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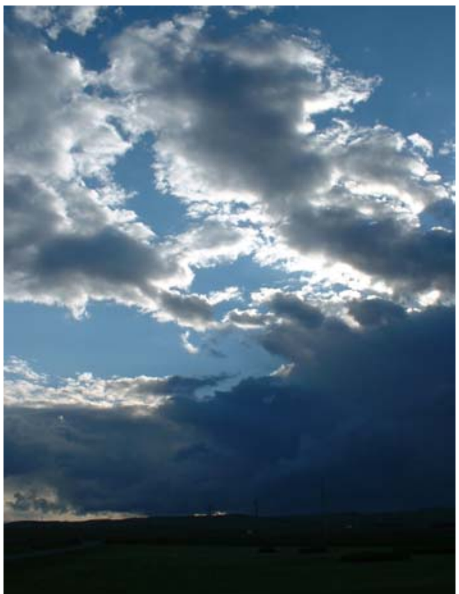

The Alberta Heritage Savings Trust Fund

Alberta's Inheritance

October 2007

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Executive Summary

At the request of the government, The Institute for Public Sector Accountability is very pleased to offer our opinion on the future management of $40 billion in savings and investments. Since its creation the Alberta Heritage Savings Trust Fund has been the subject of controversy. It has either been criticized for being badly managed, or being too large and should have been used for government spending - Either way over the years it has grown and now requires a review to ensure its long-term existence and future use.

We have approached our submission by looking at the impact of ***Alberta's New Royalty Framework*** because any view of future savings cannot be looked at without an examination of its main source. While we have been proponents of a royalty review, we are not supporters of the government's final decision, despite the compromise made by the Premier to reduce the proposed intake to $1.4 billion from $2 billion.

We differ because in the first place the original 'Our Fair Share' report was remiss in its assessment of the economic impact on the province's economy and future investment in the industry. In second place the appropriation of only a third of the new revenues for investment in the Heritage Fund is not enough to really give future Albertans a fair share.

The decision to use two-thirds of the additional revenues for so-called investments, is in our opinion a vaguely disguised increase in government spending on programs that really need to be examined for their delivery systems rather that their lack of funding prior to further expenditure.

We concur that the Heritage Fund should be allowed to grow, and that its income in the short run should be used to alleviate the current problems, but we would rather see the policy changed to increase the amount invested in the funds. We therefore propose a number of scenarios based on a graduated investment regime for the next 10 years.

We also maintained that a better way to make Albertans share in the bounty of the oil industry is to reduce taxes both at the corporate and individual levels. To do so will not only continue the Alberta Advantage but create a climate of investment and entrepreneurship that has been the cornerstone of this province success in the past and gather support for the Premier's idea for 'Building Tomorrow - A plan to secure Alberta's Future."

Introduction

The natural resources of this province have generated large volumes of revenue through the private and public sectors, yet for many years and several governments Alberta has not directly consulted its citizens on this inheritance. Recently, the Stelmach government has requested opinions from the public as to how provincial savings and investment should be managed. Furthermore, the Premier promised, as a campaign strategy, to conduct a review of the royalties raised from the oil and gas industry. Since the release of this report in September and the unilateral announcement of a new royalties' regime, the government has been subject to criticisms from many quarters.

This time the government has taken a different approach and has asked the public to be part of the process for a review of the Alberta Heritage Savings Trust Fund (AHSTF). As a result the Finance Minister has requested that Albertans participate in a review of the management of these funds, and appointed The Financial Investment and Planning Advisory Commission to receive submissions from interested parties to ensure that the citizens of this province receive the maximum long-term benefit from them and to address, among other issues, whether the Alberta Heritage Savings Trust Fund (AHSTF) should be allowed to grow and how its income should be used.

In November of 2006, The Institute released a report entitled ***"A Blueprint for Alberta"***, in which many of the issues affecting Albertans was discussed. One of these issues was the future of the AHSTF and a change in its management. We also advocated a review of the current royalties' regime. The government's call for the public to participate in a discussion on the future of the fund provides us another opportunity to express our views on these matters - The Institute for Public Sector Accountability is grateful to the government for this opportunity.

