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Alberta Royalty Myths

This article dispels three myths about Alberta's royalty system:

1. Comparison with Norway is not relevant;
2. Comparison with the United States is not appropriate; and,
3. Alberta's royalty framework needs to be complex.

NORWAY:

Many say that comparison of Alberta's government share with that of Norway is not relevant, even misleading. **In fact, it is totally appropriate to compare Alberta's share with that of Norway.**

How can jurisdictions representing very different situations be compared? Norway is a country – Alberta is a province; Norway's resources are offshore in deep water – Alberta's resources are on land. Norway produces largely light oil while Alberta's production is a combination of light and heavy oil, and extra heavy bitumen.

But different jurisdictions can be compared. Investors know this. They know that companies and industries across the world can be compared. They do this all the time. These comparisons are meaningful because the common metric is profitability. Looking at profitability, with an understanding of risk structures, makes useful comparison of situations, that on the surface look like apples and oranges,

For resource owners the comparison is about their share of resource revenues, after all costs have been recovered. Stated differently, it is simply about the price that is charged for access to oil and gas resources.

Norway charges resource developers 78% of the net income from oil and gas production. Alberta charges 50%, or less. Both comparisons are on the same basis – after all costs, either implicitly or explicitly

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In Norway the share is made up of corporate income tax (CIT) at 27%, a special tax (similar to the CIT) at 51%, but applicable only to the upstream oil and gas sector. [1]

Alberta's share is different for oil sands than it is for other commodities. The oil sands share is in the order of 55% (up from less than 50% for other commodities), consisting of CIT at 27% (both Federal and Provincial rates combined) and the royalty share that is technically referred to as a modified resource rent tax or a revenue minus cost royalty.

The royalty share ranges from a minimum 1% - 9% of gross revenue or 25% to 40% of net revenue, depending on price. It is important to know that royalty is deductible in determining CIT payable. This means that the CIT rate is effectively lowered to the range of 16.20% - 20.25%, depending on whether the royalty rate is 40% or 25%. When CIT and royalty are combined the overall oil sands government share is therefore in the range of 45.25% to 56.20%. [2]

It is also important to appreciate that in any given year the government share can be much lower; for example, data from the Ministry of energy website for 2013 shows the royalty rate for post-payout projects was an equivalent 9.0% of gross revenue, translating into an average overall government share of 33.6% at a 27% CIT rate. [3]

This represents an effective royalty rate decrease over a period when production increased, prices increased, natural gas costs are down, and statutory royalty rates also increased. This is particularly worrisome because even though royalty frameworks such as that applied to oil sands generally meet the academic qualifications for good fiscal design they are famous around the world for delivering far less in government share than resource owners expect. Alberta's oil sands regime would appear to be no exception. The following charts illustrates.

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[1] Norway also levies a carbon tax at USD 65/tonne, deductible for both CIT and special tax. Alberta's carbon levy is $15/tonne but equivalent to $1.65/tonne when all of the special triggers are taken into account. These levies do not materially change the government shares.

[2] The statutory CIT rate of 27% is reduced to 16.20% if the royalty share is 40%. The calculation is: 27% x (100 - 40) = 16.20/100 = 16.20%. These two rates can then be added for a total government share of 16.20% + 40.00% = 56.20%. A royalty rate of 25% translates into an overall government share of 41.20% (27% x (100 - 25) = 20.25/100 = 20.25% + 25% = 45.25%)

[3] (27% x (100 - 9) = 24.57/100 = 24.57% + 9% = 33.57%)

