**Alberta's 2015 Royalty Review: An Analysis**
Briefing for AUPE Provincial Executive
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## Summary


- On January 29, 2016, Alberta's government adopted the final report, "Alberta at a Crossroads," of the Royalty Review Advisory Panel, and intends to implement the recommendations resulting from the five-month long review
- The new royalty framework makes very small changes for the oil sands, regarding the process and administration of collecting royalties, and will not change the rate or government share of revenues: for oil sands companies, it will be status quo
- The framework makes more substantial changes for conventional and non-conventional (hydraulic fracturing) wells, liquids, and natural gas. However, these changes will apply only to wells drilled after 2016, and will only apply to existing wells after a 10 year exemption period
- The changes for oil, liquids and natural gas wells (not oil sands) amount to an effort to incent low efficiency producers to innovate and reduce costs year over year, thereby realizing greater total revenue, both corporate profitability and the overall amount of revenue available to Alberta's resource owners. These pricing changes do not adjust the royalty rate, which will be calibrated to remain roughly the same as the current system. They will maintain or accelerate production levels, especially as oil prices eventually rise.
- Several progressive critics are dissatisfied with both the process and the outcome of the review, suggesting it represents a capitulation to the oil industry and the financial sector
- AUPE may be concerned that the new royalty structure does little to increase the public share of resource rents or ensure they are saved, effectively perpetuating the province's fiscal structural imbalance and dependency on hydrocarbon production. In essence, the new royalty framework will do little to reduce the risk that government be tempted to cut spending on public services in an attempt to reduce the deficit


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## Background

The last comprehensive review of Alberta's royalty structure was launched in February 2007 under Premier Stelmach, and completed Sept 18, 2007 with a final report entitled "Our Fair Share." The Progressive Conservative government subsequently implemented several of the report's recommendations, boosting the government take of resource revenues by about 20 percent. This provoked the ire of the oil industry, and many junior producers in particular helped fund the newly renamed upstart Wildrose Alliance, which promised in its 2008 general election bid a reworking of the controversial changes the PCs made to the royalty regime.

The PCs increased their seat share of the Legislature in the March 3, 2008 election, and, facing retaliation from their former industry partners, subsequently revised the royalty framework. For oil sands production, effective January 2009, that rate became markedly lower than those charged by other jurisdictions for similar bitumen deposits. By March 2010, Stelmach announced that, effective January 2011, the royalty rates for natural gas and conventional oil would be rolled back. Alberta's royalty rates were effectively reset to pre-2007 levels and, by some accounts of formula and calculation errors, were a major source of the declining provincial revenue from natural resources.[i]

Though over subsequent years the government was forced to wrestle with declining natural resource revenues and the effects of an outdated royalty framework, Premier Redford insisted the PCs would not change energy royalties.[ii] Premier Prentice followed suit, ruling out raising oil and gas royalties and saying a review would "undermine business confidence at the very worst time."[iii]

## Let's Talk Royalties: The 2015 Advisory Panel and AUPE

Campaigning for Alberta's 29$^{th}$ general election, Rachel Notley and the Alberta NDP argued that the PCs had "squandered Alberta's resource wealth" and promised a careful review to report within six months of how Alberta will promote resource processing and fair royalties, aiming to ensure a full and fair return to the people of Alberta for their energy resources.[iv] On May 5, 2015, the NDP were swept to a majority and soon the 2015 review, "Let's Talk Royalties" was established.

Energy Minister Marg McQuaig-Boyd named Dave Mowat, CEO of ATB Financial as panel chair, who would work alongside three other panelists: Energy economist Peter Tertzakian, former Alberta deputy minister of finance and current President of the University of Winnipeg Annette Trimbee, and Mayor of Beaverlodge Leona Hanson.[v] The panel started work Thursday, Aug 27, 2015. It conducted a technical review involving the use of three "Expert Groups" of advisors (one for each of the three major streams of Alberta's non-renewable energy business: Crude Oil, Natural Gas, and Oil Sands) and contracted two energy data analytics firms (Wood Mackenzie and GLJ Petroleum Consultants).

