Transforming the Newfoundland and Labrador Economy: The Role of the Atlantic Accord

A Presentation to Memorial Presents
"The Atlantic Accord: A New-Found Vision?"

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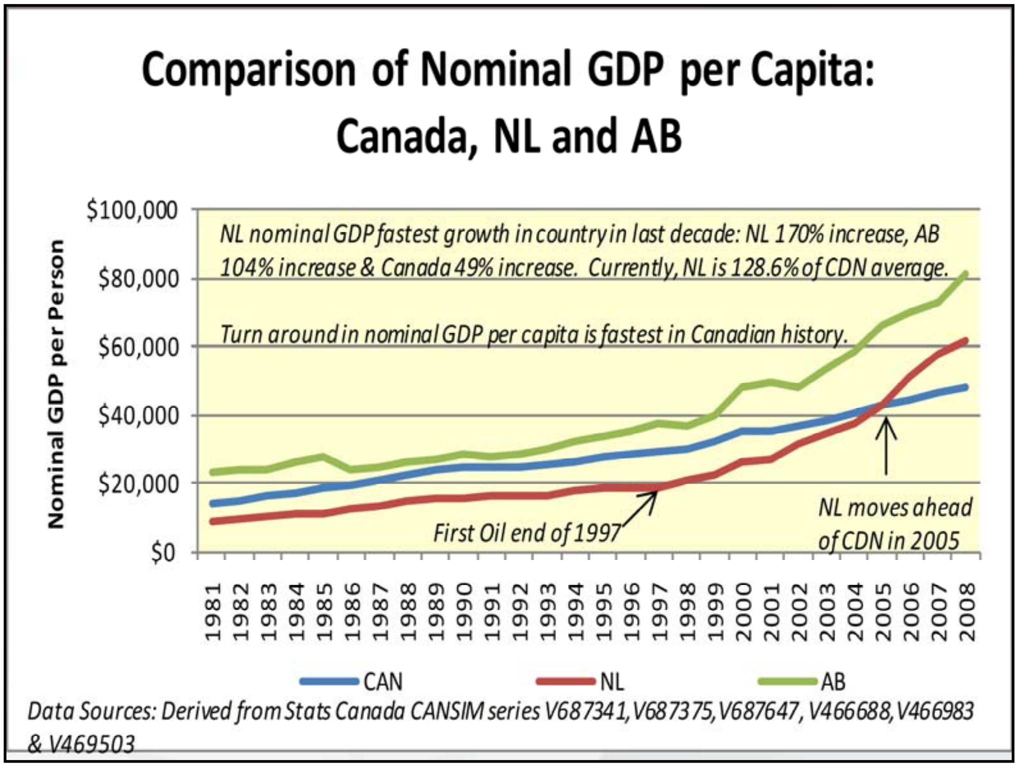
Outline

- Economic impacts
- Fiscal Impacts
- Key Aspects of Accord
- Equalization Offsets
- Full and Fair Opportunity
- Input on Fundamental Decisions
- Research and Development
- Concerns with the Accord
- Conclusion

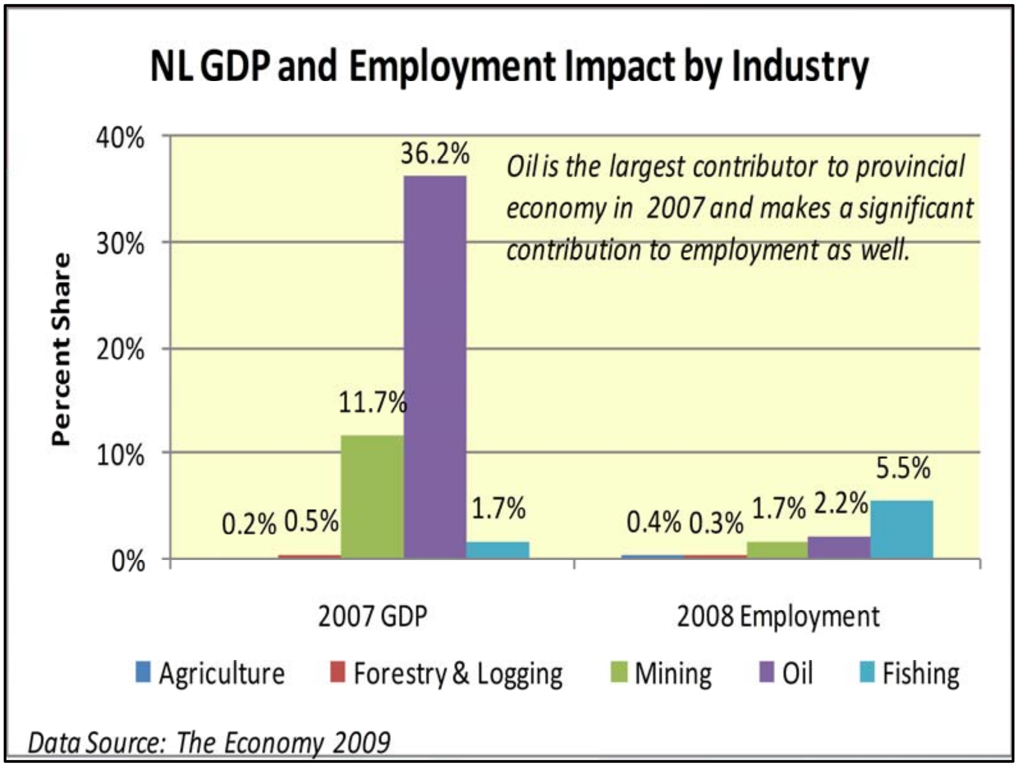
NL Economy Transformed by the Existence of the Atlantic Accord

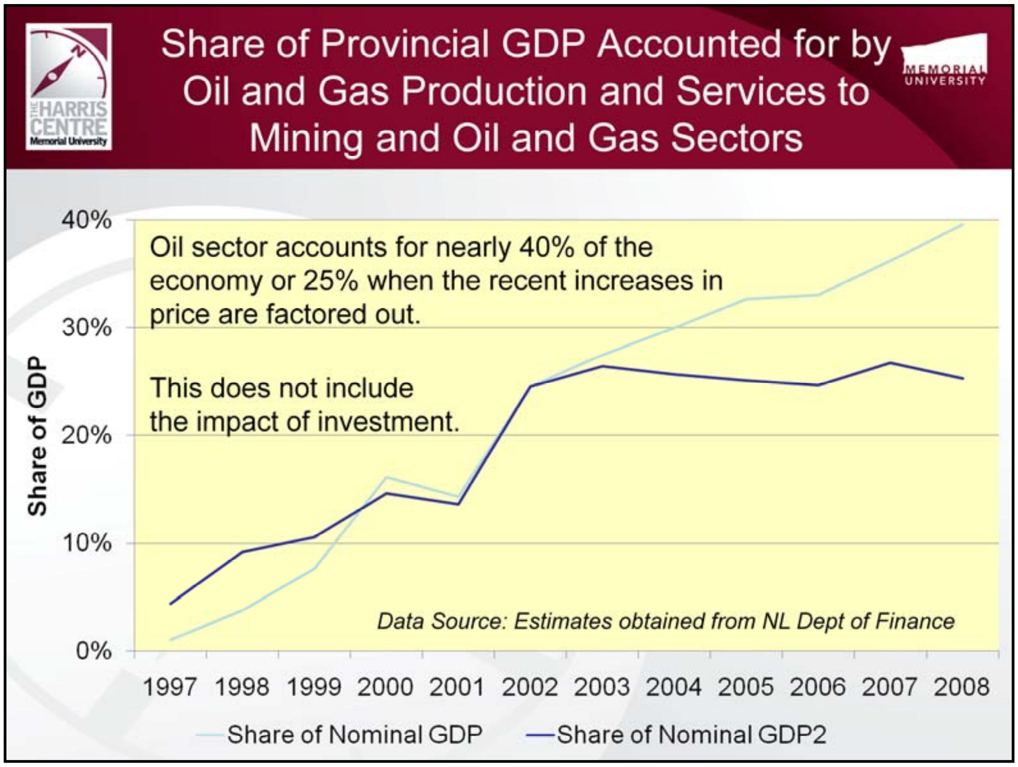
- Economic indicators have been positively affected.
- Fiscal parameters have significantly improved
- It has the potential to further facilitate prosperity and sustainability within the province, but this may require some planning.



