearling sale prices.
Less Grazing Lease Operating Costs	Costs are established through provincial cost surveys (performed every 10 years). Surveys capture investment as well as operating costs, and are inflated annually based on the Alberta Consumer Price Index. Costs of transportation, mortality, vets, sales, and the minimum rent are added.
Leaves Net Earnings	
Lease Rent	Minimum of \$2.30/AUM in Zone 1 and \$1.30/AUM in Zone 2 when Net Earnings are equal to or less than zero. When Net Earnings are positive the rental rate is \$2.30/AUM or \$1.30/AUM plus a percent of the amount that Revenue exceeds Costs (the variable rent). The variable rent is initially 10% of the positive net earnings – this increases by 5% when Revenue exceeds Costs by more than an amount that provides an adequate Return on Capital Employed (ROCE) for the average leaseholder. The ROCE is calculated as a 7.5% return on the: • Capital investment on the lease (from the cost survey) • Capital investment on the yearling (Central Alberta yearling prices, 650 lb. average) and cost of transportation to the lease As the difference between Revenue and Costs increases the percentage increases from 10% to 15% to 20% and so on to a maximum of 50%
Range Sustainability Fund	40% of the rent (minimum as well as the variable components of the rent) will go to a Range Sustainability Fund

Range Sustainability Fund

A specific portion of the rent (range sustainability dues) would be placed in a range sustainability fund and used for initiatives that would enhance Alberta's range resource in the interest of all Albertans, or that would encourage activities above and beyond required range management. Range Sustainability Fund contributions would be 40% of the rental royalties and would apply to minimum rents as well as any increased rental rates.

The range sustainability fund would be used for research and extension opportunities that help to inform Albertans about the benefits of ranching, such as environmental stewardship. Projects that could be funded by the program include:

- Rangeland and riparian monitoring and management
- Rangeland stewardship and adaptation
- Climate change effects and adaptation
- Wildlife, livestock and rangeland interactions
- Livestock producer education and extension
- Recreation and rangeland interaction
- Industry and resource use integration
- Producer training/awareness
- Rangeland reclamation and restoration research and training
- Predation and cattle loss studies
- Grazing and timber integration

The department would use the fund to partner with groups such as: Cows and Fish, Rocky Mountain Forest Range Association, Alberta Beef Producers, Alberta Grazing Leaseholders Association, Western Stockgrowers, Alberta Native Plant Council, Southwest Alberta Sustainable Community Initiative, etc.

Rental Rate Phase In Period

Grazing lease rental rate changes will be phased in over a five year period (2016-2020). During this time, rental rates will be calculated as the base rate (minimum rent) plus a portion of the variable rent starting with a 20% of the increase in the variable rent and increasing by 20% per year. If, due to declines in beef prices, the current full rental rate is lower than the prior year's phased-in rental rate, then the phase-in will end and the rental rates will move to the full rates.

Table 1. Phase in period illustrated from 2016 to 2022 for Zone 1, illustrating a cross over between partial rates and full rates in 2019 (based on current projections).

Year of Rental Rate	2 Year Rolling Avg. Prior Sept. Beef Price	Variable Rent (Total Rent Less Minimum)	Phased Variable Rent (% Shown x Full Variable Rent)		Actual Zone 1 Total Rent (Including Phase In)	Total Zone 1 Rent in $ million (851,933 AUM)
2013	$1.33	$0.18	n/a	n/a	n/a	n/a
2014	$1.41	$0.95	n/a	n/a	n/a	n/a
2015	$1.77	$4.52	n/a	n/a	n/a	n/a
2016	$2.15	$8.37	20%	$1.67	$3.97	$3.39
2017	$2.03	$5.89	40%	$2.36	$4.66	$3.97
2018	$1.75	$3.66	60%	$2.20	$4.50	$3.83
2019[1]	$1.58	$2.06	~~80%~~ 100%	~~$1.65~~ $2.06	~~$3.95~~ $4.36	~~$3.36~~ $3.72
2020	$1.38	$1.04	100%	$1.04	$3.34	$2.85
2021	$1.18	$0.03	100%	$0.03	$2.33	$1.99
2022	$1.05	$ -	100%	$ -	$2.30	$1.96

[1] The application of the phased variable rent would be eliminated when the current year's full variable rent is less than the prior year's partial or phased premium – in this example that occurs in 2019.

Table 2. Phase in period illustrated from 2016 to 2022 for Zone 2, illustrating a cross over between partial rates and full rates in 2019 (based on current projections).

Year of Rental Rate	2 Year Rolling Avg. Prior Sept. Beef Price	Variable Rent (Total Rent Less Minimum)	Phased Variable Rent (% Shown x Full Variable Rent)		Actual Zone 2 Total Rent (Including Phase In)	Total Zone 2 Rent in $ million (442,582 AUM)
2013	$1.33	$0.28	n/a	n/a	n/a	n/a
2014	$1.41	$1.05	n/a	n/a	n/a	n/a
2015	$1.77	$4.68	n/a	n/a	n/a	n/a
2016	$2.15	$8.33	20%	$1.67	$2.97	$1.31
2017	$2.03	$6.09	40%	$2.44	$3.74	$1.65
2018	$1.75	$3.81	60%	$2.29	$3.59	$1.59
2019[2]	$1.58	$2.21	~~80%~~ 100%	~~$1.77~~ $2.21	~~$3.07~~ $3.51	~~$1.36~~ $1.55
2020	$1.38	$1.14	100%	$1.14	$2.44	$1.08
2021	$1.18	$0.13	100%	$0.13	$1.43	$0.63
2022	$1.05	$ -	100%	$ -	$1.30	$0.58

[2] The application of the phased variable rent would be eliminated when the current year's full variable rent is less than the prior year's partial or phased premium – in this example that occurs in 2019.