Additionally, the Panel received 132 written submissions and more than 7,000 online responses to questions on its website LetsTalkRoyalties.ca. It held 65 public meetings and "community engagement sessions."[vi]

The Advisory Panel invited AUPE to participate and Oct 16, 2015 the Research Department submitted a 14-page briefing, making the case that:

- Albertans have not received the highest possible income from the sale of their non-renewable energy resources in the past, and royalty rates should therefore be improved and raised;
- The government should save all of its royalty revenue and invest it in productive capacity that will benefit all generations, by spending only the interest and avoiding wasting the resource endowment; the government must carefully extricate itself from its financial dependency on spending resource revenue to avoid damaging public services;
- Alberta should establish a 'Royalty Auditor', tasked with: 1) regularly reviewing and updating royalties, and whenever extraordinary market changes further warrant such review, and; 2) monitor and regulate producers and their payment of royalties, instead of relying on them to honestly report production;
- The government should attempt to account for the full costs of the oil industry operations, and establish an environment restoration fund, to save and prepare for paying the eventual costs of fossil fuel extraction, including oil spills, climate warming, health effects of polluted water and air, and cleanup and restoration;
- Alberta should consider establishing a state-owned oil company to operate within the province.

The Panel delivered "Alberta at a Crossroads," its 209 page final report on Friday, January 29, 2016.[vii] The report is divided into nine sections. After a summary, the authors describe the panel's approach and lay out some basic issues, like the value of resources being based on price and cost. By page 25, the report focuses on the current economic context and provides a brief history of the hydrocarbon markets, and changes in investment, and returns and how these affect royalties.

The Advisory Panel expands at length on major factors that have changed the landscape, noting that many of these are structural and not cyclical: advances in technology have unlocked significant new sources of oil and gas in the US, a major risk to Alberta's market share as the US is now not Alberta's prime customer, but its prime competitor; limited market access combined with increasing supply from rejuvenated US producers pressures downward the prices Alberta can receive; increasing environmental expectations; Alberta's workforce, while skilled, is small, and subsequently labour costs are higher compared to other competing jurisdictions; Alberta companies are competing for capital investment.

The findings are presented from pages 48 to 53, and then the Panel's four recommendations are spelled out. After a series of appendices, the data generated by a natural resource consulting firm, Wood Mackenzie, is presented and interspersed with the Panel members' own interpretations, in what amounts to a comparative fiscal analysis of different jurisdictions, focused on determining the relative profitability, risk, and costs of investment in Albertan oil and gas.

**Four Broad Recommendations**

"Alberta at a Crossroads" makes four recommendations:

1. Establish four guiding principles or criteria for Alberta's Royalty Framework (p. 56-58) – The four principles mirror the mandate given to the panel by Energy Minister McQuaig and Premier Notley, namely that the current and any future framework should: optimize returns to Albertans; attract investment and promote job creation; support downstream value-added industries, and; encourage environmental protection.

2. Modernize Alberta's royalty framework for crude oil, liquids and natural gas (p. 58 – 65) –this amounts to standardizing a pricing formula for all hydrocarbons (except for bitumen, which is dealt with in the third recommendation). The system will take effect for new wells drilled starting in 2017, and will allow existing wells to operate under the old, grandfathered royalty system for a period of 10 years before switching to the modern framework.

   The new framework is a set of technical recommendations designed to improve the efficiency of the system. To implement this recommendation, exhaustive testing by a "calibration team" will be conducted this Spring, and the panel recommends this work should immediately begin in order to deliver detailed formulas for pricing by no later than March 31, 2016.[viii] The new system:
   - includes a new Drilling and Completion Cost Allowance, as an average cost of similar wells (by depth and lateral length)[ix]: this is meant to incent corporations to innovate to reduce costs
   - improves the calculation of the base value of the resources, by allowing arbitrary depth and time limits on drilling for certain existing royalty programs to expire, helping improve the efficiency and hopefully the profitability

3. Maintain the rates and structure for oil sands royalties (the system implemented in 2009 will remain in effect) (p. 65 – 67)
   - A royalty rate of between 1 and 9% applied on gross revenue in pre-payout period (point at which cumulative revenue equals costs); after payout, royalty rate increases to range of 25 to 40% on its net revenue (ie. revenue minus costs)
   - "[…] the very substantial oil sands investments made durig the past decade, combined with the maturing of these projects to payout (which

produce the higher 25-40% royalties, means that Albertans are poised to reap significantly increased returns in the next decade"