Between 1999 and 2008 NL's nominal GDP growth exceeded all provinces, including Alberta

Increase in GDP/POP relative to national average is the largest turnaround in Canadian history


NL GDP and Employment Impact by Industry
40%
30%
20%
10%
0%
Percent Share
36.2%
Oil is the largest contributor to provincial economy in 2007 and makes a significant contribution to employment as well.
11.7%
0.2% 0.5%
1.7%
0.4% 0.3%
1.7% 2.2%
5.5%
2007 GDP
2008 Employment
Agriculture
Forestry & Logging
Mining
Oil
Fishing
Data Source: The Economy 2009

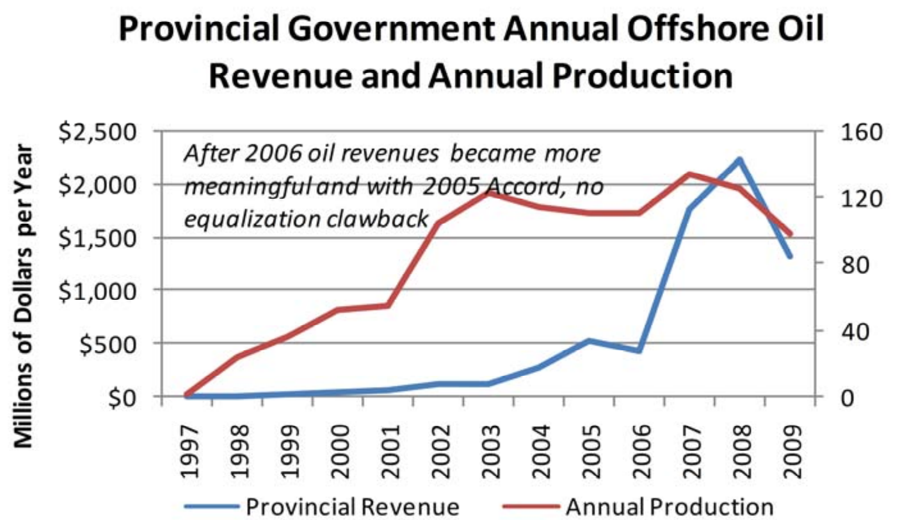


The oil and gas sector has been a dominant factor in the growth of economic activity within NL.

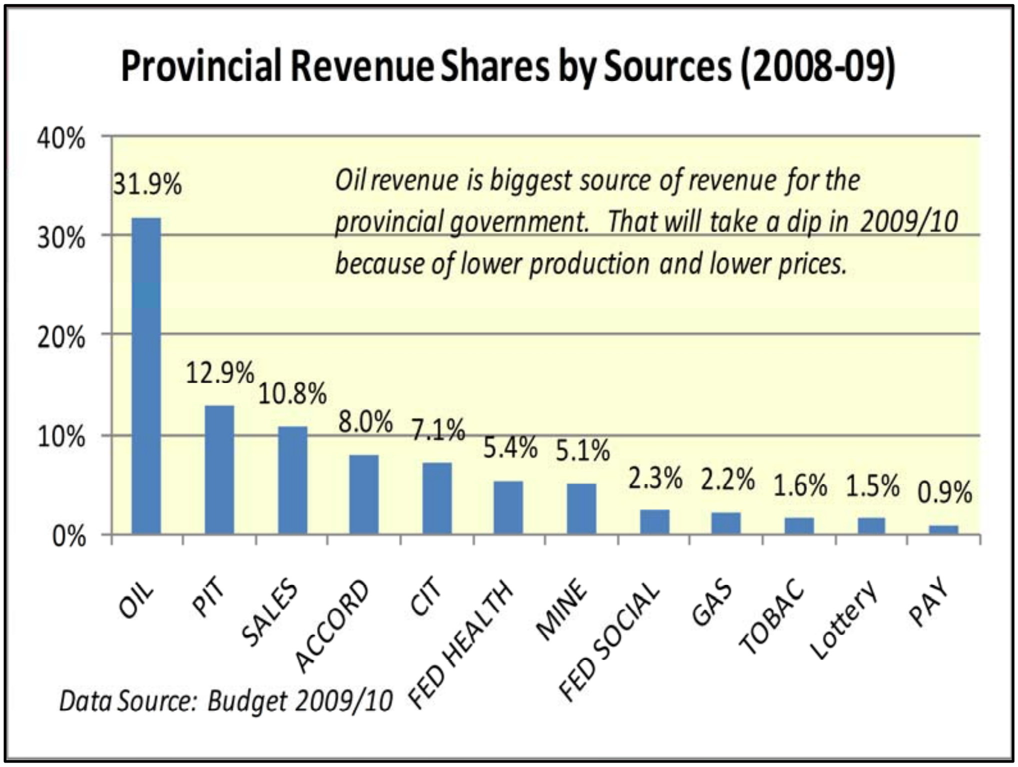
It accounts for 40% of nominal GDP in 2008, the last year for which I have data. As well, it accounts for 25% of real GDP.

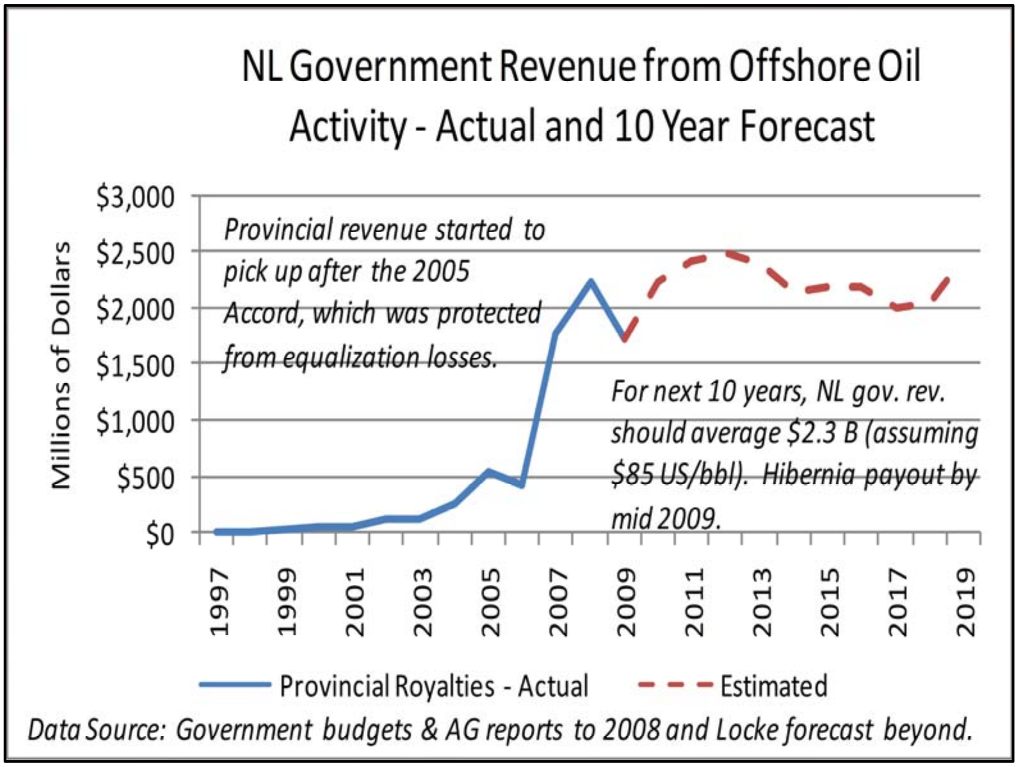
This difference illustrates the impact of the recent increase in the price of oil. This also explains the huge increase in government revenues.