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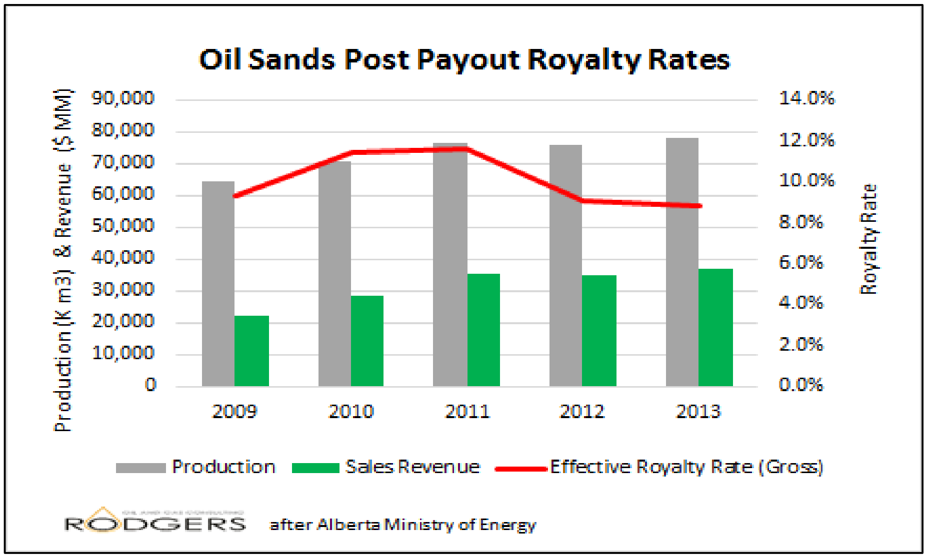

For Alberta's non-oil sands commodities, both oil and gas, the royalty share is based on a very complicated formula that includes a multitude of factors; e.g., price, production rate, well depth, time, cumulative volume, well classification (exploration or development, oil vs gas, shale vs. non-shale), technology – vertical vs horizontal wells, etc. While the rates as a percentage of gross revenue range from 0% - 40% for oil and 5% - 36% for gas, a series of "programs" or offsets substantially reduce these rates. For example, the effective rate in 2013 for natural gas was in the order of 6%.

Investors account for all of the various inter-jurisdictional differences and complexities by comparing the overall government share after costs. In summary, at prices of USD 80/bbl for oil and 4/Mcf for natural gas, the 78% share for Norway is comparable to Alberta shares of 55% for oil sands, 50% for conventional oil, and 37% for natural gas. Comparable shares for Texas are 66% for both oil and natural gas.

Another aspect of inter-jurisdictional comparison is the different fiscal structures. Fiscal structures tend to reflect the specific resource or jurisdictional circumstances. But what is important is not the specifics but the design principles. Some fiscal systems are better designed than others. In this way they avoid unnecessary costs and promote win-win outcomes where both producers and resource owners benefit proportionally. Alberta's conventional systems add costs and contribute to conflict and distrust where, in the long run, nobody wins.

Norway is recognized as a world-class oil and gas management success – an example of best practices. Comparison with a jurisdiction such as Norway is useful in understanding the combination of fiscal design features and principles that work best.

Norway represents a success that comes from recognizing that the government share should be competitive, and that saving, economic diversification, and in many cases equity participation, are not separate activities or options but parts of an integrated whole.

For a petro economy, planning without specific industry knowledge is at best precarious. This is why many jurisdictions have equity participation as a component of their resource management frameworks. Equity participation is not needed for every jurisdiction. Where it is applied however, it tends to be as much, or more, about gaining industry knowledge and insight than it is about revenue.

Economic diversification is all but impossible without saving – the source of funds for investment. Without saving, and in the longer term, economic diversification, the resource owner is unable to respond to industry structural change and the normal price declines without lowering its share of resource revenues, and then under pressured and disadvantaged circumstances. This sets up a spiral from which it is most often impossible to escape.

There is a belief expressed by industry and historically echoed by some in government management circles is that there is no better use of government money, including foregone revenue from lower royalties, than to plough it into the oil and gas sector. Somehow this is seen as diversification!

It is extremely important to recognize that when applied to petro-economies such as Alberta's, investment of Heritage Trust Fund savings into the Alberta economy is not good economic policy. When the oil and gas sector is as large a part of the economy as it is in Alberta, the entire economy is either directly or indirectly tied to the oil and gas sector. Investing government oil royalties back into the local economy, particularly the petroleum sector, is counter-productive, leading to even more dependency rather than to diversification. This is why Norway specifically mandates that oil revenues captured and saved are not to be invested in Norway but rather outside Norway in the broader world economy. This is real diversification.

