Just Let DoE Energy Officials Do Their Jobs

David Ragan
Christopher Ragan

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The Alberta Government is currently reviewing its royalty system for oil companies producing in the Oil Sands. Not surprisingly, this review has sparked an active debate. On one side of the debate, we have those people who argue that the citizens of Alberta – the true owners of the resource – are not getting their fair share. On the other side, the large oil-sands companies argue that any increase in royalty rates would adversely affect the level of development activity and harm the provincial economy.

This is a difficult debate, for two main reasons. First, there will never be widespread agreement on what level of royalties would represent a fair split between the people and the oil companies. But even if we could agree on what is fair, there is a second problem. How many of us are really equipped to assess the arguments made by the oil companies? Their business is complex, as is the system of royalties, and so if they say there will be a large price to pay for raising royalty rates, maybe we should believe them.

Or maybe not. The way that the royalty system works, the provincial government collects a percentage of net revenues from the oil companies. It is obviously true that any extra dollar of royalties paid by an oil company reduces that company's profit by the same one dollar. But because of the way royalties are computed, even relatively large increases in the royalty rate are likely to have only a modest effect on the oil companies' cash flow, and cash flow is the key economic variable used by oil companies when deciding whether to expand their operations, or to scale them down.

Perhaps the best way to clearly make this point is with some examples. The first example is with a small oil and gas company that one of us has owned and operated since 1992. Last year, when the Alberta Government eliminated the Alberta Royalty Tax Credit (ARTC), this company's royalty rate increased by 33 percent. That appears to be a large increase in the royalty rate, and it is, but because royalties are a relatively small fraction of revenues, even large changes in the royalty rate have much more modest effects on total cash flow. In the case of this small company, cash flow fell by only 3 percent.

This particular company is so small that hardly anybody cares what happens to it. But the same principle applies to the big oil companies. For example, consider Suncor's publicly available financial data from its oil-sands operations. In 2006, Suncor's revenues were $6.3 billion, and it paid royalties of $0.9 billion. With other (non-royalty) costs of $3.0 billion, this led to a cashflow of $2.4 billion. Now imagine that Suncor's royalty rate had been 33 percent higher. Its cashflows would have fallen to $2.1 billion, a reduction of only 15 percent.

Fifteen percent may seem like a lot, especially when it represents $300 million. But one way to see how small this is in today's world of the big oil companies is to think about it in terms of changes in the price of crude oil. That hypothetical $300 million represents less than 5 percent of Suncor's total 2006 revenues. In other words, if the average world price of crude oil last year had been $US 65 rather than $US 68, Suncor's cashflows would have fallen by the same $300 million. So the bottom line is this: a 33 percent increase in the royalty rate is roughly equivalent to a 5 percent reduction in today's world price of oil. Does any oil company claim that a 5 percent reduction in oil prices will lead to a collapse in economic activity? Not likely.

One other point is worth making. The large oil-sands companies argue that if the Alberta government is going to raise the royalty rate, the increase should only apply to new projects, that the lower royalty rate now applied to existing projects should be "grandfathered". They argue that their investments were made under the belief that the lower royalty rates would continue, and that it would therefore be unfair to change the rules mid-stream.

This is a nice-sounding argument, but it is entirely misleading. Contracts signed by the oil companies and the Alberta Government specifically state that the royalty rates are subject to change, whenever the government's policy changes. The oil companies are fully aware that changes of this kind are possible, and the proof of this claim is that in the past they have used the excuse of a difficult economic environment to successfully lobby the government for changes. For example, when oil and natural gas prices were much lower than they now are, the oil companies were quite content to approach the Department of Energy (DOE) to request that the terms of the contract be improved, thus increasing their profitability. The DOE, acting as the benevolent landowner, listened to the concerns and responded with adjustments designed to encourage continued development of the resources while still guaranteeing that the people of Alberta get their fair share. If the oil companies have successfully pushed the government to be more generous during the difficult years, then surely now is the time for the oil companies to respond in kind by accepting the case for modest increases in royalty rates.

The royalty review process that the government of Alberta is now conducting is important, both to the oil industry and to the people of Alberta. The issues are complex, and unfortunately it is all-too easy for the oil companies to make claims of disastrous consequences that are extremely difficult for most people to adequately assess. We need an impartial and competent group to assess their arguments and to balance the competing demands on Alberta's valuable petroleum resources. We are in good hands with the DOE at the helm. Let's just hope that the political bosses will let them do their job.

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David Ragan is a professional engineer with 29 years experience in Alberta's oil fields, and has owned and operated a small oil company for the past 15 years. Christopher Ragan is an associate professor of economics at McGill University in Montreal.