Oil Revenue and Production

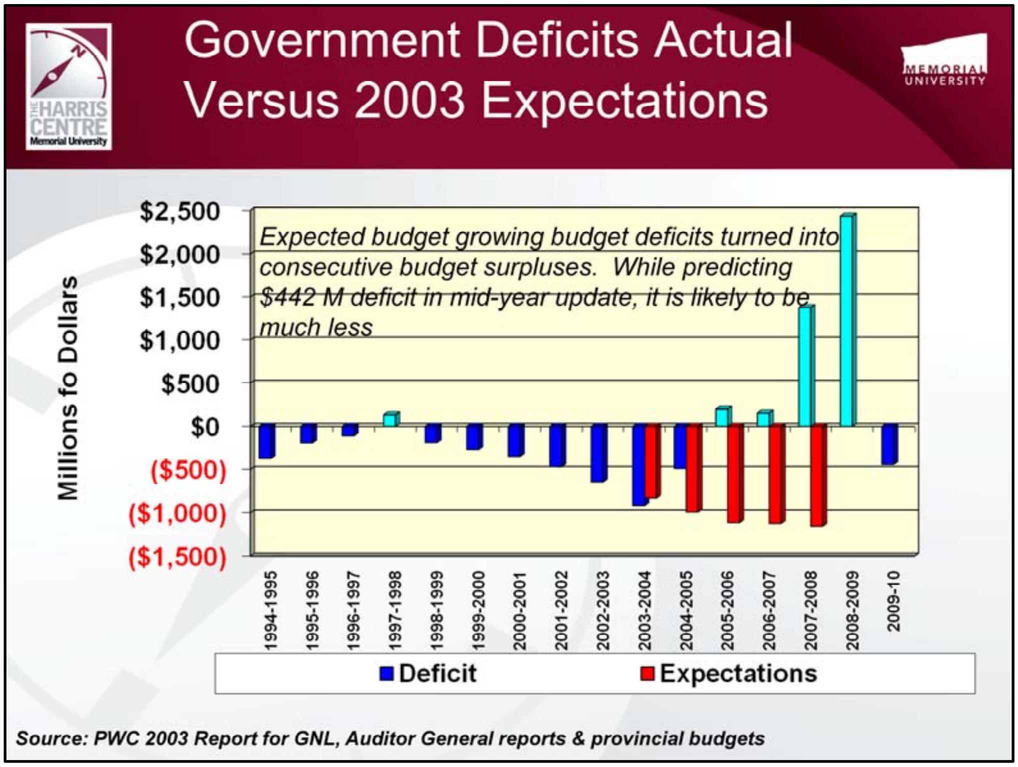


Data Source: Government budgets, AG reports and CNLOPB


Provincial Revenue Shares by Sources (2008-09)
40%
30%
20%
10%
0%
31.9%
12.9%
10.8%
8.0%
7.1%
5.4%
5.1%
2.3%
2.2%
1.6%
1.5%
0.9%
Oil revenue is biggest source of revenue for the provincial government. That will take a dip in 2009/10 because of lower production and lower prices.
OIL
PIT
SALES
ACCORD
CIT
FED HEALTH
MINE
FED SOCIAL
GAS
TOBAC
Lottery
PAY
Data Source: Budget 2009/10



NL Government Revenue from Offshore Oil Activity - Actual and 10 Year Forecast
Millions of Dollars
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0
Provincial revenue started to pick up after the 2005 Accord, which was protected from equalization losses.
For next 10 years, NL gov. rev. should average $2.3 B (assuming $85 US/bbl). Hibernia payout by mid 2009.
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015
2017
2019
Provincial Royalties - Actual
Estimated
Data Source: Government budgets & AG reports to 2008 and Locke forecast beyond.



Government Deficits Actual Versus 2003 Expectations
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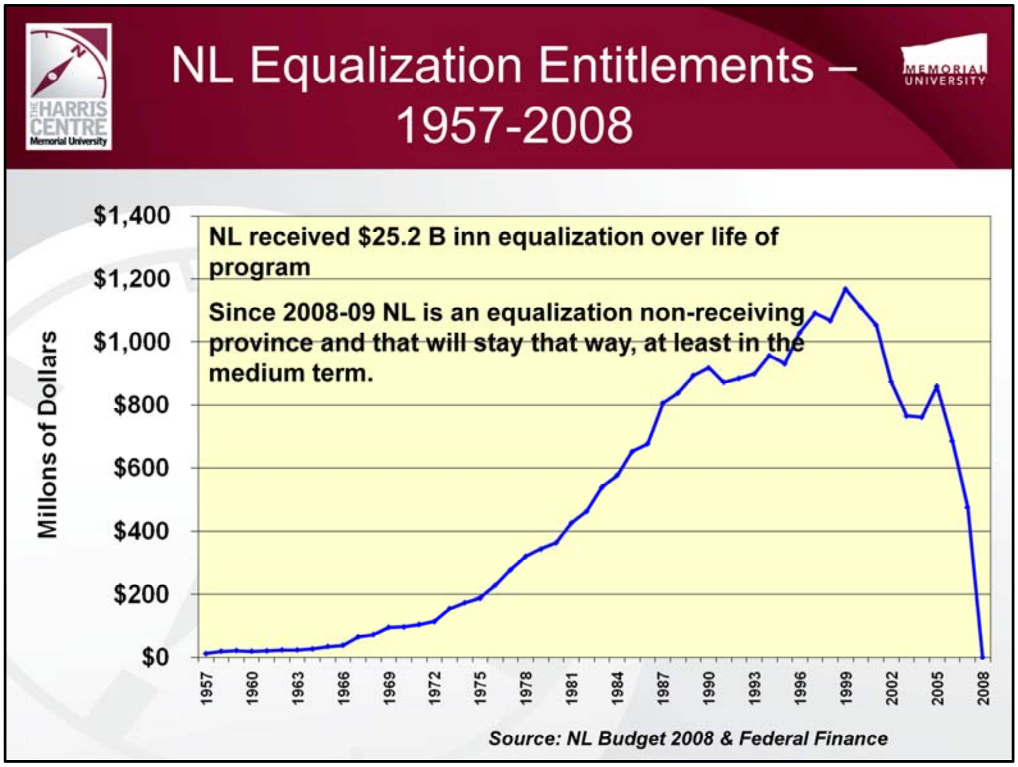
Expected budget growing budget deficits turned into consecutive budget surpluses. While predicting $442 M deficit in mid-year update, it is likely to be much less
Millions fo Dollars
$2,500
$2,000
$1,500
$1,000
$500
$0
($500)
($1,000)
($1,500)
1994-1995
1995-1996
1996-1997
1997-1998
1998-1999
1999-2000
2000-2001
2001-2002
2002-2003
2003-2004
2004-2005
2005-2006
2006-2007
2007-2008
2008-2009
2009-10
Deficit
Expectations
Source: PWC 2003 Report for GNL, Auditor General reports & provincial budgets


NL Equalization Entitlements – 1957-2008
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NL received $25.2 B inn equalization over life of program
Since 2008-09 NL is an equalization non-receiving province and that will stay that way, at least in the medium term.
Millons of Dollars
$1,400
$1,200
$1,000
$800
$600
$400
$200
$0
1957
1960
1963
1966
1969
1972
1975
1978
1981
1984
1987
1990
1993
1996
1999
2002
2005
2008
Source: NL Budget 2008 & Federal Finance

As a result of the Atlantic Accord, the federal government funded 75% and the provincial government funded 25% of an **offshore development fund (**$300 million). The purpose of the fund was to accelerate infrastructure development and defray social costs to enable the province to take advantage of opportunities created by the development of offshore oil and gas resources.

