Alberta's $2.9-billion Drilling Stimulus: Where did the money go?

In 2009, the Progressive Conservative government launched the Drilling Stimulus Initiative promising new jobs and increased royalty revenues. Just three months later, the government told us that the initiative would be extended by one year to March 2011. The cost: About $3 billion, or more than half of the entire government budget deficit for the two years the initiative ran.

For those billions of dollars of lost royalties, the government promised new jobs and royalties from increased oil and gas drilling. In the end, we got neither. Nearly 8,000 oil and gas extraction jobs were lost while $2.9 billion of public funds were spent on the stimulus. New oil and gas well starts continued to plummet despite billions of dollars going to an already profitable industry.

Where did the $2.9 billion go? Only the Minister of Energy and a handful of government staff know. The Progressive Conservative government set up the Drilling Stimulus Initiative so that all but a select few government officials know where the billions in lost royalty revenues went.

What we do know is that the government created a "grey market" – an unregulated, though legal, market – where energy firms could buy and sell royalty credits. This grey market allowed companies owing royalties to slash what they owed to the Treasury by simply writing a cheque for a fraction of the cost: no new jobs or drilling required.

The buying and selling of royalty credits on the grey market was done with the knowledge and encouragement of the Progressive Conservative government.

In the end, the Drilling Stimulus Initiative gave billions to a lucrative industry with no checks or balances, no obligations to pay the money back, and no strings attached for new job creation or new drilling.

When the Progressive Conservative government refuses to adequately fund education or other vital public services, and yet gives Alberta's extraordinarily profitable energy industry $2.9 billion in "stimulus" funding, one has to question their priorities.

Introduction to the $2.9-billion Drilling Stimulus

The Progressive Conservative government's Drilling Stimulus Initiative was announced on March 3, 2009 as part of a three-point plan "to help keep Albertans working in the province's energy sector during the current global economic slowdown."[1] The goals of the Drilling Stimulus were to create jobs and "future royalties" [2] by increasing drilling activity, we were told.

[1] Government of Alberta, "Province announces three-point incentive program for energy sector," March 3, 2009, http://alberta.ca/home/NewsFrame.cfm?ReleaseID=/acn/200903/25402CDEFE818-F1BC-5D66-DF309066E457F2A4.html
[2] Government of Alberta, "Province extends energy incentive programs; moves forward on competitiveness review," June 25, 2009, http://www.alberta.ca/acn/200906/263331805CB5E-EC56-145C-67FA561CE64D8711.html

The Drilling Stimulus had two major components: The Drilling Royalty Credit (DRC) program and the New Well Royalty Reduction program.

The Drilling Royalty Credit program gave oil and gas drilling companies $200-per-metre-drilled royalty credit to companies on a sliding scale based on their production levels from 2008.

The New Well Royalty Reduction program provided a maximum 5-per-cent royalty rate for the first year of production from new oil or gas wells

When announced, it was estimated that the cost of the Drilling Stimulus would be $1.5-billion lost royalty revenue.[3]

(in millions)	***2009 Estimated Cost (one year only)***	***Actual Cost (over two years 2009-2010)***	***% Difference***
Drilling Royalty Credit	$466	$1,688	262.2 %
New Well Royalty Reduction	$1,040	$1,205	15.9 %
Total	$1,506	$2,893	92.1 %

(Source: Alberta Energy)

What's remarkable about the above breakdown is first that: (1) the Drilling Stimulus was renewed with no evidence that it had worked; and (2) that the DRC nearly quadrupled in size from the government's original cost estimate of $466 million in 2009 to a final cost of $1.69 billion in 2011.

Why did the cost of the Drilling Royalty Credit nearly quadruple? Because the Drilling Royalty Credit program was designed with a huge loophole that allowed – actually *required* - drilling companies to pass unused royalty credits to other royalty payers, thereby reducing royalties owed to the Alberta public without creating new jobs or oil/gas production.

According to the *Alberta Drilling Royalty Credit Regulation*, firms "must allocate a drilling credit to any one or more royalty payers, such that the entire drilling royalty credit is allocated."[4] There are no obligations for job creation or new drilling in this government-designed "grey market."

The Grey Market

The Drilling Royalty Credit program's loophole was a government-sanctioned *grey market* – an unofficial, though legal, market - that allowed drilling companies to buy and sell unused royalty credits with minimal oversight.

