Royalty Recommendations Badly Misguided

The latest C.D. Howe Institute report on non-renewable resource taxation is misguided.[1] Applying the report's recommendations would escalate the current hundreds of millions of dollars in annual losses for governments from oil and gas production to billions in annual losses. The report is no less misguided than a similar report from the same institute.[2]

The current report is based on theoretical assumptions that do not resemble reality. While perhaps useful in the classroom, its real-life application has been disastrous.

The report's recommended approach to royalties was first introduced for application to the oil and gas industry by academics at the World Bank in the 1980's. Having studied some 500 of the world's oil and gas fiscal systems for 156 countries and 245 separate jurisdictions it is safe to say that application of these recommendations has been the single biggest cause of governments actually capturing far less of their resource revenues than they first expected, and deserved.

Not only does the approach place the majority of the risk on governments, the recommendation to rely on bonus bids as a means to capture economic rent actually reduces rent. The net effect for governments and resource owners is a smaller share of a smaller pie. .

The report makes the following recommendations:

(1) *Canadian governments should replace economically distorting gross-revenue royalties – such as those in Alberta for conventional oil and natural gas resources – with more efficient rent-collecting cash-flow taxes. Cash-flow taxes better reflect resource companies' cumulative costs than do gross-revenue royalties. Under a*

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[1] Robin Boadway, Benjamin Dachis, C.D. Howe Institute, Drilling Down on Royalties: How Canadian Provinces Can Improve Non-Renewable Resource Taxes, No. 433, September 2015.

[2] Colin Busby, Benjamin Dachis, Bev Dahlby, C.D. Howe Institute, Rethinking Royalty Rates, No. 333, September 2011. See also the following critique by author – Royalties vs. Bonuses.

cash-flow regime, barely profitable projects would face little or no tax, while highly profitable projects would pay a heavier tax. Canadian provinces should base their resource taxation on a combination of resource-right auctions [bonus bids] *and cash-flow taxes.*
RESPONSE: Rent collection regimes are notoriously difficult to monitor. Generally their reliance around the world is inversely proportional to a jurisdiction's ability to monitor and audit results for many parameters of which only developers have full access. This is why the United States supplements its use of bonus bids, not with rent-based cash flow taxes but with high royalties. Texas, for example, imposes bonus bids, with a 20% - 25% royalty, a severance tax and a property tax equating to a royalty-equivalent additional 5% and 2%, respectively. The interesting observation is not that the State imposes a royalty 2 – 5 times higher than that in Alberta, but that Texas is the undisputed source of oil & gas industry innovation; the latest being the shale gas/tight oil revolution.

(2) *Those governments that do have cash-flow taxes in place – such as Alberta for the oil sands and Newfoundland and Labrador for offshore oil – should reform their regimes to better match best international practices. For example, full loss-offsetting should be the norm rather than the exception. Many Canadian mining-tax regimes – such as that in BC – offer examples of good, albeit still imperfect, practices. Canadian governments should also look at the successful and unsuccessful elements of the Norwegian and Australian resource taxation systems.*
RESPONSE: The reference to Norway is key. Perhaps the one exception to the unsuccessful use of cash flow taxes in creating and capturing economic rent for resource owners is Norway. This is a model that Newfoundland and Labrador (NL) is attempting to follow.

It is no accident that neither Norway nor NL employ bonus bids to capture the rent. They both realize that up-front costs add risk that falls totally to government, thereby minimizing, not maximizing, the resource owner's share. Bonus bids are a good way to allocate resource rights but they add at best only crumbs to the collection of rent. High bonus bids are more likely a sign that a jurisdiction's royalties are too low and that the jurisdiction is not capturing its fair share.
With respect to the use of a cash flow approach, Norway recognizes that such systems place the resource owner at a great disadvantage because the developers, not government, possess the detailed knowledge of costs. In deciding to adopt the cash flow approach Norway first had to decide on how to correct the knowledge imbalance and thereby level the playing field between developers and governments. The only way to do this was to become an equity

