

Case Study From



North Atlantic Canada: Local Content Requirements¹

Canada, like many other countries, is focusing on local content requirements (employment, training and purchase of goods or services) for companies that want to develop its oil and gas resources. In Canada, especially in the provinces of Newfoundland and Nova Scotia, where this issue has developed, the Offshore Petroleum Boards are the ones that require companies to submit documentation with information about benefits for the provinces.

➤ Is it riskier to undertake any development project in North Atlantic Canada?

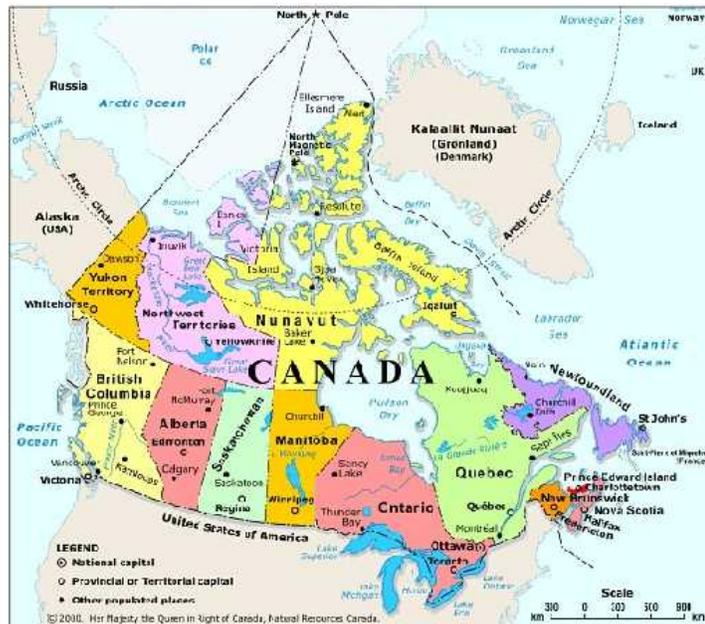
- How do local content requirements affect the cost structure of companies?
- What are some worldwide trends related to local content requirements?

Background ²

Canada is a significant energy exporter, and part of the current Canadian economic boom results from high world energy prices. In 2000, energy accounted for almost two-thirds of Canada's large trade surplus. Canada is one of the few highly industrialized economies that benefits from higher world oil and other energy prices. However, revenues flow mostly into the energy-rich province of Alberta, while the average Canadian consumer pays higher energy prices. Canada has become a significant net energy exporter. In 2001, the United States imported more oil (including crude oil and petroleum products) from Canada than from any other country. The United States also consumes large amounts of Canadian natural gas, which accounted for 93% of U.S. gas imports and 14% of U.S. gas consumption in 2001.

Oil

Canada has proven oil reserves of 4.4 billion barrels, as of January 2002. Oil production averaged 2.8 million barrels per day (b/d) on 2001, with estimated



¹ This case study was prepared using publicly available information.

² From www.eia.doe.gov

consumption of 2.0 million b/d. Alberta, in western Canada, is by far the country's leading oil producer, accounting for almost 60% of Canadian oil production in 1999. However, the province now faces decreasing reserves. Meanwhile, projects and potential projects in other provinces are shifting the oil industry focus to include the eastern and northern parts of the country. The Canadian oil industry is in the midst of consolidation, reducing the number of active companies. The largest companies operating in Canada are Exxon's Imperial Oil, Royal Dutch/Shell's Shell Canada, Petro-Canada, and Suncor. Mobil also is active in Canada, and there are no plans to merge ExxonMobil's Canadian affiliates.

There has been considerable exploration activity throughout Canada, not just in the traditional producing province of Alberta. In remote northwestern Canada, parts of the Mackenzie Delta and Beaufort Sea will be explored by: Anderson Exploration and Petro-Canada (jointly); Shell Canada; BP Canada Energy, Burlington Resources, and Chevron Canada Resources (jointly); Anadarko Canada; and EOG Resources Canada. On the east coast, reserves in the Jeanne d'Arc Basin on the Grand Banks, offshore Newfoundland, have increased by 33% (536 million barrels) in the Hibernia, Hebron, and White Rose fields. The first project in the area, the Hibernia field, came onstream in 1997 and currently produces 150,000 b/d of light, sweet crude. ExxonMobil is the operator. The area's second project, Terra Nova, began production in January 2002 after several delays, currently has a capacity of 110,000 b/d and is expected to produce for about 15 years. The White Rose field is expected to be the third Grand Banks development, beginning production in 2004, although there are concerns that development will be prohibitively expensive. Finally, the Hebron field could prove worthy of development.