While I could not find a source that lists all of the projects funded, the Government of Newfoundland and Labrador's website indicates that there were 40 projects funded. These include funding for the CERR building ($27 M), Bull Arm Fabrication Facility ($95 M), Cow Head ($40 M), Marine Institute Southside Marine Base Training Centre ($3.1 M), Petroleum Technology Program at CNA ($2.6 M) Career Development Awards and Atlantic Accord Scholarships, and an Equity Fund to increase participation of women in offshore petroleum industry.

Most of these investments laid the ground work in terms of both physical and human capital that has facilitated the level and diversity of development that has occurred and is still occurring in NL today.

Section 92A of the Canadian constitution specifies that only natural resources located within a province come under provincial jurisdiction, leaving natural resources located in frontier areas or offshore regions to the federal government's control.

Even though offshore natural resources are constitutionally under the purview of the federal government, the Atlantic Accord enabled the **Government of NL to collect taxes and other revenues** from these offshore developments. Otherwise, they would have no right to collect taxes and royalties from offshore operations. These revenues comprise one-third of provincial government revenues and enabled NL to an equalization non-recipient province for the first time in our history.

The Atlantic Accord required a Benefits Plan be submitted before a Development Plan could be approved. This is important for a number of reasons that we will consider shortly.

The Atlantic Accord provided NL with the ability **to approve or not** fundamental decisions such as the operator's development plans as they related to choice of production system, the pace and timing of the implementation of the project if Canada was self sufficient in energy supply.

While not explicitly considered in the Atlantic Accord, the ability to approve or not fundamental decisions gave NL, if it wished to exercise it, implicit leverage to ensure that an operating consortium would negotiate local benefits with the province prior to submitting its Benefits Plan as part of its Development Plan. This enabled the province to secure an equity position in the White Rose extension and the Hebron project and a similar position is outlined in the Hibernia South MOU. As well, it has enabled the province to negotiate commitments that defined which aspects of offshore projects were to be or will be completed within the province.

The Atlantic Accord established **the CNLOPB in NL** to jointly manage and regulate offshore petroleum activities, with equal board representatives appointed by both levels of government and a jointly agreed upon chair or a mechanism for deciding on the chair when there is no agreement.

The establishment of a local board with a narrow and specific focus related to NL offshore resources, in my assessment, has been good for the province in that it has enabled the Board to develop the expertise that is necessary to ensure that the resources are managed in a manner that promotes "economic growth and development for the benefit of Newfoundland and Labrador in particular and to Canada as a whole".

An illustration of this is how the Board is responding to the need to provide seismic data in truly digital form after the 10 year time period is over. It is open to interpretation of how such data should be provided by the Board, but the Board appears to be sensitive to local needs of getting data in a convenient format to facilitate additional research and appraisal in NL's offshore.

The Atlantic Accord **protected offshore revenues** from dollar-for-dollar losses of provincial equalization entitlement enabling NL the fiscal wherewithal to kick-start economic development.

The Atlantic Accord mandated that **full and fair opportunity** be given to NL factors in terms of benefit opportunities created by offshore development. Specifically, first consideration be given to both services provided within NL and goods manufactured in NL subject to being competitive on the basis of fair market price, quality and deliverability

The Atlantic Accord specified that expenditures shall be made **for Research and Development and Education and Training** to be conducted within NL

The Atlantic Accord required that, subject to the Charter of Rights and Freedoms, **first consideration** are given to **NL residents for training and employment**

The Atlantic Accord specified that the offshore oil and gas activities were to be **managed in a manner that promoted economic growth and development** for the benefit of Newfoundland and Labrador in particular and to Canada as a whole.

The Atlantic Accord explicitly recognized the right of **Newfoundland and Labrador to be the principal beneficiary** of the oil and gas resources off its shores, consistent with the requirements for a strong and united Canada.

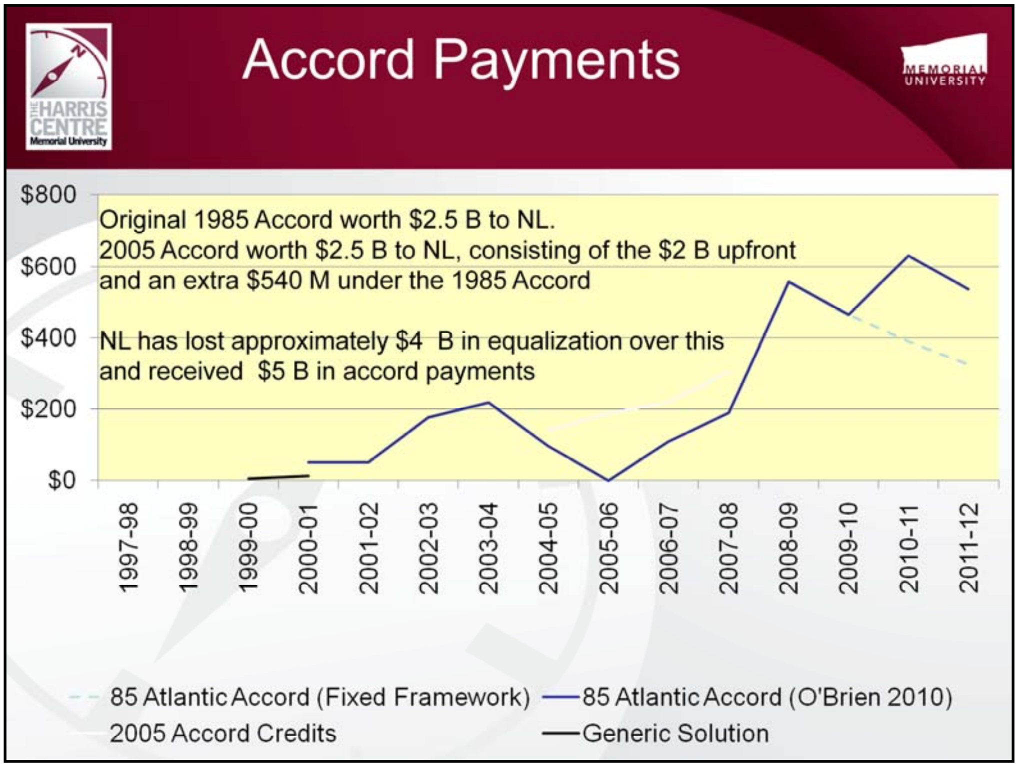
The Atlantic Accord specified that in relation to any prospective development, the Board shall conduct a public review.
The Board shall seek to ensure that all companies which operate in the offshore area establish offices in the province with appropriate levels of decision-making.

