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Fallout from the 2007 Alberta Royalty Review Panel

by Kenneth P. Green

Summary

- The new Alberta government has pledged to institute a review of royalty payments in Alberta's oil and gas sector during its first term in office.

- The last time this happened, under the Ed Stelmach government in 2007, there was an immediate plunge in the perception of Alberta as a place in which to invest in oil and gas exploration and development, as reflected in the Fraser Institute's annual *Global Petroleum Survey*—a survey of senior executives in the upstream petroleum sector.

- Perceptions of investment attractiveness remained depressed from 2008-2010, when the government announced a reversal of many of the rate increases instituted after the review.

- Investor confidence did not fully return until 2011, after most of the rate increases triggered by the 2007 royalty review were reversed.

- If the Alberta government chooses to proceed with its royalty review in the face of past experience, it is important for it to consider ways to reduce uncertainty, which is often a deterrent to investment in extractive industries.

- Ways to reduce uncertainty might include ensuring that the process is a highly transparent, with clearly defined dates, clearly defined and delimited goals, and clearly defined public and private consultation with all stakeholders included from the outset.

Royalty review an election pledge

In a historic election on May 5, 2015, Albertans rebuked the Progressive Conservative Party, which had governed the province for 44 years, and handed the reins of power over to the New Democratic Party, headed by Premier-elect Rachel Notley (CBC, 2015, May 6). The NDP's platform (quickly expunged from their website after the election) pledged to:

> Establish a Resource Owners' Rights Commission to report to the new Premier and the Legislature within six months on measures to promote greater processing of Alberta's energy resources, and to ensure a full and fair return to the people of Alberta for their energy resources. (Globe and Mail, 2015, May 13)

This will not be Alberta's first royalty review. It would behoove us to see what we might learn from previous endeavors, notably, the royalty review conducted in 2007 under Premier Ed Stelmach.

The Stelmach royalty review

The Stelmach royalty review was published as Our Fair Share and was issued by the Alberta Minister of Finance, Dr. Lyle Oberg, on September 18, 2007 (Alberta Royalty Review Panel, 2007, September 18). In that report, the Royalty Review Panel (RRP) concluded that, indeed, Albertans were not receiving their fair share of revenues from Alberta's oil and gas resources.

The RRP report did not overtly define what "fairness" means. But from its conclusions, we can infer that fairness seems to mean the maximum amount that government can "take" from the oil and gas sector (in the form of royalties and taxes) without rendering the province non-competitive with other energy-rich jurisdictions such as Texas. According to the RRP, "[t]he total government take from oil sands can be increased while keeping northern Alberta an attractive investment destination" (p. 7).

Table 1 shows the panel's conclusion regarding what Albertans were getting, compared to what it felt was their fair share.

Table 1: The findings of the 2007 *Our Fair Share* report

	Current Sharing		Recommended Sharing	
	Albertans' Share	Developers' Share	Albertans' Share	Developers' Share
Oil Sands	47%	53%	64%	36%
Conventional Oil	44%	56%	49%	51%
Natural Gas	58%	42%	63%	37%

Note: natural gas includes both conventional gas as well as coal bed methane.

Source: Alberta Royalty Review Panel (2007), p.7. <http://www.energy.gov.ab.ca/About_Us/3688.asp>, as of May 28, 2015.

Assessments of Alberta from annual *Global Petroleum Surveys*

By coincidence, the Stelmach royalty review coincided with the first years of the Fraser Institute's annual *Global Petroleum Survey*—a survey of upstream oil and gas executives that endeavors to rank jurisdictions around the world on their overall policy framework surrounding oil and gas development. Executives are asked whether the following policies and other factors in the jurisdictions they know well would deter investment, would encourage it, or would neither deter nor encourage investment. The factors are:

1. Fiscal terms—including licenses, lease payments, royalties, other production taxes and gross revenue charges; but not corporate and personal income taxes, capital gains taxes, or sales taxes.

2. Taxation in general—the tax burden, including personal, corporate, payroll, and capital taxes, and the complexity of tax compliance, but excluding petroleum exploration and production licenses and fees, land lease fees, and royalties and other charges directly against petroleum production.

3. Environmental regulations—the stability of regulations, consistency and timeliness of regulatory processes, regulations not based on science, etc.

4. Regulatory Enforcement—uncertainty in the jurisdictions with which the executives are familiar regarding the administration, interpretation, stability, or enforcement of existing regulations.

5. Cost of regulatory compliance—re: filing permit applications, participating in hearings, etc.

6. Protected areas—uncertainty concerning what areas can be protected as wilderness or parks, marine life preserves, or archaeological sites.

