Wanted: A Strategic Framework for Energy Development in Canada

By

Jack M. Mintz
President and CEO
C. D. Howe Institute

And

Deloitte & Touche Professor of Taxation
J.L. Rotman School of Management
University of Toronto

*Notes for an address prepared for the Calgary Chamber of Commerce, March 16, 2004.

Until recently, energy issues have been off the radar screen. Since the debacle of the National Energy Program ended in the mid-1980s, deregulation, oil-sands development and free trade with the United States have led to an energy-sector boom in Canada, which now enjoys a $40 billion trade surplus. Given the extraordinary growth in exports and incomes for Canadians, few significant policy issues during the 1990s have presented themselves as obstacles for further energy development. The policy framework developed in the 1980s has been working well for the industry, providing a cheap, reliable supply of energy for consumers.

However, in the past two years, signs point to new pressures that could have a significant impact on energy development. And federal and provincial governments will have to develop a new strategic framework for energy markets to deal with these new pressures. Otherwise, missteps could erode confidence among industry participants and undermine economic growth.

So what are the pressures?

The first is the end of an era of cheap energy prices. Oil prices, bottoming out at about $18 per barrel in 1988 have climbed to over $30 a barrel since 2000 (all prices are expressed in Canadian dollars). Natural gas prices have increased sharply from about $2 per mcf in 1995 to well over $6/mcf since 2000.

The outlook now is for stable or rising prices. Growth of world demand for oil, especially in Asia, will likely outstrip the supply available from the Middle East and new production in Russia. Conventional oil production in North America has peaked although Canada's oil sands production will virtually double in the next 10 years. However, for oil sands development to be profitable — and a significant source of crude for North American markets, the price of oil has to stay at or above about $25 a barrel.

Natural gas prices are likely to remain high for some time. North American demand has risen sharply, with Canadian exports to the U.S. more than doubling in the past decade. New supply from the Mackenzie Delta, Alaska and Trinidad will help feed a growing demand. But, the days of low natural gas prices are over. The cheapest source — liquefied natural gas from huge deposits in Qatar — will be priced no lower than $4.50 per mcf.

The average price of electricity has also risen briskly, with Canadian exports becoming a more important contributor to our energy trade surplus. Prices were well below 3 cents per kwh prior to 1998. Since 2000, average prices reached 8 cents per kwh. And with the recent experiences in California, consumers discovered how electricity prices could go through the roof in a short period of time. Given the need for new supply of electricity, prices are bound to remain well above levels experienced 10 years ago.

Canadian consumers, including industry, are not accustomed to such steep energy prices. Neither are they used to blackouts like the one in Ontario last summer. Governments now face angry voters who want to continue to have low prices for electricity and heating, as well as a stable supply. It is tantalizing for politicians — witness the former Tory government in Ontario — to freeze prices in order to protect themselves from voter wrath, even though such a policy are compromises the ability of the sector to supply energy for household and business needs.

A second pressure arises from increased concern for a secure source of energy supply. The U.S. is trying to avoid importing Middle East oil in favour of supply from its NAFTA partners, Canada and Mexico, and other more politically secure countries. The tremendous Alberta oil sands' reserves, second only to Saudi Arabia's, will be critical to U.S. security objectives.

A third pressure facing energy markets arises from environmental concerns. The debate over Canada's commitment to the Kyoto agreement showed that a government could receive sufficient political support to proceed with implementation even though the plan was relatively sketchy and the agreement still has not been ratified by either the United States or Russia. Kyoto was perhaps a catalyst for many Canadians to push for cleaner air and water quality. In fact, many environmental groups supported Kyoto on the basis that Canadians would enjoy better health even though the agreement was related to global warming, not sulphur or other pollutants. Environmental issues will continue to be an important concern for Canadian voters.