Under the program, drilling companies were given "drilling royalty credits" based on the amount of new oil and gas wells drilled, whether productive or not (so-called "dry holes" were eligible for credits). The program gave drillers a $200-per-meter-drilled royalty credit on a sliding scale based on firms' production

[3] Office of the Auditor General, "Report of the Auditor General of Alberta," October 2009, page 205
[4] *Alberta Drilling Royalty Credit Regulation* 4(1)

levels in 2008.[5] Firms would then apply credits against royalties owed to the public, thereby reducing their royalty payments.

However, drilling companies received far more credits than they could use.

That is, the amount of credits they received far exceeded the amount of royalties they owed. Unused drilling royalty credits were bought and sold on the grey market; other firms that owed royalties could buy unused royalty credits and apply them against royalties owed to the Alberta public without increasing exploration or drilling – i.e., no increase in jobs or future royalties.

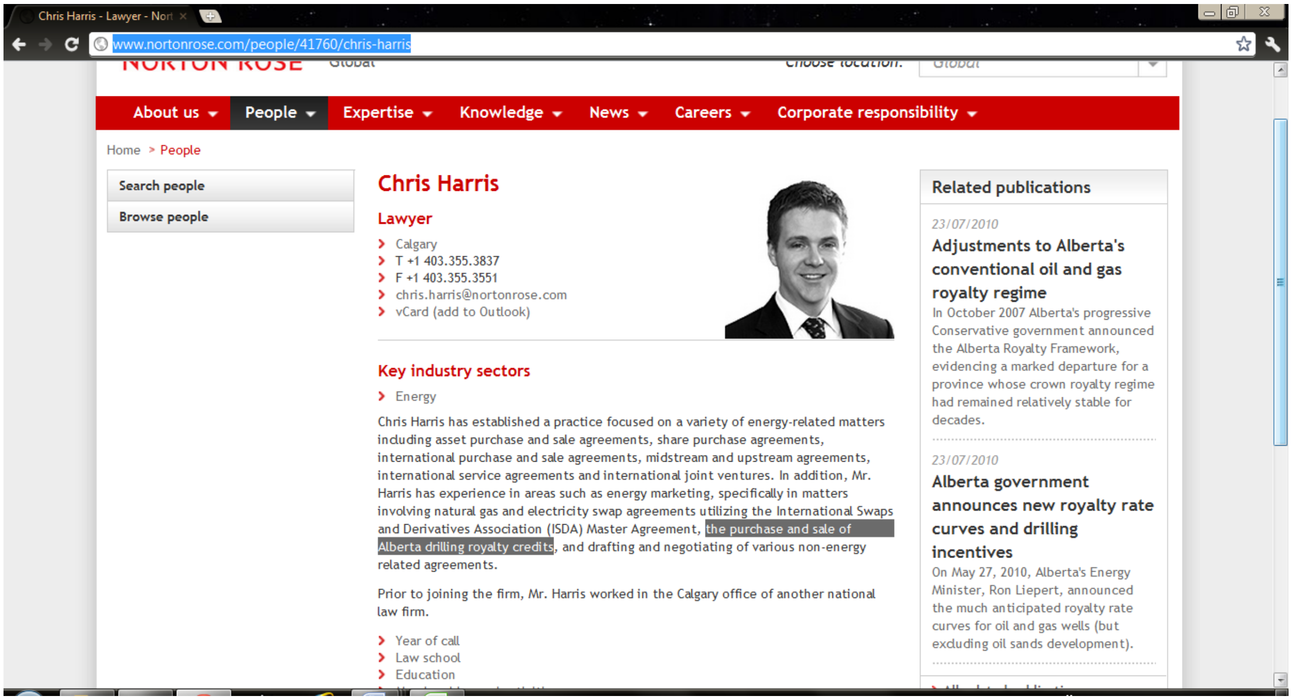
This was done with the explicit knowledge, consent and encouragement of the provincial government. According to the *Alberta Drilling Royalty Credit Regulation*, the Minister of Energy must keep a list of all transactions in the grey market.[6]

The Alberta Federation of Labour (AFL) has found several forums for the grey market in royalty credits – the *Daily Oil Bulletin*[7], the *PNG Exchange* website[8], the *Alberta Drilling Credit Exchange* website[9] – where tens of millions of dollars in drilling credits were advertised for sale.

