

MISPLACED GENEROSITY: UPDATE 2012

Extraordinary profits in Alberta's
oil and gas industry



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EXTRAORDINARY PROFITS IN ALBERTA'S OIL AND GAS INDUSTRY

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Recently released data on the tar sands industry reveals that things have returned to normal. Unfortunately for Albertans, “normal” is a royalty regime that ensures the vast majority of wealth goes to the private oil companies rather than the public, the owners of the bitumen. The diverging fortunes of the province and the oilpatch are clearly evident from the contrast between the government’s ongoing revenue crisis, which has resulted in a \$3 billion deficit, and the growing profits being reported by the oil industry. Suncor, Canada’s largest oil and gas company, reported yearly profits of \$4.3 billion,¹ while Imperial Oil, which is 70% owned by U.S.-based ExxonMobil, made profits last fiscal year of \$3.37 billion, the second largest in its record.²

The provincial government claims to have a royalty system that is “maximizing benefits to Albertans,”³ yet the data indicates that the public provides substantial subsidies to the oil companies by refunding investments through the provision of virtually royalty-free bitumen. In an update to Parkland Institute’s 2010 report, *Misplaced Generosity*, the following fact sheet details the extent to which Alberta’s royalty framework is forsaking much-needed public revenues.

ROYALTY FRAMEWORK IN THE TAR SANDS

“...the public provides substantial subsidies to the oil companies by refunding investments through the provision of virtually royalty-free bitumen.”

In calculating profits in the tar sands it is critical to recognize that the current royalty system refunds the industry’s costs through the provision of essentially royalty-free bitumen. Rather than standard business practices where initial investments are repaid, and more, over time through the profits generated by the investment, these costs in the tar sands are absorbed by the public, who are basically waving their right to charge a royalty – the price to access their

1 Lauren Krugel, “Suncor fourth-quarter profits hit \$1.43 billion, operations resume in Libya,” *Canadian Business*, 1 February 2012, accessed at <http://www.canadianbusiness.com/article/68703--suncor-fourth-quarter-profits-hit-1-43-billion-operations-resume-in-libya>

2 Dan Healing, “Cold Lake output drives profits for Imperial Oil,” *Calgary Herald*, 1 February 2012, pp. D4

3 Alberta Ministry of Energy, “Annual Report – 2010-2011,” 2011, p.23.

resources. Although in the short-term there are real costs to the oil companies, these are recouped when the bitumen, obtained virtually royalty-free, is sold. Through these heavily discounted royalties, it is the public financing the construction of the tar sands industry while guaranteeing the industry massive profits. This provision was formalized in the 1997 royalty regime, which was written “in the main” by the oil industry⁴ and was continued with minor tinkering in the provincial government’s 2009 *New Royalty Framework*.

Specifically, the main royalty rate is 25% of a project’s profits (revenue minus costs), which means that the royalty structure inherently accounts for the relatively high cost of tar sands operations. Because the industry’s revenues rise dramatically with high-priced oil, the *New Royalty Framework* tied the rate to the price of oil so that it is 25% at \$55 per barrel, and increases to a maximum of 40% at \$120 per barrel.⁵ However, this royalty only comes into effect once a project is deemed to have reached “payout,” meaning the corporation has recouped its various start-up costs through the sale of Albertans’ bitumen. During that time a small token royalty is charged, measured against a project’s gross revenue. Similar to the main royalty, this “base royalty” fluctuates according to the price of oil starting at 1% up to a cap of 9% at \$120 per barrel. The average price of oil in 2010 was \$77 per barrel,⁶ meaning the royalty rates in the tar sands were 3.7% and 30.1%.⁷

CORPORATE EXCESS IN THE TAR SANDS

According to the Canadian Association of Petroleum Producers (CAPP), the value of bitumen and synthetic crude oil produced in 2010 totalled \$36.6 billion.⁸ In return for this sale of Alberta’s resources, the public received, in the form of royalties and land sales, less than \$4 billion.⁹ The oil companies, on the other hand, received much more.

If capital and operating expenses are assumed to have been reimbursed through the sale of virtually royalty-free bitumen, then in 2010 the oil cor-

4 Alberta Chamber of Resources, “A New Era of Opportunities for Canada’s Oil Sands: National Task Force on Oil Sands Strategies Final Report.” 1996, p.6.

5 The government uses the West Texas Intermediate as its index price.

6 Calculated from CAPP, Statistical Handbook, Table 5.5g, “Reference Crude Oil Prices & Foreign Exchange Rates,” September 2011.