Equalization Offset Provision

- With equalization calculated using the 5-province standard in 1985, NL would have loss 100% of offshore revenues through reduced equalization. That is, a zero net gain, unless a non-recipient province.
- The Atlantic Accord provided offset payments to mitigate equalization claw back for 12 years from 1999-00 to 2010-11
  - With the 2005 Accord, the 1985 provisions were extended one year to 2011-12
- **Part I** – ensures that equalization plus Part I payments do not fall dramatically from between adjacent years (percentage protection determined by relative fiscal capacity)
- **Part II** – ensures province is compensated for percentage of any decrease in equalization entitlements plus Part I payments

Atlantic Accord Offset Percentages

	Part I	Part II		Part I	Part II
1999-00	95%	90%	2005-06	85%	60%
2000-01	95%	90%	2006-07	85%	50%
2001-02	95%	90%	2007-08	85%	40%
2002-03	95%	90%	2008-09	85%	30%
2003-04	90%	80%	2009-10	85%	20%
2004-05	85%	70%	2010-11	85%	10%
			2011-12	85%	0%



If NL stays with the Fixed Framework and does not switch to the O'Brien formula in 2010-11, then cumulative payments under the 1985 Accord will be $2.6 B.

If NL switches to the O'Brien formula in 2010-11, then cumulative payments under the 1985 Accord will be $3.1 B.

By switching in 2010-11, the province will receive an extra $450 M. Hence, when given the chance to switch next year, the province will opt for the O'Brien formula and be ahead by $450 M.

The original 1985 Accord would have provided $2.5 B in cash payments. With the signing of the 2005 Accord, NL will receive an extra year of payment under the 1985 Accord. This extra payment would be worth $540 M if NL switches next year.

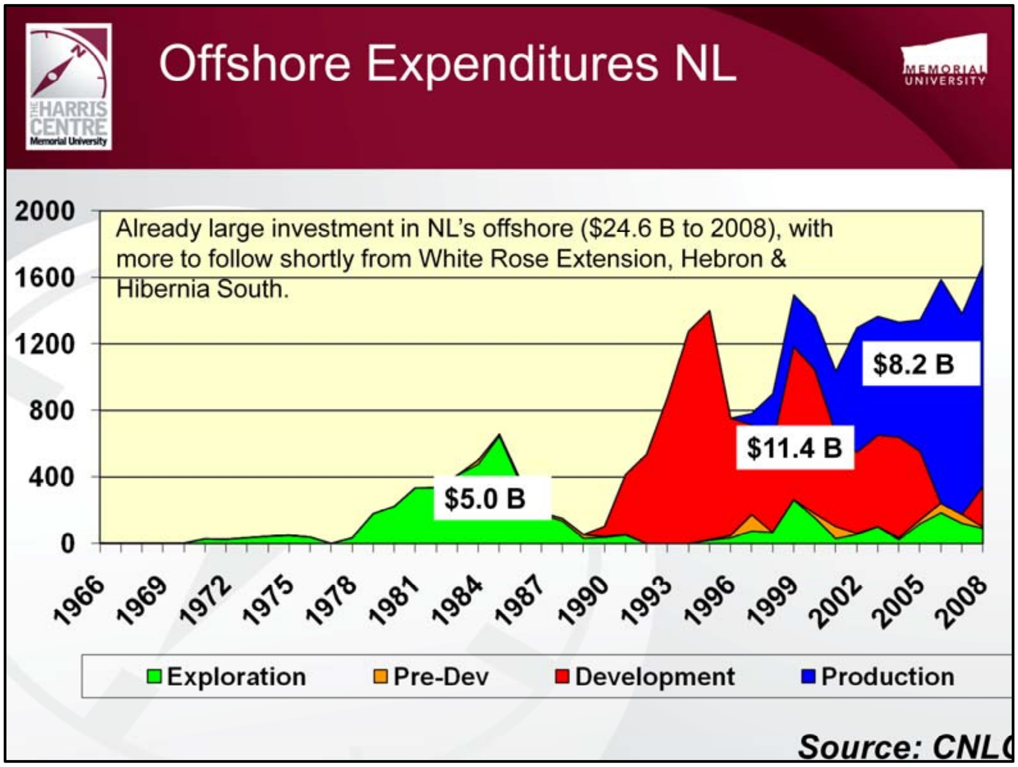
Therefore, the original 1985 Accord has provided and will continue to provide to the province a cumulative $2.5 B to 2010-11. The 2005 Accord paid $2 B up front and extended the payments under the 1985 Accord by one year, which will be worth $540 M in 2011-12 or the net value under the 2005 Accord is $2.5 B. Note, only $850 M of the original $2 B was accounted for by notional payments in the budget.

In addition, in 2000-01, we could have chosen the 1985 Accord offsets, but instead went with the generic solution. This caused payments to be $38 M lower than they could have been. The reason for this was at that time the option had to be chosen before data was finalized.

The final point to note is that to 2009-10, offshore oil revenues to the province has total slightly less than $8.0 B. Approximately $4.0 B of this has occurred since 2008-09 or we have received $5 B in combined accord payments and lost approximately $4 B in equalization payments prior to 2009-10. Effectively, we have more than 100% offset protection over this period from the Accords.

Full and Fair Opportunity

- The Atlantic Accord Benefit Guidelines outline a process for domestic workers and businesses to have the opportunity to participate on a competitive basis in the economic opportunities generated by offshore oil and gas activity in the offshore area.
- Moreover, these local benefits are expected to show **an increasingly positive trend of continuous improvement** as the industry and the local supply community evolves and matures.
- Furthermore, **any slippage** or deterioration in these measurements **from benchmarks** and achievements established by previous projects of similar scope, or similar concepts and technologies will require **significant explanatory documentation**.