4. Enhance value-added processing, especially of natural gas but also of bitumen (p. 67 – 71).

**What Does it All Mean? How will it work?**

The Government of Alberta announced January 29, 2016 that it has adopted and will implement a new royalty system based on the Advisory Panel's final report. Some things are staying the same, while others are changing. In short, the Panel recommends to:

- **Preserve the existing royalty structure for current wells and for oil sands**

All existing oil and gas wells, and those drilled in 2016, will pay royalties under the old (2009) framework for the next 10 years, after which they will be grandfathered into the new framework. Oil sands royalty rates will not change, but some small changes will be made to the process of calculating and collecting these royalties.

- **Establish a new royalty framework for 2017**, except for oil sands, which will remain the same except for some changes to allowable costs. Unlike the old royalty structure, the new structure will be harmonized across crude oil, liquids and natural gas. The new framework will permanently adopt a "revenue minus costs" model. The average drilling cost (*C) for any new well will be estimated using a "Drilling and Completion Cost Allowance" formula, based on vertical depth and horizontal length drilled.

Companies will be provided a low initial flat royalty of 5 percent for early production revenue until they reach payout (recover their drilling costs, when cumulative revenue equals *C). Companies will then pay higher posted royalty rates, broadly similar to present ones, except that the price function formula is expected to encourage innovation by crude, liquid and natural gas producers.

By applying the average industry costs of drilling to the pricing formula, it is hoped that each year less efficient producers will seek to innovate technologies to reduce costs, resulting in higher rates of return and continually lower industry averages each year. In short, instead of increasing the share of the pie that goes to Albertans, it is hoped the new framework will grow the pie, or total resource rents (and subsequently the profitability of producers and the returns to government).

Once hydrocarbon production drops below a certain rate, the well will be classified as mature, resulting in a downward adjustment to the royalty rates in proportion to declining production rates, recognizing the higher per-unit fixed costs involved with keeping a well running.

- **Increase transparency**

The new royalty framework would require Alberta Energy to improve annual reporting by providing clear details for royalties collected, calculation of allowable costs, production levels, profit margins, and net and gross revenue. Additionally, a new "Alberta Capital Cost Index," will be established and set to 100 in 2017, and allowed to float and reflect inflation or deflation of industry costs. The new index will provide information on the average costs of drilling and prices, production volumes, and the allowable costs used to determine royalty payments. Similarly, the Panel advises the government to review and improve the administration of royalty collection, to ensure corporations cannot pad their allowable expenses to extend their low-royalty pre-payout period. Together, these measures may make it easier to hold government and industry accountable.

**Concerns**

Since its release, progressive critics have raised a number of concerns about the new framework and even about the review process.[x]

The new royalty framework does not assert or schedule an increase in the government or public share of resource rents, even for after oil prices begin to recover. Note that the 2007 royalty framework under Premier Stelmach collected higher rates for Albertans (until it was rolled back in 2009) than the system just announced. Ricardo Acuna of the Parkland Institute argues that "it is unfathomable that they would determine that maintaining the existing rates will provide us anything even remotely resembling a fair share once prices recover." He goes on to say:

> "It is a fundamental principle of royalties that the bulk of economic rent resulting from high prices should go to the resource owners, not the industry. The reason for that is the high prices and increased rent are directly a result of the value of the resource itself, not anything the companies extracting it have done. If your house increases in value and you sell it, most of the increased value goes to you as the house's owner, not your realtor. The same should be true for our natural resources. The new framework does not accomplish that."

The review argues, on the other hand, that Albertans should stop focusing on whether the rates are right, and look more at what changes need to be made to position Alberta and its oil industry to address challenges:

> "the focus for Albertans should be less on the persistent questions of "are the rates right", and more on what changes need to be made to our royalty framework to position Alberta and our energy industry to address the challenges of a very different environment and outlook for the future." (p.13)

The review, and question of whether Alberta's share of resource revenue is appropriate, is positioned or framed by answering the question, "How attractive would an investment, in a typical well in different jurisdictions, be to an investor?"

