



Selling the Family Silver

Oil and Gas Royalties, Corporate Profits,
and the Disregarded Public

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ISBN 1-894949-12-9 November 2006



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Executive Summary

The world of oil and gas is split between industrialized consumer countries and their oil corporations, and less developed producer countries, many of which are former colonies. Canada is somewhat unique, as a relatively wealthy country in a close relationship of dependency with the United States, which consumes the majority of our production, and whose oil companies dominate our industry.

This paper explores the development of the sector, globally and in Canada, and the resulting modern geopolitics of oil. It discusses the environmental costs, and the fiscal and royalty structures that capture (and fail to capture) economic rents for the public that owns the resource. It examines the issues in more depth with a case study of Saskatchewan. With this context and background, it sets out the need for a new policy direction – one that puts the interests of our populations ahead of service to corporate profits and the military and consumer demands of the United States.

The geopolitics of oil

Four periods characterize the geopolitical development of the industry. In the first period, up to the mid 1970s, private sector “Independent Oil Companies” (IOCs) with vertical integration dominated the industry, working closely with their western imperial governments to secure their access to oil reserves. In the second period, former colonies pursuing national development programs strengthened OPEC and created publicly-owned “National Oil Companies” (NOCs). In the third period, from about 1980 to 2000, IOCs and their governments used debt crises to force privatization of NOCs, while reducing royalties in home countries.

The current period is one of growth in the importance of NOCs. While IOCs dominate the sales of petroleum products, NOCs dominate production. China and India have become major importers, and the global influence of their NOCs is rising quickly. Russia’s NOCs and IOCs are also becoming more important. Venezuela’s NOC has been re-energized, and has helped develop regional ties in the sector. NOCs have begun operating in other countries, and there is a growing reluctance among producing nations to sign agreements with IOCs. NOCs now control 77 percent of the 1.1 trillion barrels of global proven oil reserves.

The conflict today between IOCs and NOCs reflects the conflict between consuming states

(mainly imperial powers) and producing states (mainly less developed countries). The OICs are vertically integrated, and have thus been able to effect transfer pricing. As they move oil from production through to processing and sales, they set the prices for transfers internally, at non-market rates. Thus they are able to move profits to low-tax jurisdictions, and costs to relatively high-tax jurisdictions. They also exercise market power, and through barriers to market entry, their oligopoly has kept prices high. The IOCs have undergone major consolidation in recent years, 1997s top 20 IOCs becoming just seven by end of 2003.

Economic rent and fiscal regimes

Economic rent is the financial surplus created by the exploitation of natural resources, over and above the costs of exploitation (which include “normal” profits). In the oil and gas industry today, there is a very large rent, and IOCs and their investors expect to accumulate most of it.

The democratic theory of rent suggests that governments should maximize their collection of rent to the benefit of their publics, who own the resources. The liberal theory of rent suggests that public resources should be privatized and employed to make profits, and that rents should remain in private hands either entirely, or enough to ensure investment in the industry.

Economic rent is most easily captured for the public interest when resources are developed through state-owned enterprises. The success of such enterprises depends on the degree of democracy achieved by that jurisdiction, but those in advanced democracies are well-run and provide greater returns to the public than private corporations. Joint ventures between NOCs and IOCs also enable governments to extract reasonable rents for the public. During the last few years of large oil price increases, income to OPEC countries increased 46.4 percent, while almost all windfall profits in Canada and the US went to private corporations.

In the oil and gas industry, rents are extracted by a number of different methods, including fees for prospecting, bonus bids for exploration, discovery and production, and royalties or production fees (based on volume of production or value). Today there are limited areas where large pools of oil and gas can be found, and competition for access is keen. Thus governments are increasingly seeking a percentage of the oil and gas produced, via *production sharing agreements*. In some countries, governments take equity positions; such *joint ventures* mean that government provides capital, and shares in the risks and the profits.

The private industry dislikes production royalties and bonuses, and prefers a system based solely on taxing profits, thus enabling it to employ transfer pricing. In order to curtail tax avoidance, some countries have had to introduce a minimum tax, a *progressive profits tax* (PPT, akin to progressive individual income tax), a *resource rent tax* (RRT, a tax on cash flow), or an excess profits tax. Nonetheless, through generous depreciation allowances, tax holidays, investment tax credits, resource allowances and other tax incentives, energy corporation taxable incomes are often a very small percentage of gross revenues.