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UNITED STATES

Alberta's royalty structure is historically influenced by that in the United States. The important difference however between Alberta and the U.S. states is the influence of private ownership. Therefore, some say, it is not appropriate to compare private ownership in the United States with Crown/government ownership in Alberta.

However, state officials point out that decisions by private landowners to charge a competitive price provides an example for governments to do the same on state lands. In this way the states find the private owner comparisons entirely appropriate. A representative royalty rate on private lands in Texas is 25% of gross revenue; it is the same on state/university lands in Texas. More generally, the average royalty rate on private lands across 25 U.S. states with varying degrees of private and state ownership is in the order of 18.6%, compared to 16.5% on state lands. For the top-5 producer states the representative average private rate of 20.8% compared to 20.0% on state lands.

In addition to royalties, the U.S. jurisdictions also levy a severance tax.[4] The severance tax is very much like a royalty, but with a rate that is typically 1/5th to ¼ of the royalty rate. **Applying two separate fiscal levies - royalty and severance tax - provides a great advantage in that it identifies a portion of the government share that can be more easily used to respond to unique and changing policy situations. The severance tax thereby facilitates fiscal stability as it affords room for government initiatives without compromising the entire royalty system.** State incentives in the U.S. are typically limited to only a share of the severance tax. When these shares are combined and added to the CIT share, and expressed after costs, they translate into a 66% government/resource owner share in Texas.

COMPLEXITY:

Another royalty myth is that Alberta's royalty framework has to be complex. For many "royalty keepers" in Alberta this is accepted practice. They grew up with it, they helped design it, and now they seem to believe it. That it is a myth needs no further evidence than a comparison with Texas, or any other U.S. State. Texas has a simple fixed royalty rate of 20% - 25% yet it produces three-times the volume of oil as Alberta, with some of this production

[4] There is also a significant property tax in most states. Revenue from property taxes goes to the individual counties. The property tax in Texas is equivalent to a 2% royalty.

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coming from the offshore. At the same time Texas is the clear industry leader when it comes to innovation and cost control.

Alberta's royalty structure has morphed beyond complexity to the point of being confusing, convoluted, and conflicted. The large bureaucracy required to administer these systems adds administrative costs for government that can only be described as waste.

Complexity in Alberta has not been about necessity. It is better described as being about the favored pathway for *diversifying* the economy; but, in Alberta's case, into even more oil and gas dependence! All who want to produce oil somehow need to be accommodated, no matter how inefficient they are. Directionally, Alberta's royalty policy seems designed to accommodate the bottom 20th percentile of companies and circumstances. As a result, industry's first reaction in times of trouble is to look to government; even when government, through the royalty system, has already provided fiscal relief in the form of lower royalties. Further relief is always sought because the royalty system, no matter how low the rates, sets the operating environment and expectation. In most circumstances further relief may provide comfort in the moment, but in the longer term, and when carried to extreme as it is in Alberta, it produces a self-defeating spiral downward.

In addition to being misguided, particularly for the long term, this approach deprives policy makers of the benefit of reliable market-based price signals as they struggle to do their job, including that of responding to changing industry circumstances and maintaining a healthy economy. For sure, support for infant industries and subsectors is a legitimate policy pursuit. Categorically, there is nothing wrong with supporting Alberta's oil and gas industry. The problem comes when the support goes on for decades and when it is so extreme that it effectively removes the industry or subsector from the discipline of competitive markets.

Charging a competitive royalty share in no way compromises government policy flexibility. Government is completely free to pursue whatever policy directions it chooses. These situations can be accommodated with direct revenue transfers. As long as these two broad activities – royalty capture and government industry support – are combined as they have traditionally been in Alberta, it is Impossible to measure the value of such support. This makes it impossible to ensure that the province is getting value for money spent.

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In conclusion:

- **Inter-jurisdictional comparisons are all about the share of project net revenue that resource owners receive. Because the shares are of net revenue after all costs they are on the same basis and therefore comparable.**
- **Alberta's royalty system does not need to be "complex", at least there is no excuse for a degree of complexity that destroys transparency and trust, turns royalty keepers into gate keepers, and ignores competitive market forces, and thereby, stifles innovation.**

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