(p. 105)[xi] Many other appropriate questions come to mind, like "what royalty rate would be appropriate to regulate the pace of oil development?" or "what is the royalty rate that would optimize government share of resource rents."[xii] In short, instead of taking a public interest or development focus, the panel was biased towards the interests of investors and oil companies.

While harmonizing royalty rates across a range of hydrocarbons helps to simplify the system and increase transparency, it also will significantly discount and reduce the royalties collected for high-valued products like propane and butane.

Further, though the Panel recommends harmonized and simplified rates across the spectrum of hydrocarbons, in the same breath it recommends incorporating "strategic programs and special allowances" (p.101) on how the drilling and completion cost allowance formula is calculated. This means that high risk experimental wells like deep drilling would get to claim higher costs than other wells, but it also opens up the possibility of exceptions, from now until the calibration team finishes its work, by March 31, 2016. It raises the question of whether some companies might successfully have drilling activities classified as high-risk or experimental, just to qualify for greater cost allowances.

Some critics argue that both the old and new royalty frameworks in effect are subsidizing uneconomic activity. For example, the report notes, "Ten oil sands projects from the 2009 to 2014 vintage will take an average 12 years to reach payout using the Government of Alberta's budgeted oil prices. Twenty-seven may never reach payout due to excessive cost overruns" (p. 95, see Figure C4). Further, in Appendix D, an analysis of the "Return on Average Capital Expended" (a measure of a company's financial performance) shows that Alberta's oil and gas industry is much less efficient than other companies in the broader Albertan economy.

The Advisory Panel uses the high costs and low efficiency of oil and gas producers to justify the necessity of the pre-payout period, an incentive to invest. Other observers might just as easily conclude that segments of the industry would not be sustainable without low royalties, or that the oilsands are now a proven resource and no longer need to be propped up with incentives, given substantial amounts of capital have already been invested.

Concerns have been raised about the use of Wood Mackenzie, a privately held British natural resource data consultancy firm, to provide the Advisory Panel with comparative research, which was ultimately used to justify holding royalty rates as they are by showing that Alberta was "middle of the road" when compared with other jurisdictions. However, some important jurisdictions like Saudi Arabia and Venezuela were not included, leading some commentators to charge that there were missing comparisons.

Others have pointed out that Wood Mackenzie regularly advises oil and gas companies, has recently been expanding its Calgary office, and hires oil executives to

its staff. The company has a bias towards industry, and its findings for the 2015 royalty review are a departure from its findings for the 2007 review, in which they ranked Alberta's royalty regime for oil sands as the 11th most attractive out of 100 jurisdictions globally, and that if all the 2007 recommendations of the report were implemented, "the oil sands would still rank 44 out of 100 countries in terms of attractiveness." The proposed 64% government take in 2007 remained well below the average take of 74% calculated by Wood Mackenzie.[xiii] The 2015 findings seem inconsistent with the 2007 findings.

The Fort McMurray First Nation warned the government not to listen to advice offered by financial institutions such as those represented by two members of the review panel, pointing out that large projects such as the oil sands and companies that invest in them are valuable revenue sources and clients of institutions like ATB Financial.

Others, including one member of one of the Expert Groups of Advisors convened by the Advisory Panel, argue that the recommendations fail to use royalties like a throttle to pace the rate of development, and curtail extreme projects that require relief from royalties to operate, and that avoid paying a fair share to government. This is related to the interesting fact that the royalties framework seems divorced from Alberta's new climate change strategy, when in fact royalties can be used to slow or speed up the pace of development. The new framework is clearly calibrated to put a foot on the accelerator, by maintaining the same broad rate as before.

Finally, and perhaps most importantly for AUPE, the concern arises that without improving the government share of resource rents from hydrocarbon production, the province's fiscal structural imbalance will persist. The royalty review fails to describe a clear plan to extricate the government from dependency on its share of resource revenue, and the historic problem of tying the government budget to the price of oil will persist, and along with it the risk that in downturns, governments will be tempted to cut spending and damage vital public services rather than run deficits. Increasing royalties would have slowed the pace of development once oil prices began to rose, helping to mitigate government dependence on sudden influx of resource revenue and the temptation to consume it.

