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Pipelines or Policies: What's Behind the Fall in Investor Confidence in Alberta?

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Main conclusions

- **While an analysis of the share prices of firms show that savvy investors have already "priced in" many of the concerns about oil transport and access to outside markets, the Fraser Institute's annual *Global Petroleum Survey* shows that investor confidence in Alberta is taking a serious hit.**

- **The survey's Policy Perception Index measures the extent of policy-related investment barriers within each jurisdiction. The higher the score, the more negative the sentiment on the part of respondents, indicating that they regard the jurisdiction in question as relatively unattractive for investment. Alberta's score deteriorated from a value of 26.6 in 2014 to 34.2 in 2015, and its global rank as a desirable location for investment fell to 38th (out of 126) in 2015, down from 16th (out of 156) in 2014.**

- **Areas such as political stability, fiscal terms, uncertainty concerning protected areas, and taxation experienced large negative shifts, indicating that more investors are viewing these areas as barriers to investment in Alberta.**

- **During Alberta's last royalty review, when investors also downgraded Alberta's ratings in the *Global Petroleum Survey,* exploration and development spending in Alberta declined, while neighboring Saskatchewan and British Columbia saw increases in investment.**

The Fraser Institute recently completed its 9th annual global survey of petroleum industry executives and managers (Jackson, Green, and Ramsbottom, 2015). Alberta remains one of the most favoured destinations in the world for oil and gas development investment. But new uncertainty about policy directions has caused the province's reputation to slide dramatically in less than a year, and this should raise red flags for the provincial government.

The Fraser Institute surveyed 439 senior executives in the petroleum sector, obtaining information on perceived barriers to investment in 126 jurisdictions around the world. The survey was conducted between late May and the end of July 2015, coinciding with the aftermath of the Alberta provincial election. Respondents gave their opinions on 16 distinct aspects of the business climate, including fiscal terms, taxation, regulatory costs, data and infrastructure support, security and political stability. Within each area respondents ranked the jurisdiction on a scale from one to five, with the lowest score indicating the smallest perceived barriers to investment and the highest indicating that investment is out of the question due to this criterion.

The responses were then combined into an overall Policy Perception Index summarizing the perceived barriers to investment. Overall, Saskatchewan emerges once again as the best Canadian province for investing, followed by Manitoba. This is unchanged since last year. What has changed is that Alberta fell from third place last year to seventh this year in Canada. And in the global comparison it fell from 16th out of 156 to 38th out of 126, a massive decline.

What explains this turnabout? Additional research supported by the Fraser Institute allows us to rule out external uncertainty over the major pipeline projects, and zero in on the made-in-Alberta factors (Aliakbari and McKitrick, 2015).

One plausible explanation as to why Alberta has dropped so far in the reputational rankings is the refusal of the US administration to approve Keystone XL.[1] Combined with the ongoing uncertainty over the Northern Gateway pipeline and the Kinder Morgan twinning project, it may simply be bad luck: due to forces beyond its control Alberta would have slid in the rankings anyway. To examine the influence of pipeline-related factors, Fraser Institute Senior Fellow Ross McKitrick and researcher Elmira Aliakbari undertook an Event Study Analysis (ESA) to see what effect they were having on the profitability of Canadian energy firms.

The ESA method uses stock market data to test whether a news event causes a significant rise or fall in a company's market valuation. It is a widely-used method in the field of finance because of the efficiency with which markets use information to adjust their valuation of a firm's prospects. If negative news about bitumen export routes explains the downturn in Alberta's investment outlook, that should first show up as a hit on the stock price of the affected firms.

McKitrick and Aliakbari looked at seven key events in recent years: the 2011 US decision delaying approval of Keystone, the 2012 US presidential election, the announcement of the Kinder-Morgan twinning project and the decision of the NDP to oppose it in the last BC election, the 2013 BC election outcome, the announcement of the Energy East project in 2013, and the 2014 federal decision to approve the Northern Gateway pipeline. Each one was unanticipated in the market yet had potentially significant implications for pipeline development and returns to oil firms.

The researchers could find no evidence that any of these seven events affected the market valuation of the top 20 Canadian energy firms. This likely implies that the market had priced pipeline uncertainty into the firms' valuations a long time ago, and none of these recent decisions changed investor perceptions about

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the prospects that Alberta oil will eventually get to market. Simply put, investors in the Alberta energy sector are prepared to play a long game when it comes to working out options for moving oil to customers, and they aren't spooked by temporary setbacks in the development of specific pipelines.

This brings us back to the *Global Petroleum Survey*. The negative shift in perceptions was driven by changed perceptions on political stability, fiscal terms, protected areas (uncertainty over access to development sites), and taxation. Respondents were given the opportunity to elaborate on their rankings, and those that did generally pointed to the royalty review as the major area of concern. As one respondent put it, "Government never fails to conduct the reviews/changes at the most inopportune times with regard to oil price (either just after or before a price crash)."

The Notley government can't be blamed for the collapse in the world price of oil. But if that was the only problem, Alberta would not have fallen so far relative to everyone else since the rest of the world is also contending with slumping revenues. The issue is the timing of a series of potentially punitive rule changes for an industry already grappling with a global revenue shock (Jackson and Green, 2015). This is not attributable to external events; it is a made-in-Alberta problem.

Sadly, this also appears to be a replay of the events that unfolded in the aftermath of a royalty review initiated by then-Premier Ed Stelmach in 2007 (Alberta Royalty Review Panel, 2007). Advertised as an attempt to get a "fair share" of resource revenues, the government brought in large increases in the combined royalty and tax rates on oil sands, conventional oil, and natural gas production. Prior to the royalty review, Alberta was second amongst Canadian jurisdictions in the Fraser Institute survey and was 22nd (out of 54) globally (Angevine and Cameron, 2007). Eighty-nine percent of respondents believed the province's fiscal terms were either neutral or an encouragement to investment. A year later that fraction had fallen to 47 percent and in 2009 it bottomed out at 30 percent, with 70 percent regarding the province's stance to be a deterrent to further investment (Angevine and Thomson, 2008; Angevine, Brown, and Cervantes, 2009). That same year Alberta had fallen to 92nd out of 143 globally.

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These were not mere changes in perception. They were accompanied by real reductions in exploration activity and development spending. Between 2006 and 2008, spending on exploration and development in Alberta fell by 21 percent (Jackson and Green, 2015). This was not attributable to global factors. Over the same interval, spending in neighbouring BC rose by 29 percent and in Saskatchewan by 67 percent. Alberta stood out during this time as a place where the investment mood was turning sour very quickly due to internal policy changes.

The Stelmach government reversed course in 2010 and began a process of returning to earlier royalty rates (Green, 2015). The damage was not undone immediately: it took about two years for investor sentiment to return to similar earlier levels. This is another important lesson for the Alberta government. Once the perception is created that a jurisdiction is becoming hostile to a sector, it may take a while to win back trust.

It remains the case that Alberta is one of the best places in the world for oil and gas investment. Trouble spots like Russia, Iran, and Venezuela have a long way to go before they will be viewed as being as investor-friendly as Texas, Saskatchewan, or Alberta. But in a competitive world, advantages can be squandered if they are not carefully managed. This is the second time the global petroleum sector has sent a signal that Alberta's reputation is at risk. The Notley government would do well to pay attention to the real consequences of creating an atmosphere of fiscal uncertainty and hostility to investment.

Note

1 The Keystone XL pipeline was officially rejected subsequent to the writing of this study.

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