7. Trade barriers—including tariff and non-tariff barriers to trade and restrictions on profit repatriation, currency restrictions, etc.

8. Labour regulations and employment agreements—the impact of labor regulations, employments agreements, labor militancy/work disruptions, and local hiring requirements.

9. Quality of infrastructure—includes access to roads, power availability, etc.

10. Quality of geological database—includes the quality, detail, and ease of access to geological information.

11. Labour availability and skills—the supply and quality of labour, and the mobility that workers have to relocate.

12. Disputed land claims—the uncertainty of unresolved claims made by aboriginals and other groups or individuals.

13. Political stability.

14. Security—the physical safety of personnel and assets.

15. Regulatory duplication and inconsistencies—includes federal/provincial, federal/state, inter-departmental overlap, etc.

16. Legal system—legal processes that are fair, transparent, non-corrupt, efficiently administered, etc.

The survey's findings in the years immediately surrounding the Stelmach royalty review, particularly pertaining to the first question on fiscal terms (taxes and royalties), are revealing, as table 2 demonstrates.

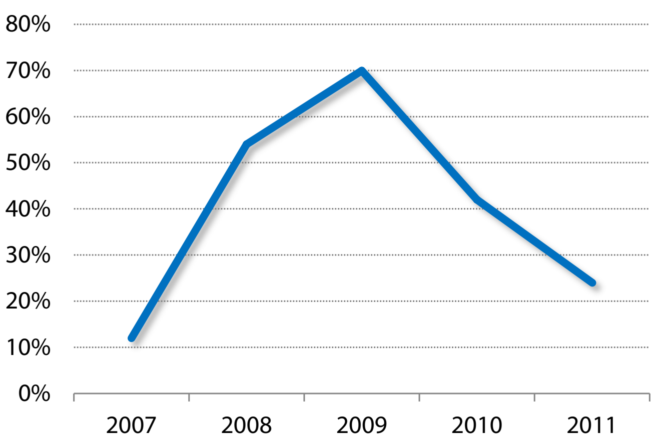
Table 2 shows how survey respondents perceived the fiscal terms component of the factors affecting the investment climate in Alberta after the 2007 royalty review. Note that, on a combined basis, the "deterrent" or negative responses jumped sharply in 2008 and again in 2009, later gradually returning to the levels of 2007. By 2009, 70 percent of the survey responses on the question about Alberta's fiscal terms indicated that they were a deterrent to investment in oil and gas development and production.

Table 2: Alberta Fiscal Terms (includes licenses, lease payments, royalties, other production taxes and gross revenue charges; but not corporate and personal income taxes)

Year	Encourages Investment	Not a Deterrent	Mild Deterrent	Strong Deterrent	Would not Invest
2007	**38%**	**51%**	**10%**	**2%**	**0%**
2008	**26%**	**21%**	**36%**	**17%**	**1%**
2009	**8%**	**22%**	**28%**	**38%**	**4%**
2010	22%	36%	31%	9%	2%
2011	29%	47%	21%	3%	0%
2012	51%	32%	14%	2%	1%
2013	48%	39%	12%	2%	0%
2014	43%	43%	12%	1%	1%

Source: *Global Petroleum Survey* (2007-2014) (various authors). Fraser Institute.

Figure 1: Percentage of responses indicating fiscal terms were percieved as a deterrent to investment, 2007-2011



Source: *Global Petroleum Survey* (2007-2014) (various authors). Fraser Institute.

Figure 1 displays this graphically, plotting the sum of the three deterrence columns from 2007 to 2011.

Open-ended comments about fiscal terms from the 2007 survey, taken from data gathered in the spring, well before the royalty review was announced, were largely positive for the Canadian provinces and territories included in the survey (Angevine and Cameron, 2007). In the 2007 survey, Alberta ranked 22nd out of 54 jurisdictions on the overall all-inclusive composite index. Alberta also led all other Canadian jurisdictions on the perceived attractiveness of its fiscal regime. Comments from survey respondents largely supported that view:

- "Best combination of fiscal terms, markets, and political stability."
- "Open, fair, competition."
- "Political risk taken out of the equation."

