IAPR POLICY BRIEF SERIES

ALBERTA'S ROYALTY REVIEW AND THE LAW OF GRANDPARENTING

Nigel Bankes
Faculty of Law
University of Calgary

Policy Brief No. 07002

September 2007

Institute for Advanced Policy Research
University of Calgary
Calgary, Alberta
Canada

http://www.iapr.ca
iapr@ucalgary.ca

Correspondence: Nigel Bankes, ndbankes@ucalgary.ca

Alberta's Royalty Review and the Law of Grandparenting

The Royalty Review Panel made it quite clear in its Report that existing projects should not be protected from the proposed changes. In other words it recommended in very strong terms that there should be "no grandparenting". In recent days this position has been the subject of considerable comment and reaction. Some (e.g. Murray Edwards of Canadian Natural Resources) seem to suggest that the refusal to grandparent constitutes an interference with vested rights and have further suggested that, if implemented, the decision not to grandparent will be open to challenge in the courts. Deborah Yedlin, a columnist, offered comments on CBC Radio on September 26 which seemed to concur and suggested that the panel's refusal to grandparent is a "non-starter" and "has to be taken off the table". Others have suggested that this may be a matter on which the government might indeed seek to "pick and choose" i.e. to accept the panel's recommendation on a go-forward basis but not to apply the recommendations to existing projects. And finally we are told that the American Embassy has been warning us that Alberta should not seek to change arrangements for existing projects.

In sum, the grandparenting issue is emerging as one of the critical issues in the debate on the implementation of the recommendations of the Review Panel. In this comment I propose to examine: (1) the reasons that the panel gave for not grandparenting, (2) the law on grandparenting, and (3) the (potentially) unique position of the Syncrude and Suncor projects.

Why did the panel reject grandparenting?

The panel rejected grandparenting on the pragmatic grounds that "almost nothing would change" if the proposed changes do not apply to existing projects. And, given the panel's further assessment that Albertans have not been getting a fair share of the available economic rent for some years, it readily reached the conclusion that this was unacceptable. The panel dealt head on with the argument that royalty rates should be treated as if they were fixed for the life of the lease and the argument that the industry would no longer see Alberta as a good or safe place to do business if royalty rates were changed "mid-course". As to the first, the panel concluded that the claim could not be supported in law or practice, and, as to the second, it observed that many jurisdictions had increased the government's share of the take with (except in the egregious case of Venezuela) little impact on their attractiveness to investors.

The law on grandparenting

With the exception of the Syncrude and Suncor projects, all conventional oil and gas projects and all oil sands projects that occur on Crown\public lands in Alberta are being developed on the basis of standard form Crown leases or licences. Each of these leases contains a clause reserving to the Crown a royalty payable at the rate prescribed by the relevant regulations. The leases state explicitly that the royalty payable by the lessee is not the royalty payable at the rate prescribed by the regulations on the date that the lease was issued but instead the royalty rate prescribed from time to time by the regulations.

In other words, with the exception of Syncrude and Suncor, no Crown lessee has any legal basis to argue that it has a right to pay only the royalty that was prescribed on the date that it acquired its lease from the Crown, or the royalty payable on the basis of the regulations as they stood the day before the Panel issued its report. And no Crown lessee has any legal basis for arguing that the Crown will breach its contracts with industry by "changing the terms of the deal" if the Crown follows the panel's recommendation and refuses to grandparent. The deal that the lessees individually signed up for was a deal that allowed the Crown to change the royalty rate from time to time. Now one might admit that if the government proposed to change the royalty rate to levy a royalty that was so high that no producer could profitably engage in oil and gas operations, or if it was proposing to take more than the available economic rent, then it might be possible for a lessee to argue that that was not the sort of change that was in the minds of the parties when they entered into these arrangements. But that is not this case. If the charts and tables prepared by the panel are to be believed, then the proposals on conventional oil will simply result in the "government take" in Alberta being repositioned within the state royalty tables from the bottom to the middle. And the past experience of the industry, as so well demonstrated by Frank Dabbs in his guest column in the Calgary Herald on September 21, suggests that this is exactly what industry might be taken to have understood when it bid on the lands (regular reviews every ten years or so after which the new regime is implemented on an across the board basis). And the proposal with respect to oil sands remains (with the exception of the proposed severance tax) fully sensitive to the costs (including costs of capital) assumed by industry in developing these assets.