Offshore Expenditures NL
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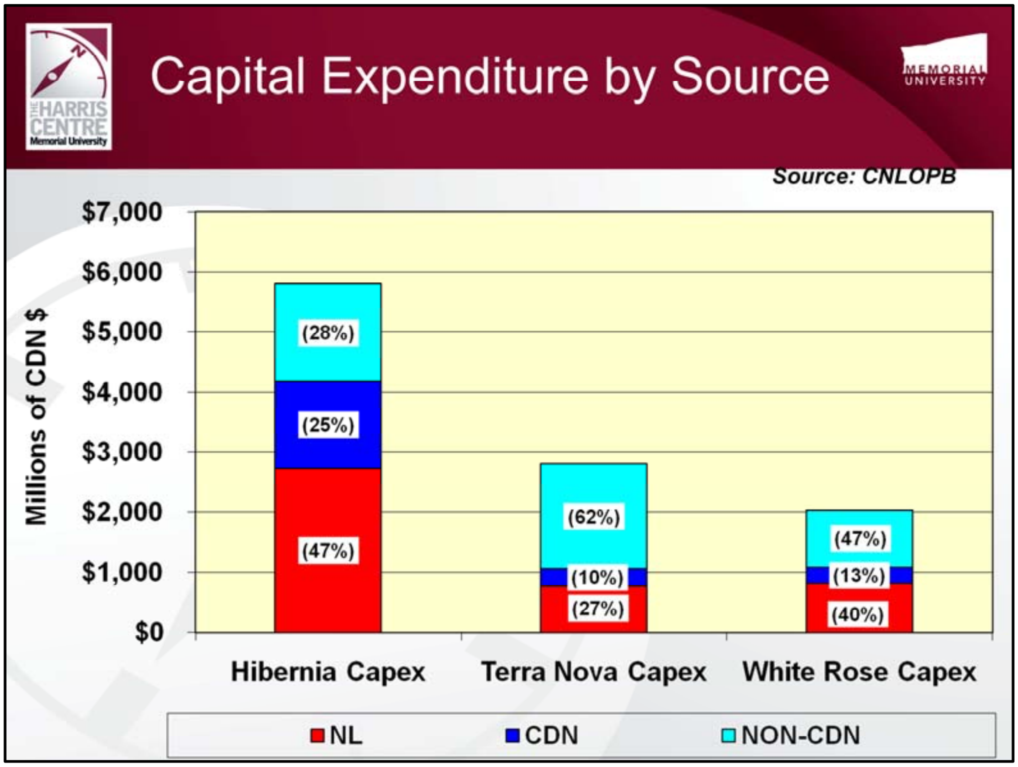
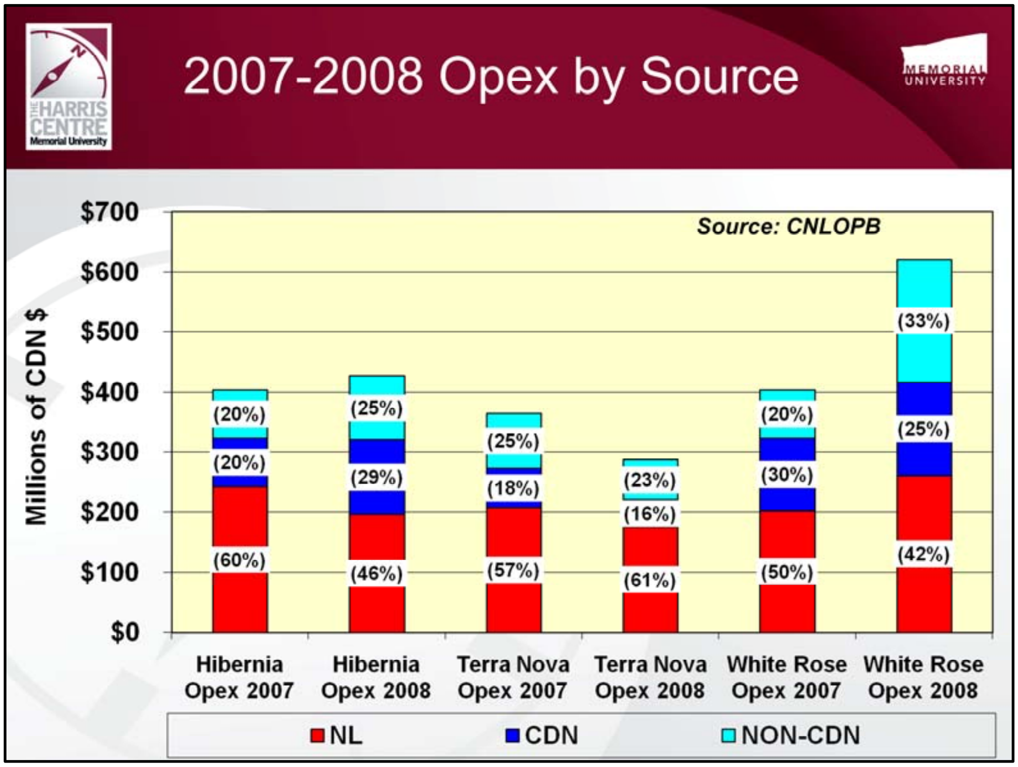
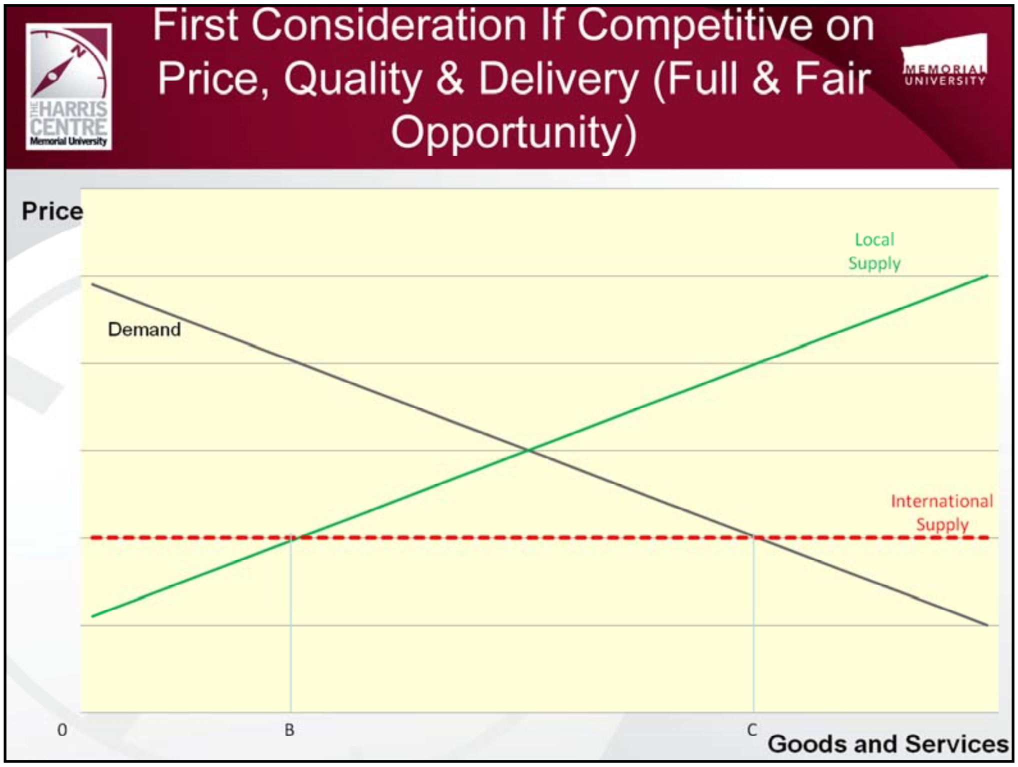
Memorial University
MEMORIAL UNIVERSITY
Already large investment in NL's offshore ($24.6 B to 2008), with more to follow shortly from White Rose Extension, Hebron & Hibernia South.
2000
1600
1200
800
400
0
$5.0 B
$11.4 B
$8.2 B
1966
1969
1972
1975
1978
1981
1984
1987
1990
1993
1996
1999
2002
2005
2008
Exploration
Pre-Dev
Development
Production
Source: CNL



Capital Expenditure by Source
THE HARRIS CENTRE
Memorial University
MEMORIAL UNIVERSITY
Source: CNLOPB
Millions of CDN $
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
(28%)
(25%)
(47%)
(62%)
(10%)
(27%)
(47%)
(13%)
(40%)
Hibernia Capex
Terra Nova Capex
White Rose Capex
NL
CDN
NON-CDN



2007-2008 Opex by Source
THE HARRIS CENTRE Memorial University
MEMORIAL UNIVERSITY
Source: CNLOPB
Millions of CDN $
$700
$600
$500
$400
$300
$200
$100
$0
(20%)
(20%)
(60%)
(25%)
(29%)
(46%)
(25%)
(18%)
(57%)
(23%)
(16%)
(61%)
(20%)
(30%)
(50%)
(33%)
(25%)
(42%)
Hibernia Opex 2007
Hibernia Opex 2008
Terra Nova Opex 2007
Terra Nova Opex 2008
White Rose Opex 2007
White Rose Opex 2008
NL
CDN
NON-CDN