Although the call for participation stipulates that the Commission will be looking at the future management of the Heritage Fund, we believe that such a debate cannot be undertaken without an examination of the sources of revenue which supports this fund. We strongly believe that these two issues are intertwined and cannot be dealt with in isolation. We must also look at the levels of government participation in the economy and the desired levels of government spending.

As a result of our analysis of these issues we also provide recommendations for the future of the AHSTF and other measures which, in our opinion, must be viewed in a greater context of prosperity for Albertans,

Royalty Review

This submission may not be the right place to discuss the pros and cons of a royalty review, but we would be remiss if we did not address the issue of the Alberta's largest source of revenue, and only discuss how to spend and save what we receive.

The controversy regarding the 'Our Fair Share' report rages on, because while addressing the government's perceived lack of will to tax the oil and gas industry, factors of economic importance seem to have been ignored in its conclusion, which states:

"Albertans do not receive their fair share from energy development. The royalty rates and formulas have not kept pace with changes in the resource base and world energy markets. Albertans own the resource. The onus is on government to re-balance the royalty and tax system so that a fair share is collected…The total government take (Alberta and Canada taxes and royalties) can be increased with Alberta still remaining an attractive destination. The Alberta Royalty Review Panel recommends that the total take for the energy sector be increased by sector as shown in this table."

Current Sharing			**Recommended Sharing**	
	Albertan's Share	Developers' Share	Albertan's Share	Developers' Share
Oil Sands	47%	53%	64%	36%
Conventional Oil	44%	56%	49%	51%
Natural Gas	58%	42%	63%	37%
Source: Our Fair Share				

The proposed increase is equivalent to 20%. The proponents' of this report seem to be very comfortable with statements like: 'increased taxes', some have even uttered the desire to appropriate 100% of the revenues for the benefit of Albertans, this is tantamount to the reminiscent and dreaded NEP or a Venezuelan nationalization of the industry. So far the supporters of this report do not seem to be bothered about any negative impact that such an increase may cause.

They ignore the view that the success of the oil industry also contributes to both the Alberta and Canadian economies. The current growth in the Canadian economy is very much driven by commodities, mainly oil and gas.

The rise in the value of the dollar may also be attributed in great part to the revenues generated by the energy industry. The oil industry generates close to 34% of Alberta's GDP not accounting for related growth in other sectors of the economy. Those who support the implementation of the report argue that the oil industry receives an unfair advantage and does not contribute enough to Albertans. The continuous rise of oil prices from $50, not so long ago, to a potential $100 a barrel has also fuelled cries for more taxes, but we must not ignore the fact that a rising 'loonie' will also diminish the amount of real Canadian revenues generated by the industry. We do not dispute that in the main, Alberta's royalty regime is more favourable than in some other jurisdictions. However we must also take into account that the costs associated with the extraction of oil is increasing, and in addition the price of gas is at a low point.

In general, the industry has reacted adversely to this report. They have forecast reductions in future investments or cutbacks in current operations. We must take into consideration that any slow down in the industry due to increased royalties, hence costs, will have a negative effect on employment and investment and other areas of government revenue not considered by the review panel. The boom currently experienced by Alberta will grind to a halt and we may not recover for years to come.

But our biggest concern with the report is that it addresses only the increase in taxation and does not take into consideration collateral economic impact. More importantly those who support the findings of the report did not tell us what the government will do with the projected increase in revenue. The review, in other words, is left to consider in isolation and without the necessary context of an overall economic plan, or vision, for the province.

Use of Funds

So far all of the discussion has been on the will to raise the royalties collected by the government. Very little has been said about, the use of this extra revenue. It is well and good to talk about increasing revenues, but the most important issue is what is done with the money. Before we discuss any of the scenarios for managing the billions of dollars in Alberta's savings and investment we should look at the levels of revenues currently collected by the government.

Alberta Revenues

In its latest budget the government of Alberta provided the following information:

MAJOR FISCAL ASSUMPTIONS

Alberta experienced extraordinary growth in 2006. The economy grew by 6.9%, the best performance since 1993. Employment growth was at its highest level in 25 years and the unemployment rate was at its lowest level in 30 years.

- In 2007, economic growth is forecast to moderate to 3.8% and, over the following three years, to average 3.5%.

In 2007-08, oil prices are expected to decline; natural gas prices to increase. This is in line with expectations of private sector forecasters.