(Source: albertadrillingexchange.com, accessed July 10, 2011)

The Alberta Federation of Labour also found a Calgary-based law firm advertising their expertise in "the purchase and sale of Alberta drilling royalty credits."[10]

[5] For more information, visit http://www.energy.alberta.ca/About_Us/1558.asp
[6] *Alberta Drilling Royalty Credit Regulation* (8)
[7] http://www.dailyoilbulletin.com/
[8] http://pngexchange.com/drilling_credits
[9] http://albertadrillingcredit.com/
[10] http://www.nortonrose.com/people/41760/chris-harris



(Source: www.nortonrose.com/people/41760/chris-harris, accessed July 10, 2010)

The grey market no doubt extended to other, less exposed forums than the ones mentioned above, like face-to-face and backroom deals. Given the sheer scale of the drilling royalty credit program - $1.7 billion – the AFL has no doubt that hundreds of millions of dollars more in drilling royalty credits changed hands without increasing jobs, drilling or capital spending.

Grey market mechanics

Companies received royalty credits based on their drilling and a few other factors. But there was another way to receive credits. Firms owing royalties to the Alberta public could buy them on the grey market by simply writing a cheque – no new jobs or drilling required.

The *sellers* in the grey market are drilling firms that have excess credits (i.e., royalties these firms owed to the Crown are nil and they had credits left over). The *buyers* in the grey market are any firm, company or corporation owing royalties on gas, oil or production from an oil-sands well.[11]

We know little of the price of the royalty credits changing hands on the grey market. That is, if a firm has $10 million in unused drilling royalty credits, how much can they get for them? Of course, it wouldn't be a straight-up $10 million – that price simply wouldn't be worth the opportunity costs and other costs of a potential buyer looking to reduce their royalty payments – the price of $10 million in unused royalty credits would have to be less than $10 million for the transaction to occur.

The Alberta Federation of Labour found numerous instances of *sellers* on the grey market but few *buyers,* even though it's clear hundreds of millions of dollars in drilling royalty credits changed hands.

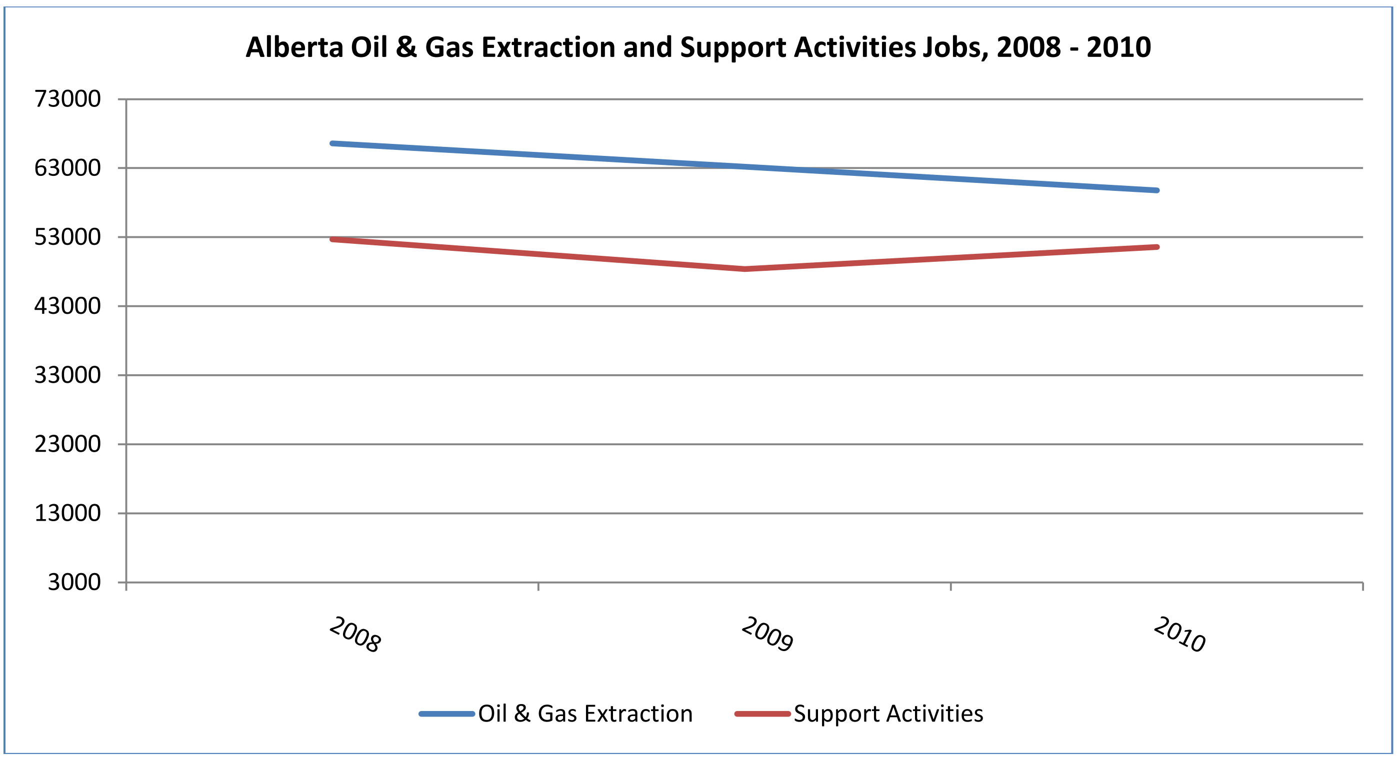
[11] *Alberta Drilling Royalty Credit Regulation* 1(1)(z)