7 Calculated from Government of Alberta, Appendix B: How are royalties calculated?, “Energy Economics: Understanding Royalties,” 2009, p.17.

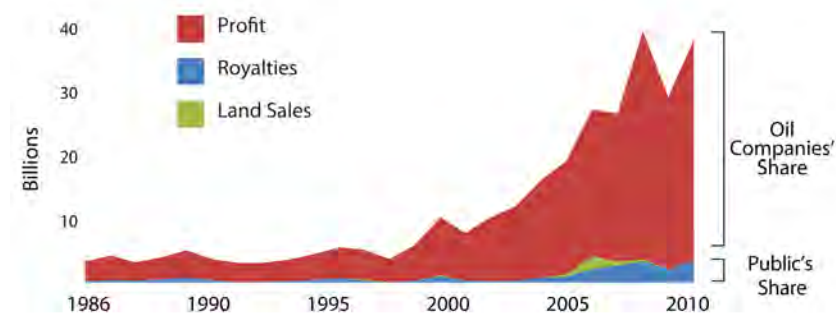
8 CAPP, Statistical Handbook, Table 4.19b, “Value of Producers’ Sales: 1986-2010,” September 2011. Dollar figures are reported in Canadian dollars and are adjusted for inflation, unless noted otherwise.

9 CAPP, Statistical Handbook, Table 4.3b, “Net Cash Expenditures of the Petroleum Industry: 1981-2010,” September 2011; Table 1.1c: “Crown Land Sales Western Canada and Canada Lands: 1990-2010,” March 2011.

porations made approximately \$32 billion in pre-tax profit.¹⁰ However, there are some capital and operating expenses that are not reimbursed, such as the upgraders in integrated projects, as these projects pay royalties on bitumen rather than synthetic crude oil. Without being able to isolate these specific costs, a much more conservative estimate of corporate profits would only account for the industry's operating costs. In 2010, that would mean the industry made \$19 billion in pre-tax profits¹¹. That said, these upgraders represent a small portion of the industry's total costs. The more accurate figure is the former and will be used for the purposes of this report.

The distribution of revenue from the tar sands being heavily skewed in favour of the oil companies is unfortunately a pattern in Alberta. Since 1986, more than \$285 billion worth of bitumen and synthetic crude oil have been produced from the tar sands. From those resources the oil companies have netted approximately \$260 billion dollars in pre-tax profits, while the public has received less than \$25 billion in return (see Figure 1). That means roughly 6% of the total value extracted from the tar sands has gone to the public through royalties and land sales.

FIGURE 1 | Distribution of Tar Sands Revenue (\$2010)



Source: Calculations based on data retrieved from CAPP, Statistical Handbook, November 2011.

“...more than \$285 billion worth of bitumen and synthetic crude oil have been produced from the tar sands...the oil companies have netted approximately \$260 billion dollars in pre-tax profits, while the public has received less than \$25 billion”

10 CAPP, Statistical Handbook, Table 4.19b, “Value of Producers’ Sales: 1986-2010,” September 2011; CAPP, Statistical Handbook, Table 4.16b, “Canada Oil Sands Expenditures: 1997-2010,” September 2011; Table 1.1c: “Crown Land Sales Western Canada and Canada Lands: 1990-2010,” March 2011. For a more detailed description of calculations, see Regan Boychuk, “Misplaced Generosity: Extraordinary Profits in Alberta’s Oil and Gas Industry,” Parkland Institute, 2010, p.42.

11 CAPP, Statistical Handbook, Table 4.19b, “Value of Producers’ Sales: 1986-2010,” September 2011; CAPP, Statistical Handbook, Table 4.16b, “Canada Oil Sands Expenditures: 1997-2010,” September 2011; Table 1.1c: “Crown Land Sales Western Canada and Canada Lands: 1990-2010,” March 2011. For a more detailed description of calculations, see Regan Boychuk, “Misplaced Generosity: Extraordinary Profits in Alberta’s Oil and Gas Industry,” Parkland Institute, 2010, p.41.

In terms of economic rent, rather than revenue, in 2010 the Alberta government collected a mere 11%. Rent is the value of the resources sold remaining after accounting for costs and a reasonable profit, and it is either collected by the resource owners or the corporations in a type of zero-sum situation. As is explained further below, owners are entitled to 100% of the rent and collecting anything less is equivalent to providing the industry with a subsidy. The provincial government’s low royalties in the tar sands meant that in 2010, 89% of the rent, worth approximately \$30 billion, went to the oil corporations through what is referred to as “excess profit.”¹² As noted above, the public’s share, taken to be royalties and land sales, totalled \$4 billion, meaning the corporate share of rent exceed the public’s share by a factor of four.