Fiscal Year Assumptions	2006-07	2007-08	2008-09	2009-10
Oil Price (WTI US$/bbl)	64.97	58.00	54.25	52.50
Bitumen Price (Cdn$/bbl)	36.53	28.29	26.93	26.42
Natural Gas Price (Cdn$/GJ)	5.95	6.75	6.50	6.25
Exchange rate (US¢/Cdn$)	87.9	86.0	86.9	87.0

FISCAL SUMMARY

- **Revenue** is estimated at $35.3 billion in 2007-08, down 4.7% from 2006-07. This reflects lower resource revenue and the expectation that income tax revenue and investment income will not be as high as they were in 2006-07.

- **Expense** is estimated at $33.1 billion in 2007-08. This includes an increase of 10%, or $2.4 billion, in operating expense and an increase of 37%, or $1.3 billion, in capital grants. These increases will help address the pressures caused by Alberta's rapid growth in 2006.

- **Surplus** is estimated at $2.2 billion in 2007-08. The 2007-08 surplus is being used primarily for inflation-proofing the Heritage Fund, an allocation to the Medical Research Endowment Fund and to meet capital cash requirements.

Fiscal Summary (millions of dollars)	2006-07 Forecast	2007-08 Estimate	2008-09 Target	2009-10 Target
Revenue	37,059	35,332	35,170	34,707
Expense				
Operating expense	24,577	27,023	28,147	29,317
Capital grants	3,452	4,739	4,435	3,239
Other expense	1,642	1,387	1,201	1,226
Total Expense	29,671	33,149	33,783	33,782
Net Revenue (surplus)	**7,388**	**2,183**	**1,387**	**925**

IN-YEAR SURPLUS ALLOCATION POLICY

- If the surplus is higher than estimated in the budget, the additional cash available will be allocated one-third to savings/investments and two-thirds to capital requirements.

- At least 50% of the capital allocation will be used to address capital maintenance and replacement requirements.

As we can see, the majority of the estimates are already out of sync. The price of oil has soared to a record $93, and may reach levels of $100, while the price of natural gas has sunk below the forecast amount. The surpluses, as usual are well above the estimated amounts and therefore, in the short-run surpluses are also above estimates. But we cannot be sure that this growth in revenue will be sustained in the long run, especially as the royalty review is implemented and the industry decides to cut back its operations.

The Alberta Heritage Savings Trust Fund

So far Albertans have been given a plethora of saving strategies for surpluses. The Heritage Fund is being topped up by various amounts and will continue to grow. The problem is that currently there is no predetermined contribution required, furthermore the fund's income has been transferred to general revenues and have been used for different programs and ***'political legacies'***. Since 1997, the Fund cannot be used for economic development and social investment purposes. In our opinion that should continue to be the case.

According to government reports:

"In 2006-07, income of the Heritage Fund is forecast to be almost $1.8 billion. Of this amount, $202 million will be retained in the Fund to provide the inflation-proofing required by legislation and the balance of almost $1.6 billion will be transferred to the government's General Revenue Fund.

The fair value of the Heritage Fund is forecast to be $16.3 billion at March 31, 2007, up from $14.8 billion at March 31, 2006. In addition to growing by $585 million due to inflation-proofing, the value of the Fund has increased over the past two years as a result of a total of $3 billion in deposits made by the government. In each of 2005-06 and 2006-07, the government deposited $1 billion from the surplus into the Fund. The government also made contributions of $750 million in 2005-06 and $250 million in 2006-07 into the Heritage Fund on behalf of the Access to the Future Fund. The Access to the Future Fund was created by the government in 2005-06. The money contributed to the advanced education endowment within the Heritage Fund is invested with other Heritage Fund assets. Earnings from the principal amount go to the Access to the Future Fund administered by the Minister of Advanced Education and Technology and are used to provide seed."

To date about $30 billion of investment income from the fund has been appropriated to fund several health, infrastructure and education programs, but we have not seen significant improvements in the delivery system of these services. Still we are bombarded by requests from lower levels of government and other groups for more expenditure.

What we said then:

In our report of November 2006 we stated: “The fund’s growth depends on the revenues generated from royalties from oil and gas, and as such are not a steady stream and long-term benefits are hard to judge, especially if we continue to use the income for expenditures that may be political rather than economic. Those expenditures and the growth in the oil and gas industry have fuelled the rate of inflation in Alberta. To continue to budget on the basis of revenues from a constantly fluctuating source is pure madness.

