

# **Public-Private Partnerships in Saskatchewan: A Tale of Two Upgraders**

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by  
Mark Jacob Stobbe

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## **ABSTRACT**

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*Public-Private Partnerships in Saskatchewan: A Tale of two Upgraders.*

Most of the literature dealing with public-private partnerships (P3s) examines the impact of private sector involvement in the provision of infrastructure or services normally provided by the public sector. This thesis uses the two case studies of the NewGrade Heavy Oil Upgrader and the Bi-Provincial Heavy Oil upgrader to examine the dynamics of P3s entered into by government in a market-driven, commercial sector for the purposes of promoting economic development.

In the 1980's, there was a political consensus in the Saskatchewan legislature that the province needed upgrading capacity to convert heavy crude oil into more marketable and valuable light synthetic crude and that the upgraders should be built through P3s. The result was the creation of the NewGrade and Bi-Provincial Upgraders. In the 1990's, financial losses at both upgraders caused the Saskatchewan government to demand renegotiation of these partnerships. The thesis examines these partnerships in their initial negotiation, construction/operation and renegotiation in order to determine what environmental factors and internal dynamics contributed to the success or failure of the partnerships and the relations between the partners.

The thesis argues that the upgraders successfully achieved their public policy objectives and gained the benefits of synergies arising from the differences between the public and private sector. However, the partnerships came under severe stress arising from a prolonged downturn in oil markets and the price of crude oil. The resulting financial losses caused the Saskatchewan government to seek a renegotiation of the terms of partnership. Despite this common cause of stress in the partnerships, the renegotiations of the agreements varied greatly. It is demonstrated that these differences arose from the financial structure of each partnership, the nature of the private sector partners and the number of partners involved in the project. The thesis provides some observations of potential value for governments and corporations considering entering partnerships for economic development projects. The differences between partners that can create synergistic benefits can also be the basis for the erosion of trust between the partners. The different financial tools used by government to participate in P3s can have significant impacts on both project viability and relationships between the partners.

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## Contents

PERMISSION TO USE	i
ABSTRACT	ii
ACKNOWLEDGEMENTS	iii
LIST OF TABLES	viii
<b>Chapter 1: P3s as the Pursuit of Synergies between the Public and Private Sector</b>	<b>1</b>
1.1 Continuing Legacy of P3s	1
1.2 P3s Conceptualized	2
1.3 Factors Contributing to the Success of P3s	5
1.4 P3s in Activities Normally Private	7
1.5 The Case Studies	11
1.5.1 The Selection of the Case Studies	12
1.5.2 The Case Studies and the Analytic Framework	13
1.6 Methodology	14
1.6.1 Data Sources and Issues of Access	14
1.6.2 Review of the Manuscript	15
1.6.3 Methodological Issue: The Decision to be Document-Based	16
1.6.4 Position of the Author: Ethical Considerations	16
1.7 Research Objectives, Questions and Conclusions	17
1.7.1 Research Objectives	17
1.7.2 Research Questions	17
1.7.3 Major Research Findings	18
1.8 Structure of Thesis	19
References	21
<b>Chapter 2: The Partnerships Established: Negotiating the Upgrader Agreements</b>	<b>24</b>
2.1 Introduction	24
2.2 Why Saskatchewan Needed Upgrading Capacity	25
2.3 Preliminary Initiatives: the Plains Consortium	27
2.4 Negotiating NewGrade	28
2.4.1 CCRL as a Project Partner	28
2.4.2 The 1983 Agreement-in-Principle	34
2.4.3 Deteriorating Economics and FCL's Decision to Withdraw	36
2.4.4 Changes to the 1983 Agreement-in-Principle	40
2.4.5 NDP Reaction to the Upgrader Agreement	42
2.4.6 Negotiating the Detailed Project Agreements	43
2.4.7 Negotiations with the Lenders	47
2.4.8 NDP Reaction to the Final Agreements	50