Offshore tax havens enable even greater tax avoidance. An illustration of the problem comes from energy giant Enron, which had hundreds of subsidiaries registered offshore in havens with zero corporate taxes. A web of respectable auditing firms, law firms and banks helped it avoid taxes with paper transactions such as:

- selling oil to a subsidiary in a tax haven for a very high price and re-exporting it at the market price

- shifting capital to an offshore subsidiary and they borrowing it back at a high interest rate
- transferring the ownership of patents and services to the offshore company and then paying large royalties for their use
- buying inputs from offshore companies at highly inflated prices

Such tax avoidance practices are common in business circles, and by 2003, 58 percent of US corporate profits were taken in offshore tax havens. In Russia, similar schemes and firms were used to avoid oil company taxes of around \$9 billion per year.

Canadian oil industry

Global developments have had their impact on the Canadian industry, which has always been dominated by foreign-owned corporate giants. A few large Canadian firms have emerged, such as En-Cana, Petro-Canada and Suncor, but industry analysts note that the majority of their stock is now owned by citizens of the United States.

Prior to the discovery of Alberta's Leduc Field in 1947, almost all the oil consumed in Canada was imported. The large refineries were all owned and controlled by foreign-owned majors, and they had a lobby group, the Canadian Petroleum Association (CPA). As Alberta's industry developed, Canada emerged with two markets: Western Canada and parts of the US and the Eastern Canadian market.

The Canadian corporations formed their own lobby group, the Independent Canadian Petroleum Association (ICPA), and lobbied Ottawa to require eastern markets to accept more expensive Alberta oil. The Conservative government agreed, though caving in somewhat to lobbying by the CPA and the majors. The result was the National Oil Policy of 1961, which decreed markets east of the Ottawa River would continue to be served by the majors. Alberta's more expensive oil would be sold at all points west of the Ottawa River. Essentially, Ontario residents would support the growth of Alberta oil corporations.

In 1975, the Federal government created Petro-Canada, and in 1980 established the National Energy Program. The aim was to increase public and broader Canadian ownership of the industry. The oil corporations, the business press, the Reagan administration, and Alberta's Conservative government were all strongly opposed. Eventually these reforms were all

undone, with the privatization of Petro-Canada and the development of continental trade deals.

The Canada-U.S. Free Trade Agreement in 1987 surprised many, including provincial premiers, by its inclusion of a continental free trade agreement in energy. The Agreement ceded Canada's sovereignty dramatically. The federal government was prohibited from reducing Canada's exports, even in times of energy shortages (the "proportional sharing clause"), prohibited from controlling transfer pricing, and prohibited from setting export prices and taxes, among other things. These prohibitions were strengthened in the subsequent North American Free Trade Agreement (NAFTA).

World oil prices have risen dramatically in the last few years, more than doubling to over \$70 per barrel at times. These price increases are entirely unrelated to production costs; in 2003 Canadian production costs, including royalties, averaged \$5.57 per barrel. Even with higher costs and relatively lower oil prices in the tar sands, prices are still well in excess of costs.

Because of the cuts to royalties and taxes as well as the move away from national or public ownership in Canada, the private oil industry has enjoyed windfall profits, as have the gas companies. According to the US Energy Information Administration, Canadian royalties, are among the lowest in the world at an average \$0.23 per barrel. The result of high prices and low royalties and taxes has been a very high return on equity, rising to 22.4 percent in 2005 and making the oil and gas industry the most profitable sector in Canada.

The oil industry in Saskatchewan

Most oil extracted in Canada comes from the Western Canadian Sedimentary Basin (WCSB). This basin is considered "mature," as the extraction of conventional light and medium oil has been declining for a number of years. The extraction of light crude in Saskatchewan peaked in 1997, while medium extraction peaked in 1998. Heavy oil is now the majority of oil extracted in Saskatchewan. At the same time, recent drilling in Saskatchewan has focused more on extracting from existing pools rather than finding new sources.