For an example, in November 2010, Anderson Energy Ltd. reported that it had "more drilling credits than it will be able to claim."[12] The Alberta Federation of Labour found Anderson Energy Ltd. advertising $12 million in drilling royalty credits for sale on the *Daily Oil Bulletin* website in April 2011. According to company communiqués, Anderson "received $4.5 million in proceeds on the sale of some of these surplus credits in 2010."[13]

All of these aspects – the lack of information on the transactions and buyers and sellers – constitute a grey market. Another aspect is the fact that with legitimate markets in Canada, there are tax implications with transactions. If you buy something at the supermarket, you pay sales tax. If you sell stocks, capital gains tax may apply. Even if you buy carbon offsets, you'll have the GST or HST. But not with the grey market for Alberta drilling royalty credits. This is entirely uncharted territory when it comes to tax implications.

Government spent billions, but jobs are lost and drilling declines

In terms of jobs in oil and gas extraction and support activities, the $2.9-billion Drilling Stimulus was a resounding flop. In fact, 7,950 oil and gas extraction and support activities jobs were lost while the $2.9-billion stimulus was up and running.



(Source: Statistics Canada, CANSIM Table 383-0010)

But the government did not keep track of jobs created under this program. During the Standing Committee on Public Accounts meeting for the Ministry of Energy, Deputy Minister of Energy Peter Watson indicated

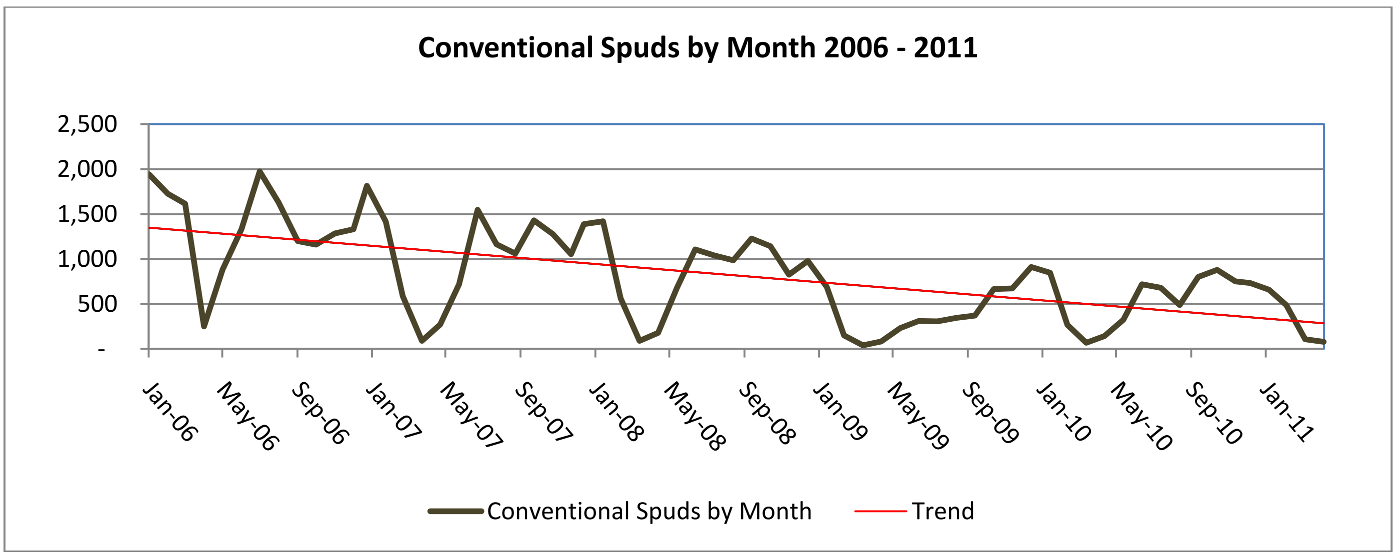
[12] Anderson Energy Ltd., "Anderson Energy Announces 2010 Third Quarter Results," November 15, 2010, page 14.
[13] Anderson Energy Ltd., "Anderson Energy Announces 2010 Fourth Quarter and Year End Results," March 28, 2011, page 18.

