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The sky is falling, let's blame the royalty review

By Nigel Bankes

I have lived in Alberta and this city for nearly thirty years. During the fall of 2007 I thought that we had the best public policy debate that I have ever seen in this province. The subject of that debate was the province's royalty review.

I think that it was a good debate because it was a well informed debate on a crucial public policy issue. It was a well informed debate because the province, for the first time in its history, struck a public review which articulated a set of principles that should govern royalty design. Prior to that, royalty reviews were essentially private affairs between government and industry.

The royalty review panel made a number of recommendations both in terms of process and substance (see here).

On the process side the panel recommended that there should be greater accountability and transparency in the way that we set and review royalties.

On the substantive side the key recommendation of the panel (when you step back from the detail) was that the royalty regime should be sensitive to price and profitability. In slightly more technical terms the review recommended that that the regime should be somewhat more aggressive in attempting to recover available economic rent, subject to competitiveness considerations. We can think of economic rent as the difference between price and costs (where costs are defined to include a reasonable return to all costs assumed and capital committed by the industry).

What sensitivity means in terms of royalty design is that when prices are high the royalty rate should rise. But equally when prices fall the royalty rate should also fall and a royalty should never seek to extract economic rent that does not exist. All this should be built into royalty design. The scheme should be flexible enough to accommodate oil at all realistic price points; which these days means that the scheme should be workable without adjustment whether oil is at $15 a barrel or $150.

Note what happened following the review. Prices went sky high but the royalty rate did not change. In fact the royalty review panel told us that the old royalty system lost its sensitivity at absurdly low prices.

The royalty rate did not change as a result of the review until January 1 of 2009. What that means is that oil companies in the first ten months of last year were laughing all the way to the bank and at our (the public's) expense. (See my post: "Why are we waiting").

It's true that industry is screaming now but what a wonderful ride! A ride that is recorded in Esso\Imperial's recently released record profits for 2008.

There is a real risk that we will lose what we achieved in 2007 in terms of transparency and accountability and commitment to a set of workable principles for recovering a fair return for the public owners of the oil and gas resources of the province. The clamour for a quick fix is rising.

Don Braid in Saturday's Calgary Herald (January 31, 2009- see here) reports with apparent satisfaction that the province is launching a competitiveness study. Who is appointed to sit on this study panel? Who else but representatives from the oil and gas industry and government. Are the terms of reference publicly available? This is not clear; Braid refers to "draft terms of reference obtained by the Herald." All this suggests a return to the good old days of back room deals between government and industry about what is good for Albertans (a.k.a. the oil and gas industry).

I think that the royalty review panel had it right. Royalties should be sensitive to price and especially profit. When prices fall so should royalties. But when prices rise so should royalties and the share of the government take. Why? Because we the people own that resource and the up side belongs to us as long as we properly compensate industry for its capital and its risk.

What the last 15 months shows us is that the industry is incredibly adept at making sure that the public does not get its fair share when prices sky rocket; but they are equally adept at ensuring that when prices fall we get a very quick and private review of the royalty regime.

The Stelmach government needs to reassure Albertans that it remains committed to an open and transparent process for reviewing royalties and that it remains committed to recovering a fair share of available economic rent for Albertans. That means that royalties should be sensitive to price and profit. If that means that we need to lower the royalty take so that it does not seek to recover non-existent rent or negative rent then I would support that change; but we should not lose the basic principles that animated the royalty review. There is nothing in the current price collapse that undermines those principles. Indeed the current crisis simply reminds us that a royalty regime needs to be flexible both on the upside and the downside. Industry will always support flexibility on the downside but will be considerably more reluctant to commit to the equivalent flexibility on the upside.