Without a new strategic framework for energy markets, it would be very easy for Canadians to "kill the goose that lays the golden egg" with bad policy. The debate over Kyoto is in my view one example of a policy adopted without understanding the implications for this country. Another recent example of an ill-thought idea was the call by one politician to impose an export tax on oil and gas exports in order to push the U.S. to resolve the lumber dispute in Canada's favour. The threat is simply not credible. The NAFTA agreement, which prohibits discriminatory export taxation, would have to be torn up. Our partners know we would never be able to carry out the threat. The potential economic collapse from losing access to the largest market in the world would find little support among voters whose employment and incomes depend on our $1 billion-a-day trade with the United States. A realistic strategy is needed if Canada is to protect its interests.

So what could we achieve with new strategic framework for energy markets? Several broad objectives come to my mind:

- Canadians should have a secure, reliable source of energy supply to avoid disruptions in electricity supply and maintain stable prices.
- Canada should push for a continental approach to energy development to ensure resources are efficiently allocated to produce the cheapest sources of energy for markets. Negotiations could be part of a new trade pact with our NAFTA partners that facilitates greater trade, labour mobility and security within North America.
- Canada should seek to conserve energy and develop alternative sources that help achieve environmental objectives.

In my view, all three objectives can be achieved if Canadians are willing to accept that consumer prices should be determined by market forces rather than being held at levels below costs of production, as in the case of Ontario's electricity supply. Without appropriate pricing for energy, supply will be uncertain and inadequate, energy will not contribute to North American security and our environment will be less protected.

With this framework for energy markets federal and provincial governments could undertake a number of regulatory and tax reforms that would achieve higher incomes for Canadians, as well as achieving other objectives, such as greater environmental protection. Let me provide four examples.

The regulatory environment for energy producers should be improved. Regulations that ensure consumers pay prices that reflect incremental cost of supply should be implemented to provide sufficient returns for building energy infrastructure. Better regulatory co-ordination is needed among different levels of government, but also within governments. For example, three federal departments — Natural Resources, Fisheries and Oceans and Environment — and several provincial government bodies, regulate offshore oil and gas production. Regulatory co-ordination could be improved by an intergovernmental agreement that leads to a single entity handling all aspects of regulation for a particular jurisdiction.

An attempt should be made to achieve greater efficiencies in electricity markets to reduce costs for consumers and encourage supply. Some actions that could be taken include greater use of time-varying prices according to peak and non-peak demands to improve conservation. Provincial power supply could be deregulated so new power producers can enter markets, and barriers to cross-provincial ownership of power companies should be scrapped.

A new continental energy pact with the United States and Mexico should aim at developing new sources of energy without distorting the allocation of resources amongst different sources of supply. Canada should secure the Mackenzie Valley pipeline to transport natural gas from both the Delta and Alaska. Mexico should open up its markets to Canadian and U.S. producers to help develop their resources at less cost. All three countries should seek an agreement to ensure a level-playing field so that companies will allocate their scarce investment funds to develop the cheapest sources of energy first.

As well, Canadian governments should review their tax systems to ensure that taxes and royalty systems do not discourage energy production, including that from alternative energy sources. A quick payoff can be had if the federal government were to implement more quickly its package of tax reform for resource companies — measures that are scheduled to take place over five years. As seen with the recent Ontario corporate tax increases, governments need not be committed to scheduled decreases in rates over a long period of time. As another example, the current capital cost allowance rate for pipelines — based on a 50-year life of an asset — is inadequate if a pool of oil or natural gas is not expected to last more than 20 years. Other capital cost allowances should also be reviewed to ensure that obsolescence and capital goods uncertainty are properly recognized as part of depreciation costs. Stable royalty systems should not impose onerous levies on investment and production — Alberta, to its credit, has developed a generic royalty on business cash flows that effectively applies the levy on revenues net of investment and production costs for the oil sands and heavy oil production.

None of these policies implies that governments have to provide special business subsidies or grants to industries. Instead, deregulation, tax reform and marginal cost pricing will ensure that resources are adequately provided and consumers will conserve energy.

A framework for policy following this prescription is the best way that Canadians can make sure that they have secure and reliable sources of energy supply.