In his submission to the royalty review panel, economist Mark Anielski reported how Alberta would have benefited if it had kept Lougheed's approach to a robust royalty regime and savings plan:

> "Had Alberta maintained a 30 percent royalty rate on the share of the value f the oil and gas produced between 1971 and 2014, Albertans would have generated $471.4 billion in oil and gas royalties. Had 50 percent of these royalties been invested in the Alberta Hertitage Savings and Trust Fund with annual average return of five percent per annum we would not have an investment account worth over $481 billion."

This critique align's with AUPE's own recommendations to the Advisory Panel in its Oct 2015 submission, when we suggested the government must save the revenue as an endowment for all generations of Albertans, which would also provide a failsafe protection for public services. "Alberta at a crossroads" fails to deliver on the main policy concerns raised by AUPE, except in part one: AUPE suggested a Royalty Auditor be set up, and some elements of this proposal will exist in the new reporting schemes designed to increase transparency and accountability. Other innovative suggestions that would have protected Alberta's public services have not been incorporated in the Advisory Panel's report, though arguably in fairness some of the suggestions might be out of the scope of the review.

**Conclusion**

The 2015 review of royalties on the revenue from Alberta's non-renewable hydrocarbon resources lacked a bold vision that would have improved Alberta's fiscal situation and lessened our reliance on fossil fuel extraction. The new policies may very well incent less efficient producers to become more efficient, but this in some regards amounts to maintaining or even accelerating production levels. For many observers the report does not adequately address the issue of the pace of development or improve the public share of resource rents – policies that would provide a sign to AUPE that the government was rebalancing its broken fiscal structure and ensure that in the future the temptation to cut public services in desperation to balance the budget was not a problem.

**References**

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[i] See Appendix C, p. 93, of “Alberta at a Crossroads” for detailed analysis of royalty revenues in Alberta from mid-1970s to present;

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[iii] Graveland, Bill, “Rachel Notley accuses Jim Prentice of fearmongering on royalties, pipelines”, CBC News, April 28, 2015, http://www.cbc.ca/news/elections/alberta-votes/rachel-notley-accuses-jim-prentice-of-fearmongering-on-royalties-pipelines-1.3052858

[iv] Alberta NDP, “Leadership for What Matters; Election Platform 2015” retrieved from: http://d3n8a8pro7vhmx.cloudfront.net/themes/5538f80701925b5033000001/attachments/original/1431112969/Alberta_NDP_Platform_2015.pdf?1431112969

[v] See. p.81 to 86 of “Alberta at a Crossroads” for bios of the panel members

[vi] See p. 15 to 17 of “Alberta at a Crossroads” for more on the approach of the panel

[vii] Alberta Government, “Alberta’s Royalty Review is Now Underway”, Aug 28, 2015, http://www.alberta.ca/release.cfm?xID=3845594C850AE-E87E-9ECE-469515545E814EFB;

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[viii] see Appendix E, p. 99 of "Alberta at a Crossroads" for detailed information about the Panel's recommendation regarding a short calibration period, and directives to the "calibration team"

[ix] see. Appendix E at p 99-100 of "Alberta at a Crossroads" for the new formula for *C (the drilling and completion cost allowance) and the establishing of an Alberta capital cost index (ACCI), to be initially set to 100 in 2017, and thus factoring in inflation or deflation into the calculation of allowable costs

[x] Nikiforuk Andrew, "Critics Slam Alberta's New Royalty Review as Policy Disaster", The Tyee, February 2, 2015, http://thetyee.ca/News/2016/02/02/Alberta-Royalty-Review-Disaster/;

Acuna, Ricardo, "the good, the bad and the ugly of Alberta's new royalty framework", Parkland Institute, February 1, 2016, http://www.parklandinstitute.ca/the_good_the_bad_and_the_ugly

[xi] See p. 104 of "Alberta at a Crossroads" for the Wood Mackenzie data and the Panel's interpretation.

[xii] Weir, Erin, 2002, "Economics, Ideology, and Elections: The Political Economy of Saskatchewan Oil Royalties in the 1980s and 1990s"

[xiii] "Special Edition on the Royalty Report", Department of Economics, University of Calgary, Fall 2007, retrieved from: https://econ.ucalgary.ca/sites/econ.ucalgary.ca/files/RoyaltyReportEC.pdf