Since paying down the Alberta debt the Heritage Fund has reached $14.6 billion (Dec.2005). Not only is it the envy of the rest of the country, it is also fast becoming a subject of discussion among economists as to how it should be managed to garner the maximum benefit from these riches. A few are proposing that the Fund be managed along the lines of the Norway model. Created in 1990, fourteen years after the Alberta Heritage Fund, the Norwegian fund stands at $215.5 billion (Nov 2005). One hundred per cent of Norway’s oil and gas revenues are placed in the fund and invested abroad, and net earnings are deposited back into the fund. All budgets are drawn without any revenues from oil and gas. Any budget deficit is covered by the fund as long as it does not exceed 4% of annual deposits. From a national point of view the fund buffers the economy from the ups and downs of fluctuating commodity prices. Should Alberta do the same with its revenues? Difficult to envision, while Norway is a country, and Alberta is a province, it should not prevent a strategy that will suit Alberta.

Save or Spend?

The answer may lie in sound fiscal policies. When Ralph Klein stated that it would be wise for municipalities to put some of their infrastructure expenditures on hold, he may well have a point. The Heritage Fund’s success is a source of political tension. As it gets bigger everyone wants a share of the pie, municipalities are spending without restraint and with an expectation that the provincial government will fund their excesses. While inflation in the rest of Canada has been fairly steady, the rate in Alberta has soared over the past year. In addition the value of the Canadian dollar has also risen on Alberta’s oil riches, causing a drop in exports resulting in lower profits and rising unemployment in the manufacturing sector.

In the mean time continued expenditures and bonus cheques contribute to the low level of the Heritage Fund compared to Norway’s fund. There is also another issue which must not be ignored in this discussion – that being the important debate about equalization. To the rest of Canada the riches of Alberta should be included in the equalization formula and shared with the rest of the country. While Alberta restructured many of its service delivery and programs and paid down its debt, other provinces have not made many changes and with the exception of a few provinces have continued to accumulate deficits.

In our opinion the policy of saving revenues from oil and gas should continue. However many of the policies must change. At the heart of these changes is that income from the fund should be reinvested and not used to top up general revenues. Alberta should also adopt a policy of not including oil and gas revenues in its budget because of their volatility. Based on conservative estimates of future resource revenues, we advocate that for the next 10 years, 75% of the net surplus be placed in the Heritage Fund, the remainder 25% or approximately $10 billion should be used to bring real infrastructure to par in the province. Roads, water and sewer should be a priority, and not 'social infrastructure,' which is undefined and not the proper role of government. Once we have closed the infrastructure gap, we should gradually increase the percentage of the resource revenues allocation to the Heritage Fund, to be managed for future generations. While the proportion of savings to expenditure may vary in the short term, we still believe that in the long run we should save 100% of the revenues from non-renewable resources. The income from the investment would then be used for tax reductions and specific programs approved by a plebiscite, and not by the government alone. This policy will require that the government reduce its expenditures and improve fiscal discipline. This measure is advocated to remove the savings from the hands of eager politicians who may decide to spend to build 'political legacies'.

What we say now:

Now that we know what the government's proposals are for ***Alberta's New Royalty Framework*** notwithstanding that the proposed increase has been reduced, it is more imperative to have a clear strategy for the Heritage Fund.

Despite what recent surveys said, the likelihood is that out of the reported 88% who support an increase in royalties, very few have read the report or even understand the economic impact of the decisions. The media and some groups have high jacked the process by telling Albertans that they were being deprived of their asset, and that the government should re-balance the situation by giving them more. The problem is that 'investments' - as the government states – appears to be primarily a strategy to increase government expenditure.

The government has made a compromise and reduced the proposed intake from $2 billion to $1.4 billion, and stated that one-third of the amount raised through the review will be put into the Heritage Fund, and the rest will be re-invested into programs in health, education and infrastructure. This means that two-thirds of the newly acquired revenues will be committed to capital-spending projects, in other words increased government expenditures.