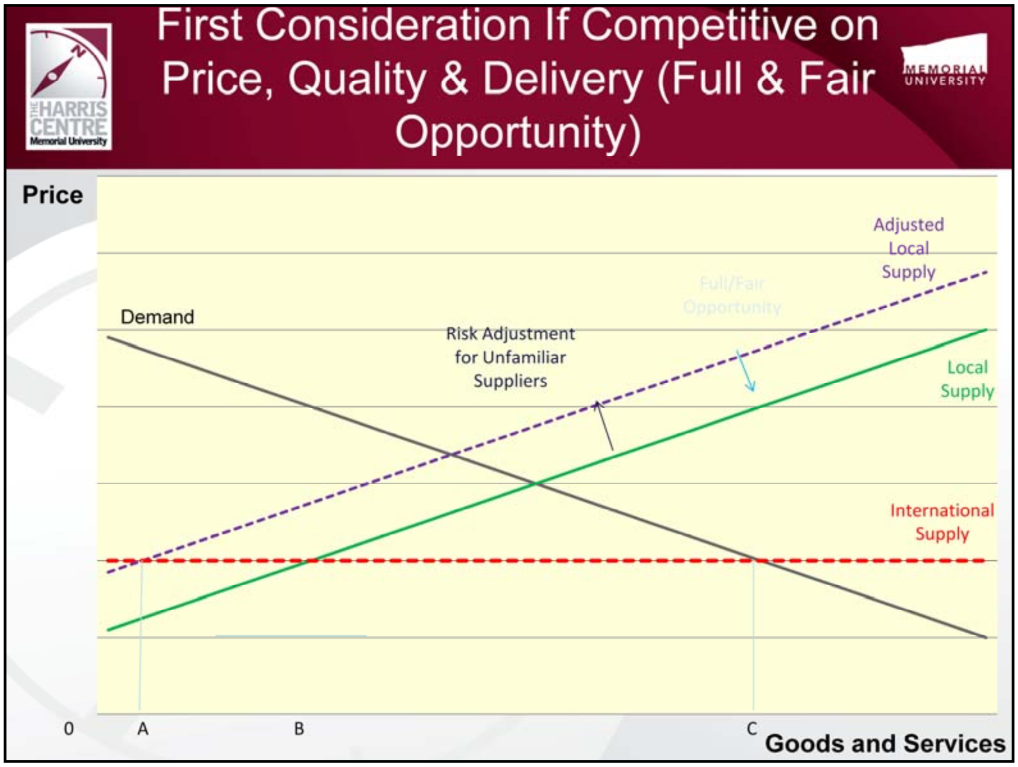


With the development and operation of petroleum projects in NL's offshore, there will be a demand for numerous goods and services. The higher the price for these goods and services, the smaller will the demand for these goods and services. This is reflected by a downward sloping demand curve, indicated by the blue line in the diagram.

There will be some international ability to supply these goods and services to the projects being developed and operated in offshore NL. Since the NL industry is not large by world standards (currently representing less than 0.4 of one percent of daily world production), it is not likely that the NL requirements will be sufficient to have any perceptible effect on prices in the international market. This is reflected by the horizontal red line in the diagram.

Even in the early stages of the industry, there will be some capacity of local firms and labour to satisfy some of the needs of the local industry. As well, this will grow as the industry matures and local firms gain experience. The higher is the price that can be commanded for supplying goods and services to the offshore industry, the greater will be the ability and willingness of local firms and labour to supply the local industry. This is represented by an upward sloping supply curve or the green line in the diagram.

Based on the ability to compete fairly on the basis of price, quality and deliverability, we would expect local firms to provide 0B of the goods and services needed and the international market place to supply the remaining BC of the goods and services.



However, Brown et al (2000, p.21) note that "where investors…have successfully won tenders to develop oil /gas field projects in foreign markets, they often bring their Scottish suppliers with them, resulting in 'pull through' of suppliers into markets they might not have entered independently." Additionally, Brown et al (2000, p 24-5) go on to further note that "North Sea subsidiaries are procuring not just for the North Sea markets, but often for other oil and gas markets and …make use of regular suppliers in the North Sea."

Cameron (1986, 17) warned that "unless the involvement of supplies companies is subject to a measure of supervision, there is a risk that industry in the host country will not benefit from spinoff activities associated with field development."

Because of the uncertainty of doing business with new firms or because of the comfort level associated with utilizing known firms or because of habit-persistence, the bureaucrats in the oil and gas industry might choose to go with a supplier that they have dealt with in the past, rather than risk going with a new supplier. In this circumstance, the oil and gas companies might assign an additional risk premium to dealing with new Atlantic Canadian suppliers that they do not know.

This was recognized in Atlantic Energy Roundtable (2002, p.15), where it was suggested that "when a major contractor has not dealt with the local service and supply industry and must assess the experience of a local bidder, it [lack of experience] may be seen as a risk…"

As well, Weatherill (2003) noted that "using local suppliers and contractors usually entails some cost and delay in the short term…"

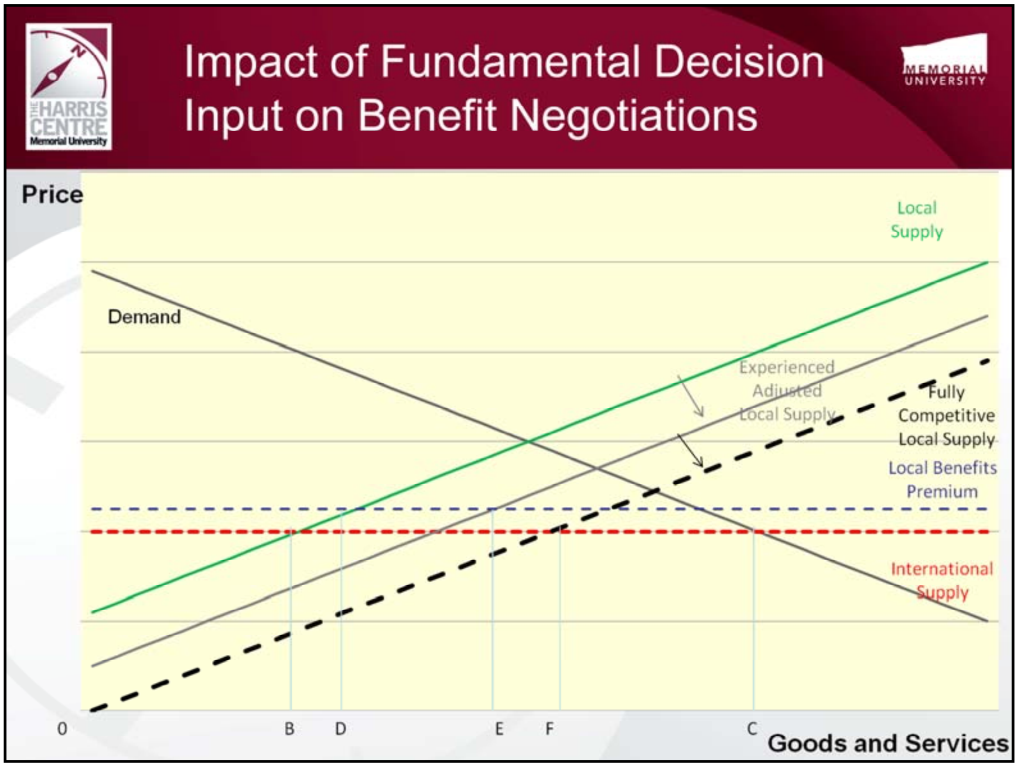
Brown et al. (2000, p.21) "investors may find …that there are advantages to working…with firms where a long-term working relationship has already been established.

Ramm (2002) notes that Norwegian suppliers "piggy back" on oil companies and enter other markets through their past association with oil and gas companies.

Cameron (1986, p. 10) suggested that oil companies use firms that they know because of the potential cost implications for the oil companies that could be associated with going with a supply firm that they do not know.

Adding a risk premium for dealing with unknown local firms, the oil and gas developers and operators would see the dashed purple line as reflecting the risk-adjusted local capabilities and as such, local supply will be OA and the rest, AC will be imported.

Full and fair opportunity makes it difficult to discriminate against competitive local firms. It ensures that the green supply curve will be appropriately considered and NL workers and business full and fair opportunity to bid on offshore tenders, resulting in OB of the goods and services being supplied locally and BC being imported.



