Royalty mandate missing the point: Opinion

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The Alberta government introduced the province's royalty review panel in Edmonton on Aug. 28, 2015. From left, chairman Dave Mowat, Annette Trimbee, Peter Tertzakian and Leona Hanson. LARRY WONG / EDMONTON JOURNAL

The royalty review panel risks repeating the mistakes of the past.

All governments since Peter Lougheed's have failed to achieve a fair share for Albertans as the resource owners. The incremental jobs created through low-royalty policies have not been sustainable. Albertans were told after the last review that low royalty rates would secure jobs. But no sooner had the lower rates been secured when some companies began to signal a transition of some assets out of Western Canada.

The West already has the lowest royalty rates in the world; the royalty system isn't causing this transition any more than a low-royalty policy could stop it. In fact, it is quite likely that by overheating Alberta's energy sector, the low royalty policy is a cause of this transition. Albertans understand that by developing vast new supplies, our once-captive U.S. customer no longer needs as much of our oil and gas.

Unlike jurisdictions such as Norway and even British Columbia, where the royalty/fiscal system goal is simply to maximize resource owners' value, Alberta's royalty review mandate seems to have been extended, in bureaucratic and otherwise confusing language, in at least three different ways.

The problem is, the language continues to reflect the royalty goal as stated by past administrations. With a responsibility to optimize, government never gets the benefit of a clear market signal. This means the Ministry of Energy and the oil and gas industry ultimately provide this signal. Government never knows what level of royalty benefits it could or should receive. It also means it's impossible for government to measure if it is receiving value for money spent in the form of forgone royalty revenue.

The point is not to challenge government's responsibility to optimize across a multiplicity of possible outcomes; it is that this optimization role is placed within the Ministry of Energy. This constitutes a public policy failure to set up appropriate governance institutions and analytic approaches.

Governance is the single most important factor in the successful outcome of the royalty review. The mess we are in stems from a failure to appropriately balance the royalty responsibilities of a specific ministry with the broader government policy responsibility that also includes industrial development, and revenue management. Industry development, diversification and a host of other matters are important, and decisions related to them are not always based on purely monetary considerations. However, policies to balance these objectives should be within the broader government policy mandate, and not in the royalty mandate.

Legislators, and Albertans, need to know the potential royalty revenues to government under policies designed to maximize those revenues. Then they need to separately know the revenue implications and other compromises associated with other legitimate policy initiatives. This is the only way government can be sure to receive objective advice and, consequently, it is the only way a robust debate can take place in caucus and in the legislature.

Other than ultimately to favour industry activity over the resource owner's share, one reason for a reluctance to maximize resource values seems to be the mistaken view that this goal would mean maximizing the resource owner's share. It doesn't mean this at all. It means maximizing the resource value. It is a given that government is entitled to the surplus share. A failure to recognize this distinction has caused the sector to be overheated, costs to rise, innovation to fall and the resource surplus to be less than it would be otherwise.

This review should not be seen as an initiative by the government of Rachel Notley potentially to increase royalty rates. Rather, it's about correcting what may be considered a mistake of the past — unintended consequences. Just as when government reduced rates following the 2010 competitiveness study, after industry argued that the 2007 review went

too far in increasing rates, the lack of public involvement in 2010 contributed to the rate correction going too far in the opposite direction.

A reasonable interpretation of the implicit agreement between government and industry following the last reviews (2007 and 2010) was that government intended to receive an increased share when prices are high. This would balance the 2007 panel's recommendation to reduced shares when prices are low.

The unintended consequence is that government's share did not increase when prices were high — in fact, it declined. The royalty formulas work to reduce the government's share when prices are low. They do not, however, work when prices are high. It is simply not reasonable to think that this was intentional.

A necessary prerequisite for resource management success is to break from the conflicted royalty policy and management practices of the past by separating government's royalty and revenue management functions from the industry promotion and industrial development functions.

The current situation — where the resource owner reduces its royalty share when prices are low, but does not realize an increased share when prices are high — is clearly an unintended consequence that ought to be corrected, and one that industry and the public ought to support. Since this problem relates only to high prices, correcting it would have no impact on industry's cash flow in the current low price environment. This is why this is the perfect time for government to fix Alberta's royalty fair share.

Barry Rodgers established Rodgers Oil & Gas Consulting in 2010 to provide clients with upstream economics analysis, training, and related information services.