More to the point, the result of this new royalty regime will only add an estimated $425 millions to the Heritage Fund. How is that giving Albertans a better share? The only increase in sharing is in government expenditures. This strategy could backfire if Alberta's or the world economy takes a turn for the worse. The proponents of government re-investment should be deeply concerned; any economic slowdown will mean less revenue for the government, but the increased expenditures will very likely not see any cut backs and the result will be quite clear. To sustain the government expenditure, unless the government changes legislation forbidding deficit budgets, Alberta will require new taxes. Is this what Albertans call 'Our fair Share'?

Recommendations

A better strategy would be to give Albertans what they deserve first, and then the residue can then be used in areas where it can top up current program spending. We therefore propose the following recommendations:

- We must recognize that the revenues from non-renewable resources should also benefit future generations
- Cut taxes for both corporations and individuals immediately
- For the next 10 years the government should place 75% of net surplus, including the increased amount of revenue generated by the royalty review, into the Heritage Trust Fund
- For the next 10 years the government should use 25% of the net surplus for infrastructure construction and debt repayment on the costs of construction
- After the next 10 years 100% of resource revenues should be placed in the Heritage Trust Fund
- Current income from AHSTF should be used only for specifically allocated programs approved through a plebiscite.
- After 10 years, the income from the Heritage Fund should stay in the fund and not appropriated to general revenues for political legacy expenditures.
- Cut health premiums for all Albertans over 60 and resident in the province for at least 10 years
- Reduce health premiums by 50% for all Albertans (under the age of 60) resident in the province for at least 10 years.
- No funding, except for the purchase of land required for a High Speed Train and use as a utility corridor between Edmonton and Calgary.
- Refrain from using the AHSTF as a source for government intervention in the economy.

Conclusions

The Institute for Public Sector accountability was one of the first to support a royalty review in November of 2006; we also made recommendations on how any extra revenues should be used to benefit Albertans and also produce a competitive strategy that would benefit the rest of Canada.

Unfortunately, the government has moved away from the creation of a climate of entrepreneurship and wealth creation and has sided with a progressive approach to wealth management – that is to increase revenue intakes and increase spending. This is not a path that is supported by those affected in the oil industry and is one which will negatively affect Albertans down the road. So far the markets have not shown too much of a reaction to the decision, but it is too early to accept that the government's policy will not have a long term effect. Planning and investment in the oil industry takes time, and it is only in the coming months that we shall see the real effect on future investments, as neighbouring states and provinces make invitations to companies to invest in their jurisdictions.

Since the announcement of Alberta's New Royalty Framework, the government has been vague on what it intends to do with the extra revenues. We therefore proposed that the government refrain from additional spending and instead give Albertans what they really deserve by reducing taxes and finding alternative ways to deliver services at a reduced cost. We ask that the government creates incentives and not impose punitive penalties or taxes to achieve and sustain growth in the economy. The idea that governments are the only one who knows how to spend 'our' money can no longer be accepted in this economic environment. By not choosing a path of less government interference in the economy the government runs the risk of killing the existing Alberta Advantage for 'Building Tomorrow - A plan to secure Alberta's Future" and instead produce a regime for high expenditures and higher taxes.

Canada is one of the most democratic countries of the world. Its diversity and cultural richness are the basis for our prosperity. However in recent past there have been too many instances of government mismanagement, which if left unchallenged can and will endanger our democratic system.

In the 21st century we can no longer manage our public institutions with 20th century models. It is time to re-examine the role of government in our society and seek new ways for the delivery of public services. We need more transparency and accountability in the public sector. There is a need for a new vehicle to allow citizens to express their opinions and provide new ideas to maintain our prosperity.

The Institute for Public Sector Accountability (IPSA) is a non-profit organization founded to promote transparency and accountability in the public sector. **IPSA** is dedicated to the enhancement of democracy.

Vision:
Through research, analysis, evaluation and the publication of papers and articles, IPSA will inform and provide new ideas and add a new voice to the democratic process.

Mission:

- **To inform the public on issues related to the public sector**
- **To be a voice to make government more transparent and accountable**
- **To educate the public on matters concerning public policy**
- **To promote dialogue between the public, politicians, and public sector administrators**

How can you help?
The Institute for Public Sector Accountability is a not-for-profit organization, and we cannot enhance democracy and promote your ideas without your help. We invite you to support us and make a donation. Please contact our President and CEO at (403) 238-3865 for more information.

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