There is an extensive pipeline system to transport western oil to eastern Canadian and U.S. markets. There are two major pipeline networks. The first is Enbridge Pipelines Inc. (formerly Interprovincial Pipe Line-IPL), an 8,700-mile network of piping and terminals, delivering oil from Edmonton, east to Montreal and eastern Canada and the U.S. Great Lakes refineries and markets. The other major pipeline system is the Trans Mountain Pipe Line (TMPL), which delivers oil mainly from Alberta west to refineries and terminals in the Vancouver area, as well as to the Puget Sound area of Washington State.

Natural Gas

Canada holds about 60 trillion cubic feet (Tcf) of proven natural gas reserves, and additional reserves are thought to lie off the Canada's eastern coast between Newfoundland and Nova Scotia. Canada currently produces about 6.3 Tcf of natural gas per year, making it the world's third largest gas producer (after the United States and Russia) and second largest gas exporter (after Russia). Canada's gas exports go almost exclusively to the United States. Canadian gas consumption is projected to grow significantly in coming decades, largely for use in electricity generation. As natural gas production and infrastructure grow, there is a potential for emergence of a unified North American natural gas market.

Like the oil industry, Canada's natural gas industry is based primarily in Alberta, reaching into neighboring Saskatchewan, British Columbia, and the southern Northwest Territories. Another important industry focal point is offshore Atlantic Canada. Nova Scotia's Sable Island reserves are estimated at 0.8 Tcf. Offshore Newfoundland is thought to hold as much as 18.8 Tcf between the Jeanne d'Arc Basin (home to the Hibernia oil project) and the Ridge Complex. Sable Island Offshore Energy, a consortium led by Mobil Canada and including Shell Canada, Imperial Oil, Nova Scotia Resources and Mosbacher Operating, began production in January 2000. About 420 million cubic feet per day of natural gas is pumped from three reservoirs at Sable Island's Thebaud platform. The Arctic Northwest Territories and the Yukon are thought to hold great potential for new gas discoveries.

There has been considerable progress in recent years on gas interconnections between Canada and the United States. The Northern Border Pipeline, an extension of the Nova

Pipeline, came onstream in late 1999 and connects to Chicago through the upper Midwest. The Maritimes and Northeast Pipeline came onstream in January 2000, running from Sable Island to New England. The Alliance Pipeline is a \$2.5-billion, 1,875-mile pipeline, the longest ever built in North America, and is designed to carry about 1.3 billion cubic feet per day (Bcf/d) of gas from western Canada (Fort St. John, British Columbia) to the Chicago area. The pipeline began commercial service on December 1, 2000. The Millennium Pipeline remains in the regulatory approval stage of development; it is slated to connect Canadian sources to southern New York and Pennsylvania. Exploration and production activity in the Mackenzie Delta, Beaufort Sea, and Alaskan North Slope has sparked interest in an Arctic pipeline.

As Canada's energy interests shift to its northern and eastern regions, there is a need to understand what the provinces in those regions have experienced in the past to fully comprehend the magnitude of the local content requirements that certain organizations propose.

Emergence of the Atlantic Canada Offshore Industry³

From 1889 to 1912, federal lands owned by all Canadians were given to Quebec and Ontario. These were lands rich with sub-soil resources and great rivers which provide huge hydro electric capacity. In the 1930's British Columbia, Alberta and Saskatchewan were specifically granted valuable subsoil mineral rights. Prior to that these sub-soil rights belonged to all Canadians. When a similar expansion occurred with the 1976 Law of the Sea Convention and the 200-mile economic zone, Nova Scotia and Newfoundland believed the same principles should apply. The federal government disagreed and the matter ended up in court. Most of the provinces intervened on the side of Newfoundland, but the Supreme Court of Canada ruled in favor of the federal case. As a result of these differences, there was a deadlock in the offshore at the operating and management levels.

Atlantic Canada's offshore petroleum industry moved forward only after the Government of Canada and the Governments of Nova Scotia and Newfoundland and Labrador negotiated a pair of offshore accords in the mid 1980's. In the latter half of this decade the royalties from the Sable Project alone are projected to be approximately \$300 million a year. In Newfoundland their royalties could reach \$800 million a year. Very large financial numbers in relation to the size of provincial operating budgets. The problem is that for every dollar that flows to governments, the federal government is set to gain more than 80 cents. Nova Scotia on the other hand is set to gain less than 20. The result is that Nova Scotia is not the primary beneficiary of offshore development.