The majority of Saskatchewan's oil production – 73 percent - is exported to the US. And although the industry contributes 6 percent of

the province's GDP, that proportion is falling, and it only contributes 0.5 percent of provincial employment. While the value of Saskatchewan oil sales has gone from \$3.6 billion to over \$30 billion, royalties have slipped from over 56 percent to less than 16 percent. Prior to 1985, Saskatchewan was in a period of increasing royalties. During this time, Saskatchewan's royalties were higher than Alberta's and yet there was no capital flight from Saskatchewan. However, since 1986 royalties in Saskatchewan have dropped along with Alberta's. And a plethora of newly-created categories of oil has enabled further reductions in the overall level of royalties collected. These changes have resulted from regular negotiations between government and industry, and this process has always excluded the public and any public input.

The natural gas industry

Conventional natural gas production peaked in the United States around 1973, and despite development of Coal Bed Methane (CBM), the volume of reserves has steadily declined. US reserves in 2003 were 40 percent lower than in 1990, and CBM reserves amount to 18tcf, less than one year of annual consumption. To fill the growing gap, imports from Canada were increased, but despite increased drilling in both the US and Canada, North American gas production has been flat since 1997. Canada's production peaked in 2001, and average production rates for new wells have dropped by two-thirds since the early 1990s.

The US Energy Information Agency characterizes the American situation as a "natural gas crisis". And despite the massive price increases in the past few years, the Canadian Energy Research Institute predicts that Canadian natural gas prices will triple in the next 13 years. In the Western Canada Sedimentary Basin (WCSB), reserves of natural gas peaked in 1984 and have been declining since. And Natural Resources Canada projected that Saskatchewan will peak in 2005 and drop by 70 percent in the following 15 years – an alarming prospect given the province's dependence on gas for home heating. Although environmentally damaging CBM will help prolong production in Canada, it will not make up for the decline in conventional sources.

As imports from Canada fall off after 2010, US imports of liquefied natural gas (LNG) are expected to rise. LNG “trains” rely upon liquefying natural gas, transporting it, and regasifying it, and the costs are significantly higher than for regular natural gas. Developing the infrastructure – the liquefying and regasifying plants, transport ships and pipelines, is expensive and risky.

Meanwhile, the industry is doing quite well with higher prices despite short term fluctuations. The US Department of Energy date confirms that the bulk of the economic rent from natural gas extraction is going to the owners of oil and gas corporations. In the WCSB, conventional natural gas production is allowing the industry to capture 27 percent to 53 percent of the market price as rents. Royalties in Saskatchewan are quite low on a global scale, averaging less than 14 percent of sales in recent years, while many countries get 50 percent or more.

Conclusions

In the last 20 years, Canadian governments have gone along with the policy demands of the major and super-major IOCs. They have reduced royalties, increased exports, avoided addressing global warming and other environmental costs of fossil fuel consumption, and ceded control over the resource.

A better government policy would put the public interest ahead of corporate profits. It would place a high priority on securing energy supply for future generations. It would maximize returns to the general public on the sale of the resources. It would address greenhouse gas emissions and the social, economic and environmental costs of

global warming. It would develop alternative energy sources. It would recognize that fuelling America’s addiction to fossil fuels is wrong, and that exports to the US cannot continue to rise.

The Saskatchewan example illustrates that there are many policies a government willing to protect the public interest could implement. These policies are not radical, and in some cases have been employed with success in the past. The following are a few suggestions.

- Create a provincial energy conservation board to cover these industries. All sales would be made to this agency, allowing public control over sales, prices, profits, resource rents and a level of proven reserves to be held for future generations.
- Raise royalties up to the level that they were during the Saskatchewan government of Allan Blakeney, which was around 50 percent of sales - a common rate around the world today.
- Implement an excess profits tax, as several countries have done recently.
- Merge SaskEnergy with SaskPower and give it control over natural gas development and distribution within the province. The priority would be to conserve natural gas for present and future generations.
- Re-establish the Heritage Funds, allocating at least 50 percent of the royalties from the depletion of oil and gas to them, and invest in renewable energy development.
- Re-create SaskOil as a Crown corporation with the goal of gaining ownership and control over the remaining provincial oil reserves. Require all future developments to include the right of SaskOil to 50 percent ownership.

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