



Taming the Tempest: An Alternate Development Strategy for Alberta

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Executive Summary

With over \$169 billion in large scale construction projects on the horizon, Alberta's already overheated economy is only going to get worse. Alberta's inflation rate has reached national highs. Housing prices have increased at rates as high as 50% per year in Edmonton and Calgary. Public infrastructure is being built at enormous premiums. Meanwhile, homeless rates are rising across the province, climate change emissions are increasing dramatically, conventional fuels like natural gas are being depleted, and the government is even considering using nuclear power to fuel tar sands development.

There is no question the bulk of this boom is being driven by fossil fuels and specifically investment in the province's tar sands-over \$100 billion of the \$169 billion in projects slated for development is for the tar sands alone. The desirability of this level of private investment is not being questioned by the Alberta government; it is being seen as an end in itself. However, investment is not a goal; it should be considered a tool to be harnessed towards achieving social goals.

Unlike Alberta, many oil rich regions have a framework to guide their resource development and this report shows that the Alberta government is under-selling the people's resources. Alberta is in a very strong strategic position in terms of global oil dynamics for the following reasons.

1. According to Robin West, chairman of PFC Energy, "national oil companies now control over 80% of the resources...most of the resources are off-limits to investment."

2. Conventional reserves are declining around the world and the industry is being forced to look more and more towards high risk, high cost oil sources such as off shore. Risks are relatively low for exploration and development in the tar sands; we know where the reserves are and how to get them.

3. Combined royalties and taxes are currently disproportionately low in Alberta relative to other oil producing regions. There is room for those to increase without deterring investment.

4. With the real estate market crash in the U.S., there are investment dollars looking for a secure place to earn high returns.

In this context, an alternate development strategy for Alberta is not only feasible, but necessary; Alberta cannot afford to be giving away its non-renewable resources. This reports lays out the framework for a development strategy that would slow the pace of investment to minimize the boom and bust cycle, and put into place policies to maximize returns from Alberta's fossil fuels, maximize the processing and upgrading of those resources into higher value products, and put into place a long term

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plan for using the resource revenues to guarantee a future for the province. Though this report is limited in scope, it is meant to stimulate public debate on the variety of options open to the government and show that there are alternatives to the crash course the province is on.

Pacing - Lack of Planning and a Framework for Investment

Alberta's economy is overheated, inflation is the highest in the nation and workers are being brought in temporarily from abroad. Much of the current boom is being driven by an increase in construction, leaving the province dangerously reliant on construction as a driver. The high concentration of investment will guarantee that the construction boom ends quickly, which will leave more than half of the workers currently in the tar sands out of work.

Public sector spending is also fuelling the boom. The provincial government opted during the 1990s to exercise pro-cyclical spending - cutting infrastructure and social program spending in the downturn. The province thus entered the boom with a social and physical infrastructure deficit. The government has finally embarked upon reinvestment in the provincial infrastructure. However, not only does this spending fuel inflation in labour, materials and construction costs across the economy, but it also means that the public is paying a high premium for building at this time

Failing to Maximize Fossil Fuel Revenues for Albertans

Oil prices have almost tripled since the mid 1990s but royalties have not kept pace. Low royalty rates are not due to prices or profits being low. Returns on equity for Canadian upstream oil and gas have risen from the high level of 15.4 percent in 2001 to 22.4 percent in 2005. As the industry makes record profits, the Alberta government received only a 19 per cent share of oil and gas revenues in 2004. And, though already low, the revenues from oil and gas are set to fall. With the shift away from

conventional oil and gas, as well as the lower royalties on the tarsands, the provincial government is forecasting that royalty revenues will decline from \$11.7 billion in 2006-07 to \$7.8 billion by 2009-10.

A number of studies by the Parkland Institute and others have shown that Alberta collects much less than other jurisdictions such as Norway and Alaska. Generous estimates are that Alberta collects 58% of available rent from the tar sands while Alaska and Norway collect 88% and 99% of rent respectively. Policies elsewhere include: in Bolivia 82% of all revenues from natural gas go to the government; in Kazakhstan 80% of oil extracted goes to the government in a production sharing agreement; in Abu Dhabi and the United Arab Emirates, the profit margin for companies is limited to \$1 per barrel; in Russia the government takes 90% of the value of sales above \$25/barrel. In many other countries the rent recovery is 100% because the government does the extraction itself through a national oil company (OPEC countries, Mexico and China).