There are difficulties in trying to effect change. For example, the Canada Nova Scotia Offshore Petroleum Board (CNSOPB) is governed by two statutes these statutes, one federal and one provincial are "mirror legislation." Any change would need to be endorsed by both levels of government. However, the federal government would have a complementary interest in legislation effecting Newfoundland where they essentially have the same "mirror legislation" with the Newfoundland Offshore Petroleum Board (CNOPB). The fact that there are two offshore boards in Nova Scotia and in Newfoundland is a reflection of the fact that there is a significant jurisdictional debate.

At the present time the industry deals with a number of federal and provincial agencies, each of who deals with their own area of responsibility for example;

Provincial Departments & Agencies

³ From www.otans.com

- Department of the Environment and Labour
- Department of Natural Resources
- Nova Scotia Petroleum Directorate
- Department of Agriculture and Fisheries
- Nova Scotia Utilities and Review Board

Federal Departments & Agencies

- Human Resources Development Canada
- Canadian Coast Guard
- Canada Customs and Revenue Agency
- Canadian Environmental Assessment Act
- Department of Fisheries and Ocean Canada
- Environment Canada
- Natural Resources Canada
- Citizenship and Immigration Canada.¹²

Joint Federal – Provincial Agencies

- Canada-Nova Scotia Offshore Petroleum Board
- Canada-Newfoundland Offshore Petroleum Board

Canada Royalties

Payments made by producers to owners are termed *royalties*. Royalty instruments take various forms, such as lease bonuses, gross production shares, and profit sharing. The resource value on which royalties are ultimately predicated is *economic rent* – the value at the point of sale less economic costs of production. The two main methods to acquire rents are up-front payments and a flow of payments over time. Of the various royalty instruments, the most relevant in the context of the Atlantic Provinces regimes are gross royalties and resource rent royalties. A resource rent royalty (RRR) taxes resource profits above a stipulated floor level. It involves specification of a threshold return representing normal profits, no tax on returns up to the threshold, and a relatively high tax on returns in excess of it. Because a single threshold rate introduces bias in the presence of differential project risk, setting the appropriate threshold rate(s) is a major issue with an RRR.

Newfoundland's gross royalties are more lenient at earlier stages and more severe at maturity. Nova Scotia's net royalty rates are higher at higher profitability levels, but are imposed after award of more generous return allowances. Cost eligibility is much the same, except that Newfoundland allows compounding of return allowances. But Newfoundland does not provide relief for high-risk projects as does Nova Scotia. The royalty regimes in both Nova Scotia and Newfoundland are competitive when compared with relevant international practice. Thus the regimes are not vulnerable to criticism that the governments are not getting fair value for the resources on behalf of their citizens. By the same token, the fact that industry has endorsed the regimes and is making investments under them suggests there is no compelling need for reductions. Governments are not trying to grab too much and producers are not enjoying a free ride.

Local Content Requirements

In the provinces of Newfoundland and Nova Scotia a trend to increase local content requirements has developed. Below are some relevant aspects for each province.

Newfoundland⁴

Section 45 of the Atlantic Accord Implementation Acts require that before any work or activity is authorized in the offshore area, a Canada-Newfoundland benefits plan must be approved by the Board. In general terms, a benefits plan must describe a plan for the employment of Canadians and, in particular, members of the labour force of the province; and for providing manufacturers, consultants, contractors, and service companies in the province and other parts of Canada with a fair opportunity to participate on a competitive basis in the supply of goods and services.

A benefits plan must also contain specific provisions to ensure that:

- Before carrying out any work or activity in the offshore area, the proponent shall establish an office in the province where appropriate levels of decision-making are to take place;
- Individuals resident in the province shall be given first consideration for training and employment;
- Expenditures shall be made for research and development to be carried out in the province and for education and training to be provided in the province; and
- First consideration shall be given to services provided from within the province and to goods manufactured in the province, where those services and goods are competitive in terms of fair market price, quality and delivery.

However, the Board cannot exceed its authority under the federal and provincial Atlantic Accord legislation by forcing proponents to enter into contracts for goods or services which are not competitive.