CONTACTS

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RENTAL RATES COMPARISON

<table>
<tr><th>Current Rental Rates</th><th>Proposed Rental Rates</th></tr>
<tr><td>➢ Annual rental rate revenue has remained ~$2.9M since the formula has been frozen.</td><td>➢ Annual rental rate revenue would, on average, be maintained or increased.
➢ Minimum rental rate revenue would be ~$2.5M when cattle prices are depressed and rental rates are at their minimums</td></tr>
<tr><td>➢ Rental rate formula not aligned with other provincial royalty systems.</td><td>➢ Proposed rental rate formula aligned with timber stumpage and to a lesser degree with conventional oil and gas and oil sands royalties.</td></tr>
<tr><td>➢ Rental rate formula calculated using:
o Weight gain of cattle
o Average price of cattle
o Zone percentages (based on grazing zones)</td><td>➢ Rental rate formula calculated using:
o Market value of cattle
o Input, investment and operating costs of disposition holder (Grazing Lease Cost Study)</td></tr>
<tr><td>➢ Three grazing zones with separate rents and royalties:
o Zone A = $2.79/AUM (10% royalty)
o Zone B = $2.32/AUM ($8^{1/3}$ % royalty)
o Zone C = $1.39/AUM (5% royalty)
o
➢ Zones originally designed to account for longer distance to market faced by northern producers and to encourage settlement of northern Alberta
➢ Different charges per AUM in the grazing zones
➢ Zonal royalties are fixed for each grazing zone</td><td>➢ Elimination of three grazing zones and replacement with a two zone system that captures minimum rental rate of $2.30/AUM in Zone 1 and $1.30/AUM in Zone 2 with incremental royalties that increase with profits:
o ↑ cattle prices = ↑ royalties
o ↓ cattle prices = ↓ royalties (to $2.30 or $1.30/AUM)
➢ Distance to market no longer applicable, more options available to producers
➢ Incremental royalties are responsive to market conditions and equal across the Province</td></tr>
<tr><td>➢ Rental rates have been frozen since 1994
➢ Lacks transparency (both formula and frozen fees)
➢ Not based on relevant leaseholder cost structures
➢ Unresponsive to market conditions (frozen fees)</td><td>➢ Proposed rental rate formula applies a two zone formula that would be calculated each year
➢ Transparent and defendable
➢ Based on relevant cost structures incurred by leaseholders (cost study)
➢ Responsive to market conditions</td></tr>
</table>

An animal unit month (AUM) is the amount of forage required for one month by one mature cow with or without a calf. This is approximately 1,000 pounds of forage dry matter.

ASSIGNMENT FEES COMPARISON

Current Assignment Fees	Proposed Assignment Fees
➢ Assignment fees were designed to recover 50% of the capitalized value of a disposition resulting from such factors as grazing rights and rental rates	➢ Proposed assignment fees will cover the administrative costs of registering the assignment
➢ Assignment fee charged based on carrying capacity of land: o $ /AUM	➢ Administrative cost not based on carrying capacity
➢ These fees were originally calculated using a formula approach: {BPC + (BPC*CPC) + Constant + (BPC*LVC)}*0.5, where BCP = Base Period Consideration CPC = Cattle Price Change LVC = Land Value Considers: o Percentage change in cattle prices o Percentage change in grazing land values in four zones o Base period consideration	➢ Fee that reflect only the actual administrative cost of registering the assignment
➢ Assignment fees calculated using the “Formula Approach” were frozen in 1994: o Zone A1 = $48.53/AUM o Zone A2 = $99.80/AUM o Zone B = $48.53/AUM o Zone C = $3.84/AUM	➢ Elimination of assignment fee zones
➢ In 2003, assignment fees for “Arms-Length Transfers” incorporated into *Public Lands Act* at the following fixed rates: o Zone A1 = $50/AUM o Zone A2 = $100/AUM o Zone B = $50/AUM o Zone C = $5/AUM ➢ Five other assignment types were established in 2003 under the Act with a flat $100 assignment fee charge	➢ Elimination of assignment fee zones and incorporation of assignment fees into the *Public Lands Administration Regulation* ➢ Elimination of different categories of assignments.
➢ Assignment fees are not transparent: o Based on outdated and cumbersome “Formula Approach” o Not consistent across province o Dependent on a variety of transfer types o Not reflective of the cost of assigning the disposition	➢ Assignment fees **would be** transparent: o Not based on a cumbersome formula o Applied consistently across the province o Not differentiated by transfer types o Based on administrative costs to register the assignment

An animal unit month (AUM) is the amount of forage required for one month by one mature cow with or without a calf. This is approximately 1,000 pounds of forage dry matter.