that he could not tell the Legislative Assembly of Alberta how many jobs were created as a result of the $2.9 billion Drilling Stimulus.[14]

Despite the stimulus, Alberta actually faired much worse than other western provinces which did not have stimulus programs nearly as generous. In 2009 and 2010, British Columbia also lost jobs in this sector, but only less than one hundred, or 0.9% of the workforce. Saskatchewan, on the other hand, actually increased the number of these jobs by 300, or 2%. Compare that with Alberta where a whopping 7,950 oil and gas extraction and support activities jobs were lost, or 6.7 percent of the workforce in this field.

As with the above case with Anderson Energy, it appears as though small drilling firms received far more royalty credits that they could use, but got far less for the credits on the grey market than they needed. If the small drilling firms couldn't use the entire amount of the credits, then the excess was sold to other royalty payers at a discounted rate.

In terms of new wells drilled, $2.9 billion did not spur a rebirth in Alberta's drilling industry.

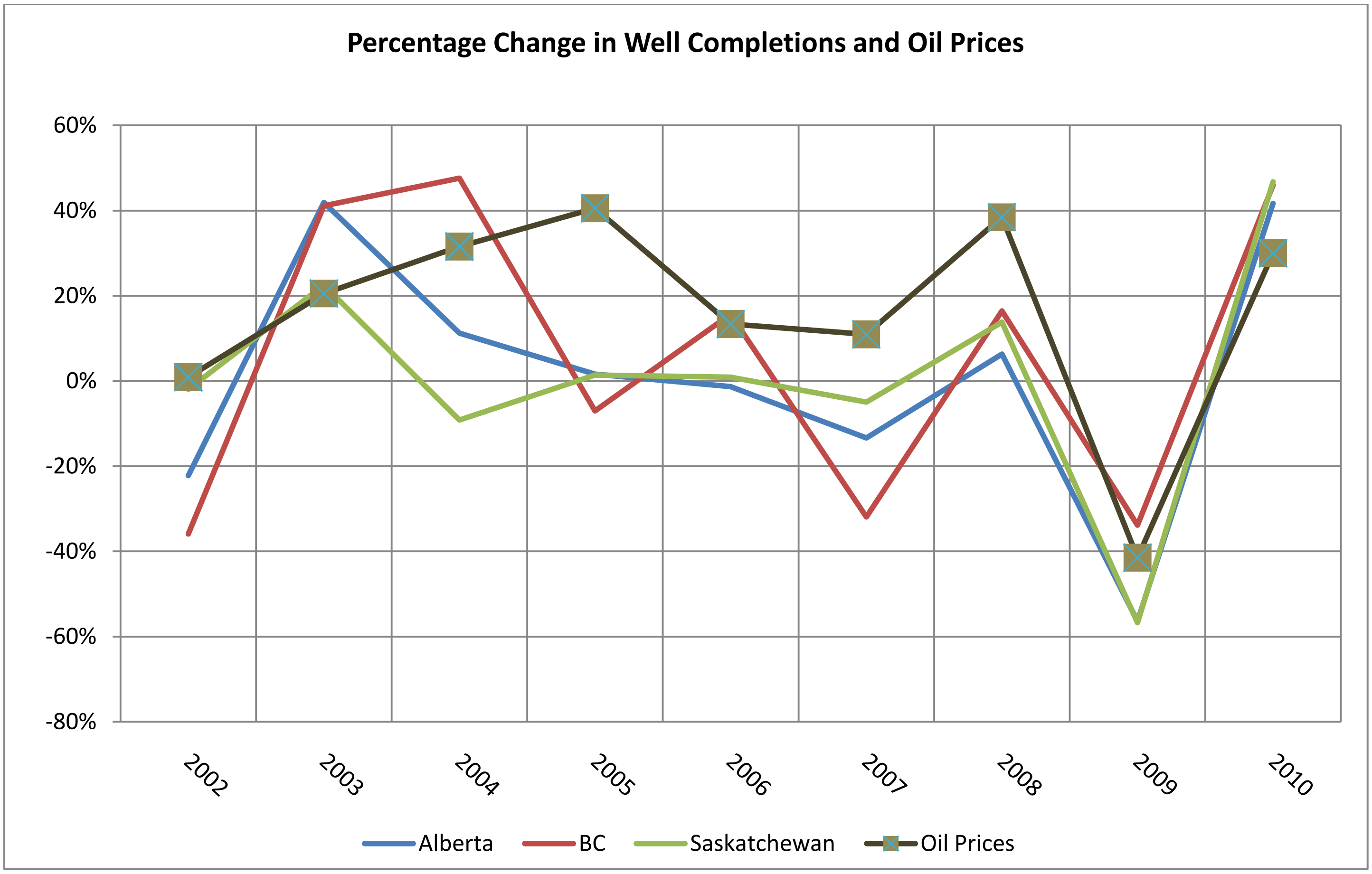


(Source: Alberta Energy)

New well starts, or "spuds," have been declining since 2005. Apart from seasonal changes, the trend of Alberta spuds has remained consistently on the wane and the massive drilling stimulus had little to no effect. The downward trend of new well starts appears unaffected by the $2.9-billion injection.

Without a doubt, the most important factor in drilling is oil prices.

[14] Legislative Assembly of Alberta, Public Accounts Committee – Energy, March 23, 2011