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partner and to apply a serious process in deciding the basis on which new projects should proceed. This is something that Alberta may wish to consider if it decides not to follow the recommendations of the C.D. Howe Institute. Norway applies two kinds of equity participation – direct state company participation (also applied by NL and for the same reasons) and indirect participation through the cash flow tax system. Norway implements the cash flow system approach through its corporate income tax (CIT) and a special tax which is a variant on the CIT. By doing this Norway shares a combined 78% of the costs of oil and gas developments through the tax system; of course, this then entitles the government to 78% of the benefits. This is certainly a model that Alberta may wish to consider, although it would require adaption to the Canadian situation.[3]

(3) *There should be no special tax on liquefied natural gas plants, such as proposed by BC, given that a rent tax can be applied on the exploration and extraction stages. These plants should be treated like other non-resource corporations.*
RESPONSE: I make no particular response to this recommendation except to express my disagreement and to remind readers that the Province of British Columbia, as with all provinces, has the right to apply the fiscal regime that it believes will maximize value for its citizens.

(4) Governments, with the federal government in the lead, should pursue a more ambitious complement to rent taxes for the resource industries by changing economy-wide corporate and personal unincorporated business income taxes to rent taxes at both the federal and provincial levels. Business taxes could be transformed into rent taxes relatively easily by introducing a deduction for equity finance and ensuring that loss-offsetting applies, as discussed in Boadway (2014) and Milligan (2014).

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[3] Taxes in Norway are paid to the national government. The Federal system in Canada sees taxes allocated among the Provinces by a formula based on company sales revenues and wages. This would likely make direct application of the Norway model impractical for Canada. This said, and subject to consideration of the required administrative burden, it may be worth ring-fencing the oil sands so that something like the Norway cash flow model can be applied. Applying this model would largely eliminate issues related to judging competitiveness, as determining the government's share would be no different than determining the share of any equity farm-in/out participant; for example, contributing 75% of project costs, assuming full access to the cost information and appropriate auditing by tax experts, would entitle Alberta to 75% of the profits. Given Alberta's cultural history, this may not be a model that Albertans would want to support; however it would be a full extension of the C.D. Howe report's recommended cash flow approach. For a more in-depth discussion of how Norway captures a higher share – see How Norway Captures a Higher Share

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RESPONSE: I make no particular response to this recommendation except to say that it is important to be practical, which, in the real world, often includes a variety of fiscal instruments where some incremental loss in tax efficiency is most often offset by the benefits from applying a system of fiscal checks and balances.

SUMMARY: The C.D. Howe's recommendations represent a resurrection of past attempts along the same lines. No matter how many times the old rhetoric is dragged out it does not become any less misguided. Governments concerned with securing fair competitive shares should stay away from the approach pursued by the authors. The only exception possibly being a decision to go all-in on the cash flow approach and follow Norway's example, which would need to include equity participation and strict ring-fencing provisions.[4]

There is no need to redesign the entire system in Alberta. This would likely be more of a distraction than a practical solution to a real issue. The problem with the existing system is: (a) extreme complexity and lack of transparency and (b) a system of royalty offsets that amount to industry subsidies, with no way for government to measure success and judge value for money spent or royalties foregone.

Rather than introduce the fiscal uncertainty that would come with the C.D. Howe's recommendations, the current system in Alberta can be readily modified to fix the unintended consequences following from the last reviews; this would provide a win-win for both developers and resource owners. Fixing these unintended consequences can be easily accomplished with two simple steps: (1) make the system transparent for all to understand - analysts, policy makers, and resource owners, and (2) remove the current system of royalty programs or hidden subsidies that prevent the delivery of full value for governments and resource owners.

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[4] Even if this decision were taken for the oil sands it would in all likelihood be prohibited from extension to Alberta's other oil and gas resources, based on the necessarily high administrative costs. Resource rent based cash flow fiscal systems were designed for situations represented by a relatively small number of highly capital-intensive projects, such as the oil sands, offshore Newfoundland & Labrador, and Norway. To extend the required administrative burden required by these systems to the tens of thousands of individual wells in Alberta could only be described as quixotic, at best.

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