Again, this pattern is not new. . Since 1997, the public’s share of rent in the tar sands has consistently been dwarfed by that of the oil companies, regularly by a factor of ten or more (see Table 1). Yet for such a small share of the pie it was the public who, over decades, paid for the bulk of the research necessary to make the tar sands industry possible, including developing the technologies at the centre of mining and in-situ extraction.¹³ The table below reports

TABLE 1 | Public vs Corporate Share of Rent in the Tar Sands (\$2010)

Year	Public's Share	<	Corporate Share
1997	\$575,029,554	7x	\$4,096,725,139
1998	\$103,700,805	32x	\$3,365,648,526
1999	\$413,061,379	12x	\$5,123,076,410
2000	\$1,157,865,210	7x	\$7,802,238,106
2001	\$407,148,370	16x	\$6,616,141,098
2002	\$238,194,874	39x	\$9,346,896,818
2003	\$326,324,001	34x	\$11,164,934,362
2004	\$937,835,274	15x	\$14,340,669,298
2005	\$1,345,198,060	12x	\$15,917,734,582
2006	\$4,352,479,186	4x	\$17,692,848,099
2007	\$3,453,994,729	5x	\$18,546,845,053
2008	\$3,867,752,225	8x	\$31,295,754,032
2009	\$2,250,502,821	11x	\$24,120,440,950
2010	\$3,773,800,000	8x	\$29,869,200,000
TOTAL	\$23,202,885,486	9x	\$199,299,152,471.94

Source: Calculations based on data retrieved from CAPP, Statistical Handbook, November 2011.

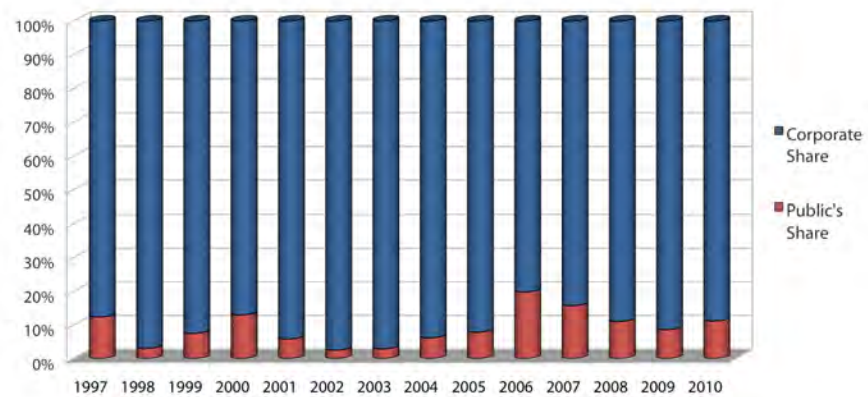
12 Calculated with data retrieved from CAPP, Statistical Handbook, September 2011. For a detailed description of calculations, see Regan Boychuk, “Misplaced Generosity: Extraordinary Profits in Alberta’s Oil and Gas Industry,” Parkland Institute, 2010, p.42.

13 The Alberta Research Council developed the hot water separation process still used by the industry today to isolate the bitumen, and tested the technology in a pilot plant. The Alberta Oilsands Technology and Research Authority spent over \$800 million dollars between 1974 and 1999 working to develop, in part, the steam-assisted gravity drainage (SAGD) technology that made the vast majority of the tar sands extractable. For more see Larry Pratt, “The Tar Sands: Syncrude and the politics of oil,” 1976.

the distribution of rent in the tar sands from 1997 to 2010, including the size by which the excess profits of the oil industry, labelled “corporate share,” have exceeded that of the public each year (see Table 1). As can be seen, the share of rent given to the industry exceeded that secured by the public every year by at least a factor of four, reaching as high as 39 in 2002, and has on average been a factor of nine.

Alternatively, the distribution of rent can be reported in percentages. Albertans have never received more than 20% of the rent in the tar sands, and since 1997 have averaged only 9% (see Figure 2).