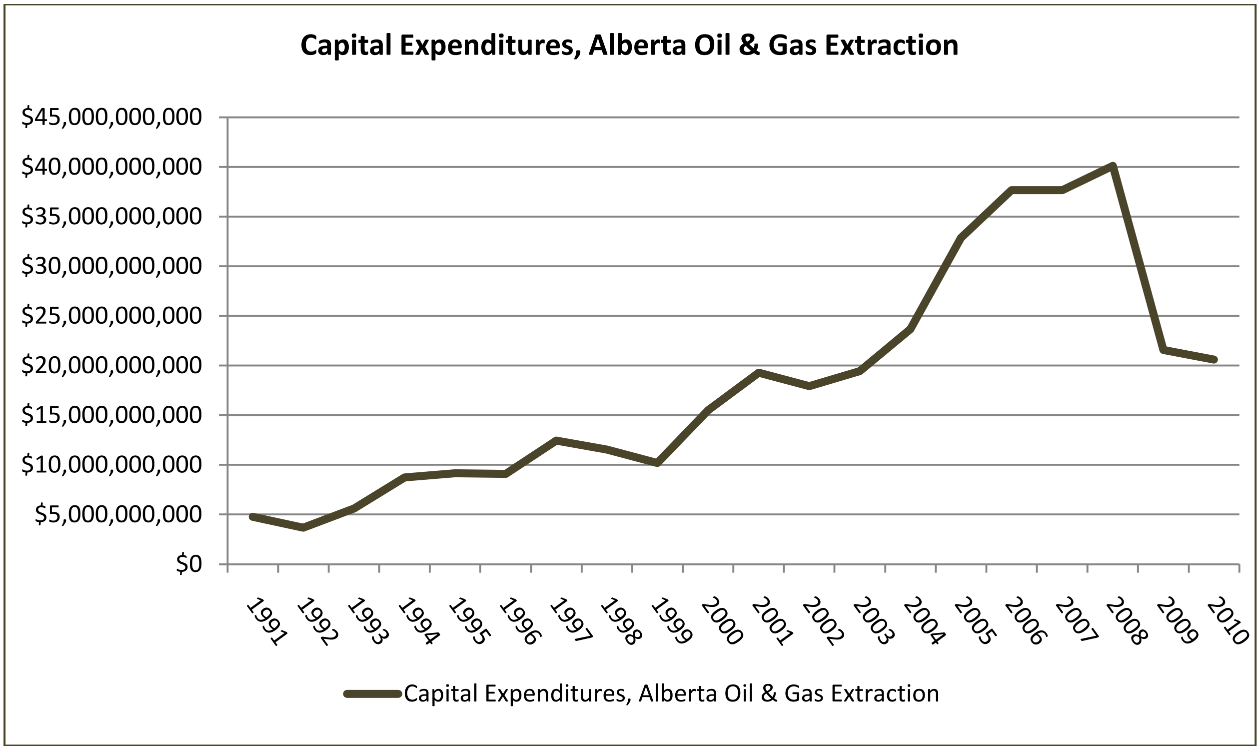


(Sources: Drilling data from the Canadian Association of Oilwell Drilling Contractors, Canadian par spot prices from U.S Energy Information Administration)

The above chart shows that well completions rebounded at the same rate as other western provinces. These provinces did not provide drilling incentives at nearly the same scale