Government Needed More Balanced Advice

Based on the Mowat panel's assessment, the New Democratic Party (NDP) government's royalty review confirms the position of past Progressive Conservative governments and that of oil and gas industry lobbyists.

The problem is, the Mowat panel's report does not provide evidence of sufficient quality to support its advice. In fact, independent evidence points to the opposite conclusion – that Alberta has not, is not, and, under the new NDP government's plan, likely never will achieve a fair share for the resource owners.

It is important to highlight the difference between the two positions, the NDP government's position and that of the Alberta owner's. The fundamental difference between these positions is relatively straightforward.

The NDP's new position since the 2015 election, maintains that Albertan's do receive a fair royalty share, under all price conditions, while the Alberta owner's position has been that this is not true when prices are higher. The government position gives everything to industry, while the Alberta owners would give a little less when prices are higher.

The Alberta owners are simply saying that '*we understand that royalty rates should not be increased in the current low price environment; however, we are saying that industry should contribute somewhat higher royalties when prices are higher*'. This was the fundamental bargain in all past royalty reviews, but, for a variety of reasons, it never worked for resource owners when prices were high.

The Alberta owner's position is quite modest when compared to that of resource owner's in the United States, and in almost all other countries for that matter. With the apparent sudden about-face by the NDP, one wonders yet again about the power of "big oil" and its brutish penchant for zero compromise and bullying.

The new government's position is based on the Mowat panel's report, which is, in turn, based on two fundamental premises. These two premises are:

1. **Existential Threat:** Alberta's oil and gas industry is fighting for its very existence, not only at current low prices but at any price;
2. **Wood Mackenzie Analysis:** Alberta is capturing a fair share – a share comparable to that of other jurisdictions such as North Dakota and Texas.

The Existential Threat is False – Those that understand the global oil industry see no existential threat to the oil sands; in fact, they see the oil sands development as the threat. Here is what OPEC thinks of Alberta's oil sands:

From 2025–2040, conventional crudes and NGLs, oil sands and biofuels become increasingly important sources of supply growth as tight crude production reaches a maximum and then contracts.

OPEC, World Oil Outlook 2015, p.93.

OPEC also understands that half of the world's remaining free market oil reserves are in Alberta's oil sands. They concur with the reports of Alberta companies like Cenovus (August 2015 Presentation) that the oil sands can be developed at a WTI equivalent price of USD $45 – $50 per barrel. Recent cost savings across the entire industry will bring this cost even lower. A more sensible resource development policy would see even more cost savings. The existential threat is nothing more than a fear tactic used to support industry's position. It has no basis in reality, except, of course, for those companies that cannot compete without heavy government subsidies.

What is remarkable is that the government thinks that Alberta is getting a fair share under current cost and price conditions; however, there is essentially no recognition that this share will, by definition, erode further as either costs and/or prices improve.

Wood Mackenzie's Analysis is Inadequate: Wood Mackenzie correctly supports the understanding that the government share ultimately depends on a jurisdiction's costs, not just on the statutory royalty and tax rates. It is important, however, to identify these rates and illustrate how they work.

By comparing Alberta with the United States, it cannot be denied that Alberta's rates are considerably lower – both the royalty rate and the corporate income tax rate (CIT). Alberta's total combined CIT rate is 27%, compared to a representative 40% rate in the U.S. Similarly, representative royalty rates are 25% in the U.S. compared to, say, 6% - 16% in Alberta. For the following illustration we use 12%.

Fiscal systems are compared on the basis of the government share of net revenue. This is a fair comparison because it is generated after accounting for revenue and costs, thereby accounting for location. Assumptions for illustration are selected to yield government shares that are representative of actual experience:

The table below illustrates that, contrary to the government's reading of the Wood Mackenzie report, **the Alberta government's share is likely at least 15% to 30% lower than its U.S. competitor jurisdictions**.

Case 1 shows the assumed revenue and costs with USA royalty and tax rates – a government share of 73.3%.

Illustration of Wood Mackenzie Type Fiscal Comparison Government Share Calcualtion						
			USA Case 1	Alberta Case 2	Alberta Case 3	Alberta Case 4
A	Revenue		100	100	100	100
B	Cost		55	55	65	81
C	Net Revenue	A - B	45	45	35	19
D	Royalty Rate		25%	12%	12%	12%
E	Royalty Revenue	D x A	25	12	12	12
F	Tax Rate		40%	27%	27%	27%
G	Tax Revenue	(C - E) x F	8	9	6	2
H	Government Share	(E+G)/C x 100	73.3%	46.5%	52.0%	73.1%
I	Effective Government Share	(E+G)/A x 100	33%	21%	18%	14%

Case 2 is the same as Case 1 but with Alberta royalty and tax rates – a government share of 46.5%.

Case 3 is the same as Case 2 but with 18% added to costs. This Alberta cost disadvantage is an assumption, but it is a more than reasonable representation of the net cost disadvantage and price advantage experienced by Canadian producers.

Case 3 brings the Government share in Alberta up from 46.5% to 52.0%.

