Beaulieu and Saunders: How Ottawa's policy is hurting the oilsands

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The ratification of the Canada-China Foreign Investment Protection Agreement does not undo the damaging effects of the prior policy changes by the federal government designed to significantly restrict investments by state-owned enterprises (SOEs) in the oilsands.

The oilsands industry has been facing well-known challenges, most notably around market access and regulatory delays in pipeline approvals. However, the change in SOE investment policy announced in December 2012 materially affected oilsands firms and negatively affected an industry with an economic and fiscal contribution comparable to Saskatchewan.

Prompted by the proposed purchase of Progress Energy by Petronas, and Nexen by the Chinese state-owned enterprise CNOOC, the federal government revised guidelines for investments by SOEs in the oilsands. Although permitting the Nexen sale, future acquisitions of control of Canadian oilsands firms by foreign SOEs would only be approved on an exceptional basis. The policy clearly targeted SOE investment of controlling interests in oilsands firms, but also added uncertainty by altering the definition of what it means to be state owned and what a controlling interest means, thereby increasing the discretionary power of the minister of Industry to review SOE transactions on a case-by-case basis.

Although these seemingly draconian new rules clearly restrict oilsands acquisitions by SOEs, several observers suggested that poor investment returns in the oilsands sector are responsible for reduced investment, not the change in policy.

This view is misguided and lacks a complete understanding of the oilsands resource. Oilsands projects are characterized by having comparatively long reserve lives and economies of scale that require significant initial capital outlays to achieve a sufficient level of production to realize a return on investment. The universe of well-capitalized investors with long-term views prepared to invest in oilsands projects exposure is smaller than Ottawa initially anticipated when the SOE policy was introduced.

In a recent report published through the University of Calgary's School of Public Policy, we statistically examine the impact of the policy change on the performance of firms operating in the oilsands. Focusing on the share prices of oilsands firms, and controlling for other outside factors, we find that share returns of firms operating in the oilsands sector were, in fact, materially reduced following the announcement of the policy. Moreover, junior oilsands companies were more adversely affected than larger enterprises operating in the sector. This is consistent with our hypothesis that economies of scale and increased reliance on external financing make the junior sector more exposed to foreign investment restrictions.

Rules like this create unintended consequences. In this case, the policy targeted investments of controlling interests. However, restricting foreign direct investment decreased the overall supply of capital to the oilsands sector and thereby increased the cost of aggregate capital. Moreover, oilsands firms, especially the juniors, typically engage in joint ventures for their projects. The policy changes have affected this practice, even though the intent was to eliminate acquisitions of controlling interests, not joint ventures.

Prime Minister Stephen Harper's stated intent of this policy was to preserve Canadian participation in the oilsands sector. The irony is that the result has been the reverse. Pure play junior oilsands players (exclusively Canadian) have been disproportionately affected by Ottawa's policy. Multinationals in the oilsands sector have a diverse portfolio and are not captive to Ottawa's policy. They are in effect insulated. How about that for an unintended consequence?

The federal government's policy change resulted in material destruction of shareholder wealth, both directly for those actively investing in the oilsands and indirectly through the reduced value of oilsands investments held by pension plans.

The policy change also has broader implications for the overall economy. While foreign investment in the oilsands is not new, the increased presence of SOEs is. Rather than targeting SOE investment in a particular sector, a more judicious policy would not focus on the ownership of the investor, but use the Investment Canada Act and the Canadian regulatory framework to manage the behaviour of all firms, foreign and domestic, private, public and state owned.

Ottawa's policy toward SOE investment stands in stark contrast with the recent ratification of the Foreign Investment Protection Agreement with China. Inconsistencies in policy create regulatory uncertainty for investors; the price tag is the potential loss of billions of dollars of foreign direct investment.

SOEs are not going away, nor is the requirement for significant additional investment in Canada's resource sector. It's time for Ottawa to rethink its SOE policy for the good of the whole Canadian economy.

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