Nova Scotia⁵

Under the Accord legislation, a Canada - Nova Scotia Benefits Plan must be submitted and approved before any work authorization is granted. Every application for a work authorization, whether it's geophysical or drilling, requires a Canada - Nova Scotia Benefits Plan, unless that requirement is waived by the Board. Each benefits plan must commit to the fundamental principles laid out in the Accord Acts. Those fundamental principles include full and fair opportunity and first consideration for residents of Nova Scotia and companies in Nova Scotia. A benefits plan must show a commitment to provide manufacturers, consultants, contractors and service companies in Nova Scotia and other parts of Canada with a full and fair opportunity to participate on a competitive basis. The plan must also indicate how the operator will provide employment of Canadians and in particular members of the labour force of Nova Scotia. The plan must show that residents of the province will be given first consideration for training and employment. In addition, there must be a commitment to give first consideration to services provided from within Nova Scotia and goods manufactured in the province where those services and goods are competitive in terms of fair market price, quality and delivery. Other matters to be addressed by the benefits plan include establishing an office in the province with the appropriate level of

⁴ from www.cnopb.com

⁵ from www.cnsopb.com

decision making and the promotion of education, training, research and development in the province.

Each Benefits Plan shall address the following statutory requirements and confirm the operator's commitments as to:

1. Opportunity

To provide . . . *"manufacturers, consultants, contractors and service companies in the Province and other parts of Canada with a full and fair opportunity to participate on a competitive basis in the supply of goods and services used in any proposed work or activity"* . . .

2. Employment

To provide for . . . *"the employment of Canadians, and, in particular, members of the labour force of the Province". . . More specifically . . . "consistent with the Canadian Charter of Rights and Freedoms, individuals resident in the Province be given first consideration for training and employment"* . . .

In addition, provide for . . . *"disadvantaged individuals or groups to have access to training and employment opportunities and"* . . . *"to participate in the supply of goods and services used in any proposed work or activity"* . . .

3. Procurement

. . . *"first consideration is (to be) given to services provided from within the Province and to goods manufactured in the Province where those services and goods are competitive in terms of fair market price, quality and delivery"* . . .

4. Education & Training; Research & Development

. . . *"a program be carried out and expenditures be made for the promotion of education and training and of research and development in the Province in relation to petroleum resource activities in the offshore area"* . . .

5. Establishment of Office

. . . *"the corporation or other body submitting the plan shall establish in the Province where appropriate levels of decision making are to take place;"* . . .

Thus far, even though the Offshore Petroleum Board of Newfoundland and the Offshore Petroleum Board of Nova Scotia included local content requirements, major oil companies have not altered their plans to explore and develop in Canada. However, a number of factors have contributed to investor intentions, not least of which is Atlantic Canada's proximity to high demand areas in the northeastern U.S. However, announcements during the first half of 2002 of downward reserve adjustments by operating companies are expected to place some pressure on the provinces with respect to local content promotion.

By comparison, local content requirements caused various reactions in different countries. For example:

- In Nigeria, the government with the help of major oil companies such as Chevron has increased local content and indigenous participation in the oil and gas sector. "Since 1996 government has initiated a policy where 40 % of contract in the joint venture operation of the multi-national companies in the upstream are reserved for local oil service companies... Already, government local content policy has begun to yield results. This year alone (2001), companies like Relentech, Filco, Drilllog, Petro Dynamics, Hexagon Petrol Services, Weafri and Sowsco have benefited from Chevron Nigeria joint venture contract in drilling and other related activities. More indigenous

oil service companies are also securing good contracts from other joint venture operators.”⁶

- In Brazil, it appears that government requirements have been too rigid. Various prohibitions restrict foreign investment in petroleum production and refining. Brazil also limits foreign equity participation, imposes local content requirements and links incentives to export performance. Foreign ownership of land in rural areas and adjacent to international borders is prohibited.
- In Australia relevant industry organizations are working together to facilitate participation of local industry in resources and energy projects. The Industrial Supplies Office (ISO) network has a central role in this process of matching local capability with the needs of industry. ISONET is a national body coordinating the network of ISO offices in every State and Territory of Australia and New Zealand. ISOs and ISONET are independently managed, non-profit organizations financially supported by Australian, New Zealand and State/Territory Governments.⁷
- In the UK, the Association of British Independent Oil Exploration Companies promotes the role played by British independent exploration and production (E&P) companies in maintaining a powerful and effective UK based oil and gas industry. Britain remains the only European country in which a substantial, independent E&P sector has been established.⁸

⁶ Alexander Gas and Oil Connections Volume 6, issue #16 - 28-08-2001

⁷ From www.industry.gov.au

⁸ From www.brindex.co.uk