While the full and fair opportunity, if properly administered and reacted to, should ensure that local companies and workers supply 0B of the goods and services and international firms will supply BC of the goods and services needed to develop and operate the offshore, the right of the Government of NL under the Atlantic Accord to not approve fundamental decisions of the CNLOPB, which included the operator's development plans as they related to choice of production system, the pace and timing of the implementation of the project, etc., gives the government of NL another tool for enhancing local benefits.

Without this NL approval of the Development Plan and the Benefits Plan, no project could proceed and, as such, it provides a strong incentive for operators to ensure that they have a on the same page with the NL Government when it comes to local benefits that will fall to the province in both the development and operating stages.

This is represented by a local benefit premium (the orange dashed line in the above diagram) that can be extracted from these developments to ensure that extra benefits occur locally. By way of illustration, this commitment could be in terms of engineering, the fabrication of specific modules, an equity position that involves a working interest for the government at some specific and agreed on price or enhanced royalties.

If local activities are not too costly (on or below the orange line), then local supply capability will increase to 0D.

But, local firms and businesses will learn-by-doing and increase their productivity and be more cost competitive, which is reflected by the grey supply curve that is lower than the green curve. With the local improved competitiveness, NL businesses and labour will increase their penetration of the oil and gas industry and will supply OE, leaving only EC to be supplied by international firms.

As the industry continues to mature and learn and/or as supplier development initiatives are undertaken, local firms will be competitive with international firms and will supply 0F. Moreover, some local firms will be able to exports their skills and technology internationally.

The caveat here is that if we push the economy past its capacity to absorb additional industrial activity, costs will rise and some of the rents that would be collected through royalties will be dissipated. Example of this can be found in Alberta and Australia where cost escalation of oil and gas projects is a concern.

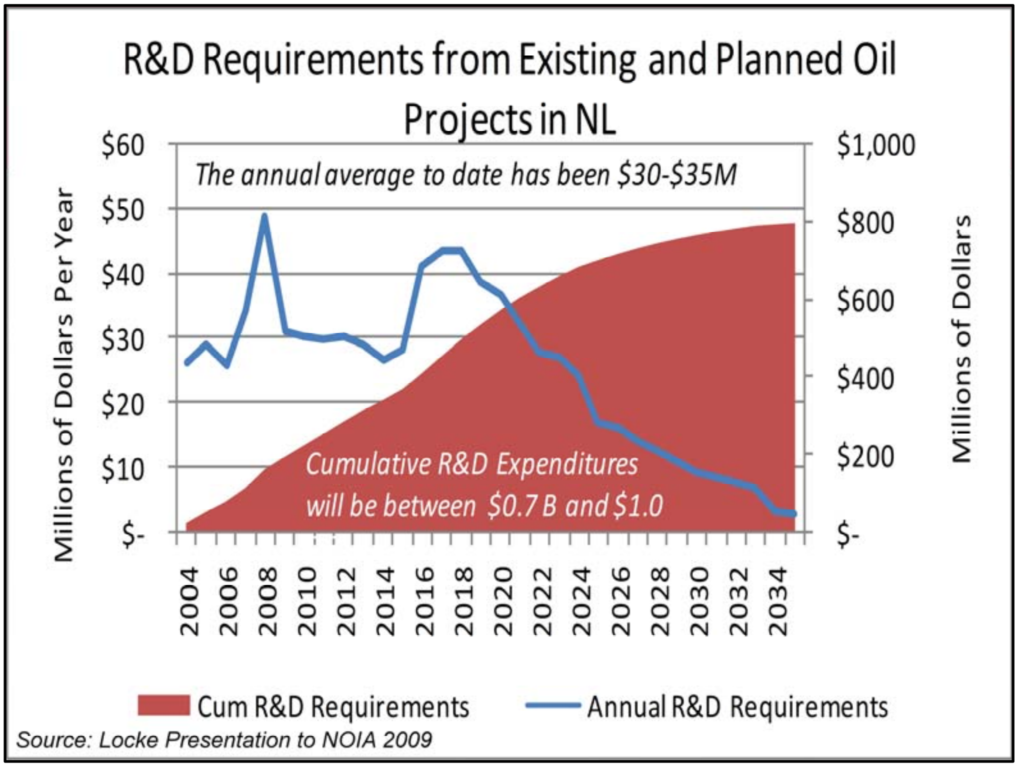
It is a balancing act – you want to optimize local benefits without dissipating rents.

NL as a Gateway to Arctic Resources

- The US Energy Information Administration, in its October 19, 2009 report entitled: Arctic Oil and Natural Gas Potential, noted that:
- "the Arctic holds about 22 percent of the world's undiscovered conventional oil and natural gas resource base, about 30 percent of the world's undiscovered natural gas resources, about 13 percent of the world's undiscovered oil resources, and about 20 percent of the world NGL resources."
- Big prize for those who unlock the Arctic puzzle

NL as a Gateway to Arctic Resources

- Given:
  - NL's proximity to the Arctic;
  - how we have met the challenges for ice, icebergs and harsh ocean environments on the Grand Banks;
  - the harsh climate challenges that it will face in developing its gas fields off Labrador and the lessons we will learn;
  - the research expertise currently resident at C-CORE and MUN's Faculty of Engineering
- Newfoundland and Labrador is the natural gateway for the exploitation of resources in the Arctic
- It can also act as a conduit for the research and development needed to overcome the Arctic challenges.


R&D Requirements from Existing and Planned Oil Projects in NL
The annual average to date has been $30-$35M
Cumulative R&D Expenditures will be between $0.7 B and $1.0
Millions of Dollars Per Year
$60
$50
$40
$30
$20
$10
$-
$1,000
$800
$600
$400
$200
$-
Millions of Dollars
2004
2006
2008
2010
2012
2014
2016
2018
2020
2022
2024
2026
2028
2030
2032
2034
Cum R&D Requirements
Annual R&D Requirements
Source: Locke Presentation to NOIA 2009

R&D, E&T and Knowledge

- Exploiting knowledge and innovation are crucial to ensuring sustained prosperity
- The province's Research Development Council will help
- Memorial University and the College of the North Atlantic will be integral components
- MUN has recently been recognized "*as the top Canadian medical/doctoral university for growth in research funding over the period 2002-2007*."
- The enhanced research funding resulting from CNLOPB guidelines will be an impetuous for expanded benefits and enhanced growth in innovative capacity
  - Anywhere from $500 M to $1 B, depending on assumptions
- R&D, E&T and Knowledge transfer will effectively expand our economic natural resource base

Concerns with the Accord

- It is not easy to change so difficult to have quick response to changing needs of a maturing and evolving industry
  - Alignment between 3 governments (NL, NS and Fed) not easy
- Access to infrastructure under reasonable financial terms is not guaranteed, but the White Rose extension and the Hibernia South MOU do indicated that when commercial interest are aligned, this can happen.
  - No requirement under the Accord that this occur if there is capacity and it may impede the development of some of the smaller fields if acceptable commercial terms can not be arranged.
- Infinitely-lived SDLs is an issue. While the accelerating rental rate for new SDLs will take care of land banking incentives, it does nothing to the incentives for grandfathered SDLs.
- To facilitate public input, the CNLOPB should make available an historic series of benefit shares on their website and include R&D/E&T requirements and what has been met to date

Conclusion

- The Atlantic Accord has been one of the most significant documents in NL since the Terms of Union with Canada.
- It has enabled the economic and fiscal transformation of NL to occur.
- It provides an opportunity for NL to continue to prosper from the offshore oil and gas resources adjacent to its shores and to develop knowledge and expertise that can be exported to other areas of the world.
- Whatever concerns or changes one might consider, it is clear that these would be fine tuning . We got this right and we should celebrate its 25^{th} anniversary!

Thank you for letting me share my thoughts