Case 4 is the same as case 3 but with still higher costs. This is the type of case that allows Wood Mackenzie's work to be interpreted as showing that Alberta's government share is comparable to that in the USA. Are Wood Mackenzie's cost assumptions reasonable? Yes and no. First, it is important to appreciate that these costs ultimately come from industry, not from an independent audit. It seems too that these costs for Alberta are higher than those being reported directly by key Alberta companies such as Encana and Cenovus, indicating that the costs do not reflect recent cost improvements. Nonetheless, before taking final decisions, and ignoring that the costs may be out of date, one might reasonably assume that they are representative for illustration.

The Alberta owner's position can accept even these assumptions. However, they would want to make it clear that this cost increment is not a natural characteristic of Alberta's resources or geographic location. Rather, the Alberta owners maintain that this cost increment results directly from government policy. This is, after all, a policy that is designed to pursue maximum production at the fastest possible pace, no matter the implications for fair share and longer term economic diversification.

This policy causes undue inflation and, more critically, subsidizes high cost projects into being developed before energy markets need the incremental production or the technology exists to extract these resources profitably. In addition to contributing to higher costs that leave a diminishing share for resource owners, this policy also contributes to a further glut of production that pushes prices even lower. For example, this would include the Government's current decision to effectively subsidize even more natural gas production at a time when the gas price has collapsed due to over-production.

This decision can be contrasted with that of Encana, where management decided not to use oil profits to cross subsidize the gas side of the business. Instead, in the face of the North American gas price collapse, Encana's management decided to separate the oil business from the gas business. No longer able to drag down the oil side of the business (Cenovus), the gas side (Encana) had to become efficient, survive on government subsidies, be bought out by another company, or collapse altogether.

Royalty subsidies in Alberta have another important distortionary effect. By muting the cost response of Alberta companies compared to that in the United States, Alberta companies are less incentivized to innovate and cut costs. This is part of the reason why U.S. companies tend to be more innovative and more efficient at getting up a new technology learning curve. Because new technologies drive the entire industry, the more rapid learning curve in the U.S. leads to lower costs, which makes it seem that costs in the U.S. are lower than those in Canada when, in this case, the Canadian costs are more likely to be simply experiencing a lag effect.

For example, a new tight oil well in Texas might cost $8 million but a similar well would cost $12 million in Alberta. In responding to such a cost difference, what government policy makers have traditionally failed to recognize is that the Texas well may have initially cost $11 million, with experience bringing the cost down to $8 million over time. In this context, the Alberta policy makers similarly fail to recognize that the cost of the Alberta well will also be reduced as more experience is gained and Canadian industry catches up with that in the USA. After all, this is the expected effect of free trade, particularly for an industry that is highly integrated with the same companies operating in both Canada and the United States.

Alberta's policy response has been to assume that the current situation will exist permanently, leading to a frantic policy overreaction that hurts Alberta resource owners over the longer term. By making policy based on the perception that an Alberta well will continue to cost $12 million, when experience shows that this cost will come down to, say, $9, the net effect is a huge unnecessary transfer of wealth to industry.

When we step back from the details in the above table and simply look at the effective government share of the overall barrel, Alberta's royalty and tax disadvantage is clear. Alberta captures more like 14% of the barrel while U.S. jurisdictions capture closer to 33%. Whether Alberta's share should be 33% or 23% may be open for question; however it clearly should not be as low as 14%.

One might quibble with the numbers, but, with vastly lower statutory rates, it is simple common sense that there would be a lower government share for Alberta. This is what Albertans believe, and this is what the facts really show.

Industry's as-fast-as-possible development goal is simply not a sound resource management policy. This goal may be reasonable for an individual company, especially where it is government financed; this policy, however, is a disaster for the overall industry, and, therefore, a disaster for Alberta – both for current and future generations. Under this policy, economic diversification is impossible because other sectors of the economy are disadvantaged by subsidies and otherwise special treatment for the oil and gas sector.

Analysis relied on from the Mowat panel appears to be both shallow and short sighted, once again locking Alberta into the fiscal past. Alberta's royalty history is characterized by successive governments' knee jerk reaction to the crisis of the day by applying permanent royalty fixes that subsequently become royalty give-aways when the crisis is over.

This article presents a different view of an appropriate forward looking policy framework for Alberta's oil and gas industry than that reflected in the Mowat panel's approach and that underlying the Government's response. However, just as the article argues that the government's response is inadequate, those supporting the Panel see the government's response as entirely appropriate. This polarization reveals a much more fundamental problem.

The entire royalty matter in Alberta has traditionally been polarized as 'pro industry and jobs' against 'anti industry and "socialism" '. Any suggestion of a different royalty balance has been immediately shouted down. A more respectful public involvement is needed because it is clear that nobody is against jobs.

Those requesting royalty change are not anti-industry. Those recommending a change from past policies simply want to be satisfied that their position is openly and objectively heard. When this does not happen suspicions grow. Such suspicions are fueled when individual companies are invited to present their views to government Minister's but those expressing a reasoned and informed alternative view are not afforded similar opportunity. Unless the traditional polarization of views can be somehow overcome and replaced with a more mutually respectful process where all feel that they have been heard, Alberta will surely continue to struggle with the fair share issue. The current crisis will pass but resource management will continue to be polarized and, perhaps worse, become even more apathetic and dysfunctional.