By the time of the Institute's 2008 survey, the verdict was in on the royalty review, and perceptions had shifted sharply (Angevine and Thomson, 2008). Alberta ranked 54th out of 81 jurisdictions on the All-inclusive Policy Index. Alberta's ranking for having fiscal terms that encourage investment fell to 6th among the nine Canadian jurisdictions included. Survey respondents' comments pertaining to fiscal terms included:

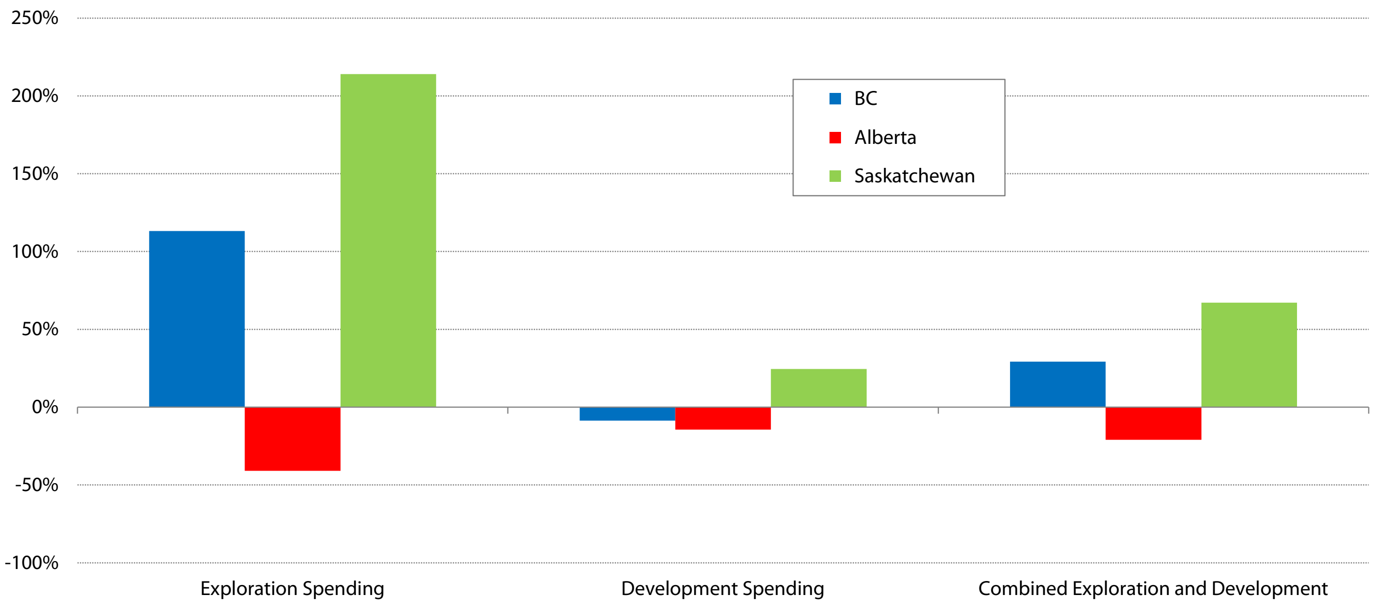
- "Alberta's Royalty Review process and related communication have severely dented investor confidence in Alberta's oil and gas business environment. The poor quality of the review process and the government's handling of the results, coupled with poor timing, have seen a flight of capital away from Alberta. This led to an abrupt decline in company valuation, including mine, which far outweighs the changes."
- "An exemplary 'horror story' is the recently introduced 'fair share' royalty regime in Alberta, which has effectively made it uneconomic to explore for gas in Alberta. Decisions to implement this policy were made without industry input, and when industry tried to forewarn of so-called 'unintended consequences,' the Stelmach government took an adversarial approach and basically misinterpreted it as a threat and thumbed its nose at the industry. Alberta is now seeing the adverse effects of this irresponsible response."
- "The royalties are now too high on high-risk, high-tech, expensive wells."
- "The new royalty framework is going to make many projects undrillable."
- "The Alberta royalty changes are onerous and not well thought out… They have gutted the small Canadian-owned companies."
- "If the new royalty structure is not changed, exploration companies will move elsewhere."

Things looked no brighter in 2009, when Alberta ranked 92nd out of 143 jurisdictions on the All-inclusive Policy Index (Angevine et al., 2009). Alberta's ranking for fiscal terms that encourage investment fell to the lowest among all Canadian jurisdictions. Comments from survey participants pertinent to the fiscal terms factor that year included the following:

- "Royalties too high, basin over-drilled. Royalties must be reduced."
- "The government has placed punitive royalties on production within the province. The companies enjoyed a few good years of profits and in turn get nailed with punitive royalties. The government has an acidic relationship with firms… it must return the royalty rates to the original levels and look at adding incentives for the unconventional resources."
- "They take the industry for granted and don't look for ways to encourage activity." "The royalty changes were made without consultation and without understanding the potential consequences."
- "Alberta needs to reverse the New Royalty Framework if it wants to have any credibility as a business-friendly province that honors existing agreements with energy companies."