FIGURE 2 | Distribution of Rent in the Tar Sands



Source: Calculated from data obtained from CAPP, Statistical Handbook, November 2011

FOREGONE REVENUE FROM GOVERNMENT MISSING OWN TARGETS

“Albertans have never received more than 20% of the rent in the tar sands, and since 1997 have averaged only 9%”

The provincial government’s poor track record in securing a fair share of the petroleum wealth for its citizens is unfortunately not limited to the tar sands. In the petroleum sector as a whole (oil, natural gas, and bitumen), the public’s share of revenue has been more or less declining since it peaked in 1979 (see Figure 3). During his decade-plus tenure as premier, Peter Lougheed attempted to ensure Albertans received maximum benefits from the oil and gas sector by setting a target for his government to capture 35% of the revenues from the industry. As shown in Figure 2, his government managed to meet or exceed that target for the 5 years between 1977 and 1981. Since that time, however, the public’s share of wealth produced from the province’s petroleum resources has fallen dramatically. Somewhat surprisingly, the public’s share reached an all-time low in 2009, the year the new royalty rates were introduced by Premier Stelmach, which reveals the extent to which the royalty review process was turned into a new round of subsidies for the oil companies. Also in 2009,

the provincial Conservative government did away with setting a target for revenue sharing altogether, perhaps due to their routine failure in meeting the target even after Premier Klein lowered it significantly. The government's objectives in determining royalty rates are now limited to ensuring "competitiveness" in relation to a group of particular jurisdictions, essentially guaranteeing bottom-of-the-barrel royalties. This represents a significant departure in that the government has abandoned even the pretence of prioritizing the public interest through rent maximization or even rent targets and is instead intervening heavily on behalf of corporate and investor interests for profit maximization.

FIGURE 3 | Public's Share of Oil, Gas & Bitumen Wealth



Source: Calculated from data obtained from CAPP, Statistical Handbook, November 2011.

Since the heyday of Lougheed, the consistent failure of the Tory government to meet their revenue targets for the petroleum industry throughout their political reign has cost Albertans dearly. If the three sectors (oil, natural gas, bitumen) are taken together, then by not meeting Lougheed's 35% target between 1971 and 2010, including those years Lougheed failed to do so, Albertans forfeited approximately \$195 billion in revenue. That figure would grow substantially, of course, if we include the interest that would have compounded over the decades.

“...by not meeting Lougheed’s 35% target between 1971 and 2010... Albertans forfeited approximately \$195 billion in revenue”

Alternatively, it is possible to account for the capital-intensive nature of the tar sands by assigning that industry a lower revenue target, for instance 25%. If we start applying the target in 2000, around which time the price of oil began its upward march, then we find that the provincial government forfeited more than \$33 billion in potential revenue, and again, not including compound interest. While implementing a revenue target of 25% in the tar sands may have delayed some investment and thereby reduced production levels, the slower pace of development would, on the flip-side, have avoided or blunted the rapid inflation that afflicted the industry at the height of the

boom and which eroded both profits and royalties¹⁴.

Similarly, if the oil and gas industry is analyzed separately and the Tory government's history of revenue collection is measured against Lougheed's 35% target, we find that since 1971 Albertans have lost out on nearly \$126 billion, not including interest.

Unfortunately, the PCs appear determined to maintain this trajectory of revenue sharing. In the pre-election budget, the provincial government announced its intentions to have royalties capture only 9-12% of all oil and gas revenues over the next three fiscal years¹⁵. By not restoring Lougheed's 35% target in the conventional sector and a 25% target in the tar sands, the government's plan means Albertans will forgo additional revenue of \$17 billion in 2012-13, and \$19 billion in both 2013-14 and 2014-15. Essentially, this means reforming Alberta's royalties is a \$55 billion question.

RENT

Economic rent is an important concept in discussions of oil and gas profits and royalties. Also referred to as "resource rent," economic rent is the value generated from resource production after the deduction of costs and a normal rate of profit. Typically, a normal rate of profit in the oil and gas industry is assumed to be 10% of the investment. Profits earned above 10% are termed "excess," as they represent the portion of economic rent accruing to the industry rather than the owners. As the chair of the Royalty Review Panel, Bill Hunter, noted "[a]s Albertans we own 100 per cent of the resource, and we should expect nothing less than 100 per cent of the rent."¹⁶ Indeed, capturing less than the entirety of the economic rent is equivalent to the provision of a corporate subsidy.¹⁷

The rate of profit, and thereby the division of the economic rent, necessary to attract capital is also determined by other factors, such as the perceived level of political risk, the quality of the work force, other forms of government support, and proximity to consumers. Alberta ranks favourably in all of these categories, justifying a high level of return to the owners – the public.

14 This is because royalties in the tar sands are calculated on a revenues-minus-cost basis. As the Royalty Review Panel noted, "[c]ost increases represent a significant loss to Albertans as resource owners" ("Our Fair Share," 2007, p.78).