as Alberta and yet their rate if increase was nearly identical as Alberta's, which was at nearly the same rate as the rebound in oil prices.

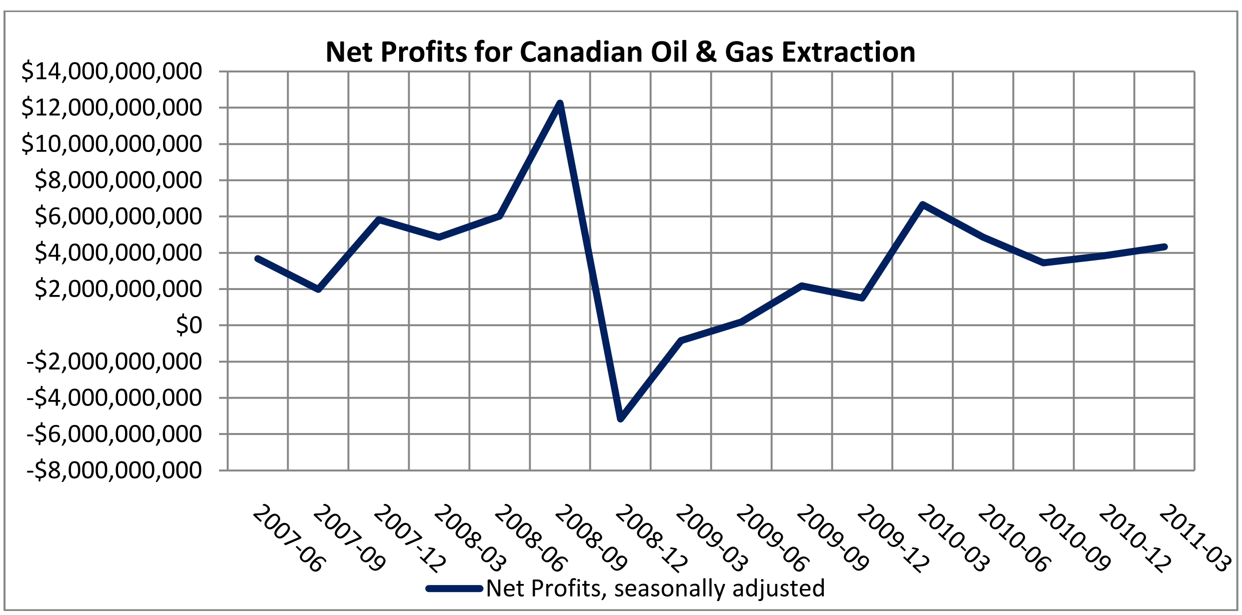
It is notable that the Progressive Conservative government's $2.9-billion stimulus was initiated as oil prices rebounded, when oil and gas companies probably needed the stimulus the least.