Industry players entering into these leases do so with their eyes open. A lessee bidding on Crown lands is not an illiterate consumer entering into an unusual arrangement and lacking access to competent legal advice. And the Crown is entitled to assume that a bidder at Crown land sales reads and understands the lease terms and that a bidder will discount what it is prepared to pay for a Crown lease by a risk factor that takes account of a series of projections including: the risk of drilling a dry well, the risk that oil and gas prices will not turn out to be as high as projected, and the risk that the government may increase its share of the royalty take.

Lessees accept these one-sided arrangements because, in global terms, they look fair and reasonable. Industry accepts that every government has a responsibility to protect the interests of its citizens and understands that a variable royalty clause such as the one Alberta uses is a common way of doing so. It allows governments to share in any unanticipated changes in the market value of the resource. At the same time, industry anticipates that when it enters into an arrangement such as this in a democracy, that there will be practical and political limits on the extent to which a democratic and accountable government, subject to intense lobbying from a resident industry and regular elections, will actually exercise its power to change royalty terms and conditions. In particular, an open, transparent and accountable political system will make it difficult for a government to change terms in an arbitrary fashion. But there is nothing arbitrary about the "no grandparenting" proposal and Premier Stelmach should be applauded for launching the most open and transparent royalty review that Albertans have ever seen.

But what about Suncor and Syncrude? It is possible that these two projects and their proponents may be in a special position and the Panel hints at this in its report. These projects were originally developed on standard form leases with the type of royalty clause described above, but then, at some point, the Government (essentially to save these projects from collapse and along with it the nascent oil sands business) entered into a Crown agreement which provided that the government would waive its right to prescribe a royalty payable from time to time and instead would levy only the royalty payable under the terms of these agreements. In other words, the terms of the contract (the Crown Agreement) fixed the royalty that was payable for the duration of the contract instead of permitting the Crown to unilaterally fix the terms of the royalty from time to time. When the Crown decided to abandon individual project negotiations for the oil sands and to put in place the existing and so-called “generic” royalty regime, the Crown negotiated transitional arrangements (i.e. partial grandparenting) with Suncor and Syncrude setting out the terms under which these two projects would be brought under the generic royalty arrangements. And it is entirely possible that the terns of those transitional arrangements will afford Suncor and Syncrude a right to some, or even complete, grandparenting. The answer to that question will turn on the precise terms of those contracts but it is possible that Suncor and Syncrude will have a distinct contractual entitlement (for which they bargained) that the government cannot unilaterally set aside. In other words, government may have to grandparent these two projects and can only avoid doing so by passing explicit legislation which may well be characterized as punitive and as an expropriation. Thus these two projects may be in a special position; but that is no reason for extending to the rest of the industry the benefits bargained for and conceded to these two early entrants into the technologically challenging oil sands business.

In sum, I for one, fully support the Panel’s proposal that the proposed changes to the royalty regime should apply to incumbents as well as new entrants. The panel’s proposal makes good policy sense and is completely in accordance with the province’s legal and moral rights. In fact, I think that if we exempt incumbents from the proposed changes then we are giving existing lessees (for free) something that they did not bargain for: a stabilization clause in the contract. And if the government does elect to protect incumbents from the proposed changes then I think that this government will simply have demonstrated that it is a government that is accountable not to the ordinary people of Alberta but to the elite of the industry.

And finally, I suspect that Suncor and Syncrude may well be in a different position. They may be contractually entitled to at least a degree of grandparenting by virtue of specific agreements with the Crown.

Nigel Bankes is a Professor in the Faculty of Law and is a Fellow of the Institute for Advanced Policy Research at the University of Calgary.