15 Calculated from Government of Alberta, "Fiscal Plan 2012-15: Revenue," 2012, p.53 & 55.

16 CBC News, "Premier won't be bullied into royalty decision," September 20, 2007. <http://www.cbc.ca/canada/edmonton/story/2007/09/20/stelmachroyalty.html>

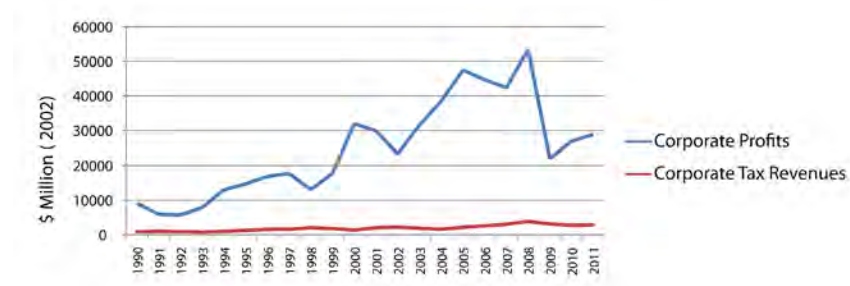
17 Dave Sawyer and Seton Stiebert, "Fossil Fuels – At What Cost?," 2010, retrieved from http://www.globalsubsidies.org/files/assets/ffs_awc_3canprovinces.pdf

TAXES ARE NOT ROYALTIES

The calculations made above regarding the share of revenues and rent returned to the government do not include taxes. We do this for the simple reason that corporate taxes are not designed to capture the rent generated by oil and gas production; corporate taxes are collected to pay for government services necessary to maintain the corporate sector, such as infrastructure and education. On the other hand, royalties are a raw material cost, in this case the oil and gas owned by Albertans, just as bakers must pay for their flour. Royalties are not a tax, therefore, but rather the cost to industry for accessing and profiting on the resources they do not own. That said, it is possible for a special tax to be imposed on the oil and gas industry as a form of rent collection that works in tandem with royalties, as is done in Norway. Since the oil and gas industry faces no such special tax in Alberta, taxes are not included as a form of rent collection in this report.

Nonetheless, it is worth making a separate, brief note on corporate taxes. The past decade has seen corporate income tax rates in Alberta reduced dramatically, both federally and provincially. In 1997, these rates were 29.12% and 15.5% respectively, and by 2011 had dropped to 18.5% and 10% with further reductions planned for 2012. These cuts to the tax rate were mirrored by an enormous rise in corporate profits. As a share of the provincial economy, from 1989 to 2008 corporate profits more than doubled their take from 9.6% to 22.6%, and before the Great Recession had grown in real dollars more than fivefold. The lower tax rates, however, meant that government revenue from the corporate sector stagnated, as shown in Figure 4.

FIGURE 4 | Alberta's Corporate Profits and Corporate Tax (\$2002)



Source: Parkland Institute, "The Lion's Share: Corporate profits and taxes in Alberta", 2011.

With regards to the tar sands, a study by renowned University of Alberta energy economist Andre Plourde concluded that the corporate tax cuts beginning in 1997 “alter[ed] the distribution of ex ante rents from oil sands development and production in ways clearly favourable to producers” and that the royalty changes in 2009 “can be seen as using different means effectively to bring back the rent-sharing properties of the 1997 generic regime, at least when oil prices are sufficiently high.”¹⁸ Unfortunately for Albertans, the 1997 royalty structure sought to induce development through basement-bottom royalties.

CONCLUSION

The tar sands are set to become the main revenue generator in Alberta’s petroleum sector. By next year, the provincial government expects the industry to account for more than 60% of income from non-renewable resources.¹⁹ If the long-standing trend of low royalty rates in the tar sands industry and the oil and gas sector as a whole continues, Albertans can expect to forgo significant and increasing amounts of potential revenue. It will therefore be crucial to the future economic health of the province to ensure we have a royalty regime that returns a fair share of the revenue to the citizens of Alberta, the owners of the resource. Eventually, Albertans need to decide whether subsidizing private oil companies to extract their resources through heavily discounted royalty rates is the best use of public wealth.

18 André Plourde, “Oil sands royalties and taxes in Alberta: An assessment of key developments since the mid-1990s,” *Energy Journal*, 2009, 30(1), p.127, 130.

19 Government of Alberta, “Fiscal Plan 2011-2014: Revenue Outlook,” 2011, p.51.<http://www.finance.alberta.ca/publications/budget/budget2011/fiscal-plan-revenue.pdf>



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