Like jobs, capital expenditures on oil and gas extraction also dropped while $2.9 billion left public coffers during the Drilling Stimulus era.



(Source: Statistics Canada, CANSIM Table 290-005)

We have some idea where the $2.9 billion went: As a whole, the oil and gas extraction industry remained profitable all the while jobs were slashed and drilling curtailed. This data in conjunction with the drop in jobs and drilling suggests that the small- and medium-sized drillers didn't benefit from the Drilling Stimulus; large companies with existing productive facilities appear to be the main beneficiaries.



(Source: Statistics Canada, CANSIM Table 187-0002)

To sum up, despite $2.9 billion spent by the provincial government jobs declined, new well starts declined, and overall capital spending declined. There's also no evidence that the stimulus program saved any existing jobs: Alberta's oil and gas sector lost jobs at a much higher rate than British Columbia, while Saskatchewan actually gained oil and gas extraction jobs. Both British Columbia and Saskatchewan did not have stimulus programs nearly as generous as Alberta.

The only thing the stimulus program seems to have had an impact on is the energy industry's profits which jumped significantly when the stimulus money started flowing. But making rich energy companies richer was not the stated goal of the program, and it is a very questionable use of public dollars (especially at a time when the government says it can no longer afford to provide adequate funding for core public services like education).

Government Secrecy

Who got the $2.9 billion? That's a secret. We asked the government, but they wouldn't tell us. The Drilling Stimulus program's records are under lock and key because of Section 50 of the *Mines and Minerals Act* (author's emphasis):

> Except as provided under the regulations, **no person shall communicate or allow to be communicated any record, return or information obtained under this Act to a person not legally entitled to that information** or allow any person not legally entitled to that record, return or information to have access to any record, return or information obtained under this Act.

The Minister of Energy can see this information, so can a handful of Energy employees. The Auditor General is also authorized to view the information.

What the AFL is calling for

The grey market for royalty credits officially closed as of June 30, 2011.[15] By now, the Minister of Energy ought to have the books in order and should have an idea as to where the billions went.

That is why the Alberta Federation of Labour now calls on the Progressive Conservative government to open the books on the program to find out where the $2.9 billion in lost royalties went, to ensure a giveaway of this magnitude doesn't happen again, and to hold those responsible for the lack of positive outcomes to account.

The Alberta Federation of Labour calls for the records of the Drilling Stimulus Initiative to be opened to a special meeting of Public Accounts Committee.

The Alberta Federation of Labour is not against stimulus measures when those measures are designed to work – that is, if stimulus measures have measurable outcomes tied to jobs, accountable leadership and transparent processes, none of which were features of the $2.9-billion Drilling Stimulus.

The Alberta Federation of Labour found that the $2.9-billion Drilling Stimulus lacked any semblance of the kind of checks and balances normally associated with government programs of this size and nature. The publicly stated goals of the Drilling Stimulus were to create jobs and future royalties through increased oil

[15] *Drilling Royalty Credit Regulation* 9(3)

and gas drilling, yet the number of jobs created with the billions of dollars of lost royalties was not tracked, nor was job creation an actual condition of the stimulus. Likewise, the number of productive wells created under the Drilling Stimulus was not tracked and unproductive wells received the same funding as those that would produce.

Jobs were lost and drilling declined while $2.9 billion was bled from the Treasury. Nearly 8,000 jobs in oil and gas extraction and support activities were lost in 2009 and 2010. New oil and gas well starts continued to decline unabated while the Drilling Stimulus was in place.

Worse yet, the Drilling Royalty Credit program created a grey market where royalty credits changed hands through backroom deals and secret negotiations. Royalties are what is paid to the Alberta public, not the government, for the right to use non-renewable natural resources and yet the Progressive Conservative government created a system where royalty credits were bought and sold without any public oversight whatsoever.

The *Drilling Royalty Credit Regulation* is written such that the grey market for royalty credits can be started up again by decree of the Minister of Energy.[16] That is why the Alberta Federation is urging both opposition and government MLAs to work together to investigate the $2.9-billion Drilling Stimulus to ensure the public interest is upheld with respect to the billions of dollars spent and the complete lack of positive outcomes for the staggering amount of money lost.

[16] *Drilling Royalty Credit Regulation* 16