In the 2010 survey, after the government had announced it would reverse many of the royalty changes brought in in 2008-9, investor attitudes began to turn around, though, as the Fraser Institute survey for that year indicates, the change was not instantaneous (Angevine and Cervantes, 2010; *Edmonton Journal*, 2015, May 15). Alberta's overall policy perception ranking in 2010 was 60th out of 133 jurisdictions on the All-inclusive Policy Index. Alberta's ranking for fiscal terms still lagged near the bottom of attractiveness amongst Canadian jurisdictions, ranking above Ontario only. There was a slight improvement in perceptions among survey respondents who were surveyed in 2010 after the royalty changes were announced compared to those who were surveyed before the changes,

Figure 2: Percentage Change in Spending on Exploration and Development in Alberta, 2006 to 2008



Source: Canadian Association of Petroleum Producers (2015). *CAPP Statistical Handbook* (2014 data)

but those improvements were too small to influence the province's overall ranking. Industry sentiment remained negative regarding the royalty review, with comments including:

- "Uninformed and uneducated premier has been making drastic revisions to royalties which lead to several negative consequences. Some changes have increased royalties to the point of projects becoming entirely uneconomic and stifling foreign investment. New government policy or substantial revisions to existing policies should be introduced rather than just putting in place band-aids (i.e., drilling royalty credits) as time goes forward to try to make things better"
- "Government is anti-energy business, with concentration on rural economic populism. They have made significant mistakes which remain uncorrected. Poorly thought-out royalty increases have been offset by short-term relief measures that do not provide assurances on investments. Regulatory environment allows individual Albertans to harass or suspend activities of entire industry."

By 2011, after restoring royalties to their pre-review levels, the industry's perception changed quickly. Alberta ranked 51st out of 135 jurisdictions on its All-inclusive Policy Index. Alberta's ranking on the fiscal terms factor shot back up to 5th place among the 10 Canadian jurisdictions included for its attractiveness to investment. Comments from survey participants also reflected the changing climate of perception.

- "Responding the most to shifting technology from both a regulatory and royalty perspective. Infinitely more 'user friendly' than in 2008."

- "While not perfect, still has relatively low political risk and an attractive royalty regime. Major companies and investors still see Alberta as an area of growth and development."
- "While Alberta has gone some distance to amend the royalty terms, it lacks the political leadership to provide for long-term stability."
- "Public attitudes still reflect the widely heldview that the industry is not acting in the public interest and must be 'fixed.'"
- "Government needs to be more consistent with policies on royalty and environmental issues."

Discussion

In 2007, the Stelmach government created a Royalty Review Panel to determine whether or not the people of Alberta (and the government of Alberta) were getting their 'fair share" of the revenues generated by oil and gas production in the province. The Panel concluded that Alberta was not getting its fair share, and royalties were increased as a result. The Fraser Institute *Global Petroleum Survey* captured the perceptions of senior executives in the oil and gas sector, which strongly suggested that the increased royalties would deter them from investing. An analysis of investment in Alberta compared to other western jurisdictions seems to support that conclusion, as figure 2 shows.

Conclusion and recommendations

As with the Stelmach royalty review, the Notley government has announced that it will implement a royalty review sometime within its first term. The new government would do well to review data showing the impact of the Stelmach governments 2007 review process on the perceptions of senior executives in the upstream oil and gas industry with regard to Alberta's attractiveness for investment.

The 2007 royalty review and successive changes were immediately reflected in declining perceptions of Alberta's investment attractiveness in the Fraser Institute's annual *Global Petroleum Survey*. A more general lesson that can be learned both from the Institute's petroleum survey and its annual *Survey of Mining Companies* is that when governments inject uncertainty into markets, perceptions of investment attractiveness in those jurisdictions suffer (Jackson and Green, 2014). To the extent that perception is reality, one should expect such injections of uncertainty to be met with reduced interest in investment in such jurisdictions, as was the case after Alberta announced the royalty review.

Given its dependence on petroleum revenues, and the current low point in crude oil prices, Alberta can ill afford a strong injection of uncertainty at this time, any more than it could in 2007. Minimizing this uncertainty should be a key consideration of the Notley government should it choose to proceed with its promised royalty review. Based on findings from the Fraser Institute's research on petroleum and mining policy, the Notley government can act to limit uncertainty by ensuring that the process is highly transparent and has clearly defined dates, clearly defined and delimited goals, and clearly defined public and private consultation with all stakeholders from the outset.

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