Failing to Maximize Value Added Jobs

Canada has suffered from its colonial past with the continued mentality of a resource hinterland. Over the last decade and a half, the province has shifted to a heavy reliance on raw resources and raw exports of fossil fuels, agricultural and forest products. Whether in bitumen, petrochemicals, agriculture or forestry, employment levels are relatively low for primary and first stage derivatives. However, they increase enormously the more the product is upgraded. The same applies to bitumen. For example, studies have found that a higher degree of upgrading will increase marketability of bitumen feed stocks. The job and economic returns increase dramatically the more the bitumen is upgraded and refined. It is in Canada's interest to ensure that those jobs and economic returns accrue to Canadians.

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However, five new pipelines are being proposed to export raw bitumen to the United States to be turned into high value products. One estimate of the Keystone pipeline alone includes the loss of 18,000 direct and indirect jobs. Those jobs will be created in the U.S. instead of Canada.

Lack of Planning for the Future

The provincial government under former Premier Ralph Klein admitted having no plan. The area where this gap was most profound was in resource revenues. This lack of planning has driven the recent government spending spree and enabled the government to cut taxes. This has created an increased dependence on fossil fuel revenues for the province's budget and has increased the province's fiscal vulnerability. It has also exacerbated inflationary pro-cyclical spending by government, exacerbating the boom.

Alberta had a savings mentality in the past. When the Heritage Fund was first established under Premier Lougheed in 1976, 30% of annual resource revenue was to be set aside annually for the fund. However, this was reduced to the point that the fund actually eroded in value. Only in 2006 was the Fund actually protected from erosion by inflation. The current value of the Heritage Fund is approximately \$12 billion US compared to \$38 billion US for Alaska's Permanent Fund, while in Norway the fund has reached almost \$300 billion US.

Options and Recommendations

This strategy identifies key goals which private investment in Alberta should serve:

- to reduce vulnerability to booms and busts;
- to ensure environmental sustainability; and
- to ensure social sustainability.

Using these goals as a framework, options are laid out for pacing development, maximizing royalties, maximizing value added jobs, and using fossil fuel revenues wisely to plan for the future. From amongst the options described in the report, the following recommendations are drawn.

Pacing Development in the Interests of Albertans

Pacing private sector development will ease the boom now and reduce the boom-bust cycle. It can be done through a combination of opening up a limited number of construction permits for competitive bidding and getting the price right through internalizing environmental costs for industry. The bids will be chosen on the basis of the highest royalties, best environmental treatment and value added. This combination will enable Alberta to meet vital social goals.

This strategy includes counter-cyclical spending recommendations. However, it does not recommend curtailing current public infrastructure spending as there is an infrastructure deficit that needs to be addressed.

It is recommended instead that private sector investment be paced to open up some space for that public sector investment to happen without fuelling the boom or forcing taxpayers to pay a premium due to cost escalation.

Maximizing the Return from Fossil Fuels

Royalties should be maximized through a competitive bidding process. A minimum floor should be set that eliminates the generic royalty regime in the tar sands and includes a windfall profits tax of 90% for profits above a 10% rate of return.

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Because the royalties are based on net profits, voluntary regulation of royalties will need to be replaced by a strong regulatory and enforcement branch with skilled auditors.

Maximizing Value Added Jobs

The government should put policies into place to maximize value added jobs generated by fossil fuels. The environmental standards should be drastically improved for those industries and adequate regulatory and enforcement bodies put into place by government to ensure that the standards are being met.

Measures to maximize value added should include a moratorium on all additional pipeline export capacity for bitumen, prioritizing natural gas for value added processing reinstating the vital supply safe-guard to limit the export of

There is a wide variety of policy options available to the Alberta government to put the province on a different path. If investment is treated as a means, not an end, fossil fuels can be used to build a future for the province. It is hoped that the strategy outlined in this report will be a starting point for that discussion. This strategy is the first step; future research will be needed to develop the framework for a longer term plan that includes diversification of the economy and a future beyond fossil fuels.

declining resources and restructure royalties to favour value added.

Planning for the Future

The government should ensure that 90% of resource revenues are kept out of general revenues, and are treated separately. The revenue should be targeted as follows: 50% should be put into a newly created renewable energies fund; 40% should be invested through the Alberta Heritage Fund in securing the future for education, health care social services, culture and the arts.

If taking such a large portion of resource revenues out of the budget creates a deficit, the provincial government should restore the progressive tax system for income - both individual and corporate.

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