2.5	Negotiating Bi-Provincial	51
2.5.1	Historical Background on the Bi-Provincial Upgrader	51
2.5.2	Reaching a First Agreement-in-Principle	53
2.5.3	Reaction to the 1984 Agreement-in-Principle	58
2.5.4	The Mulroney Government Backtracks	61
2.5.5	The Drive for a New Agreement	66
2.5.6	Reaction to the 1988 Bi-Provincial Agreement	74
2.6	Comparison of the Two Upgrader Agreements	75
2.6.1	Comparison of Characteristics of Two Upgrader Agreements	75
2.6.2	The Effect of Time on the Negotiations	76
2.6.3	The Effect of the Different Nature of the Private Sector Partners	78
2.6.4	The Effect of the Number of Partners Involved in Negotiations	80
2.7	Concluding Observations	81
	References	82
<b>Chapter 3</b>	<b>The Partnerships in Action: Building and Operating the Upgraders</b>	<b>92</b>
3.1	Introduction	92
3.2	Building and Operating the NewGrade Upgrader	92
3.2.1	Issues Related Managing Construction	93
3.2.1.1	Relationships with Contractors and Sub-contractors	93
3.2.1.2	Due Diligence Over the Expenditure of Public Funds	94
3.2.1.3	Issues Related to Upgrades of the CCRL Refinery	94
3.2.1.4	Issues Related to Staffing and Reporting	97
3.2.2	Issues Related to Operating NewGrade	99
3.2.2.1	Start-up Problems and Environmental Issues	99
3.2.2.2	Financial Issues During Operation	102
3.2.3	A Partnership in Trouble	109
3.3	Building and Operating the Bi-Provincial Upgrader	110
3.3.1	The Public and Political Response to Bi-Provincial	110
3.3.2	Contracting and Sub-contracting Issues	111
3.3.3	Issues Related to Board Composition and Competence	112
3.3.4	Issues Related to Cash Flow and Partnership Changes	113
3.3.5	Issues Related to Construction Costs	115
3.3.6	Issues Related to the Commencement of Operations	116
3.4	Similarities and Differences in Building and Operating the Upgraders	117
3.5	Concluding Observations	121
	References	122
<b>Chapter 4:</b>	<b>The Partnerships Under Stress: Renegotiating the Agreements</b>	<b>129</b>
4.1	Introduction	129
4.2	Saskatchewan's Fiscal Crisis and the Context for Renegotiation	129
4.3	Renegotiating the NewGrade Upgrader Agreements	131
4.3.1	Saskatchewan Requests Changes and Prepares for a Fight	132
4.3.2	FCL Rejects Calls for Negotiated Changes	133
4.3.3	The Provincial Government's Appointment of the Estey Commission	135
4.3.4	Canada and FCL's Position to Estey	138

4.3.5	The Estey Report on NewGrade	140
4.3.6	Reaction of Partners to the Estey Report	141
4.3.7	The Saskatchewan Government Considers Legislation	144
4.3.8	The Legislative Opposition Becomes Involved	146
4.3.9	The Provincial Government Introduces Legislation	148
4.3.10	The Protest Campaign Launched by FCL Against the Legislation	149
4.3.11	Negotiations and Other Initiatives After the Introduction of Bill 90	156
4.3.12	FCL Attacks – Gass, Threats and Legal Action	158
4.3.13	Provincial Government’s Attack on FCL within the Co-op Movement	160
4.3.14	Negotiations Resume and a Tentative Settlement	160
4.3.15	Securing Federal Support and Ending the Fight	164
4.4	Renegotiating the Bi-Provincial Upgrader	165
4.4.1	Setting the Stage for Restructuring Bi-Provincial	166
4.4.2	Bi-Provincial Exhausts its Cash	166
4.4.3	Saskatchewan and Husky Buy, Alberta and Canada Sell	168
4.4.4	The Politics of Buying and Selling	172
4.4.5	The Restructuring is Concluded	173
4.5	Comparison of the Renegotiation Process	173
4.5.1	The Question of Trust	175
4.5.2	The Different Nature of the Private Sector Partners	177
4.5.3	The Implications of Different Financial Structures	178
4.5.4	The Role of Other Governments	179
4.6	Concluding Observations	180
	References	180
<b>Chapter 5:</b>	<b>The Partnerships Assessed: Costs and Benefits of the Upgrader Partnerships</b>	<b>188</b>
5.1	Introduction	188
5.2	The Results of the Romanow Administration Re-negotiations	188
5.2.1	Results of NewGrade Restructuring for Saskatchewan	189
5.2.2	Results of Bi-Provincial Restructuring for Saskatchewan	190
5.3	Assessment of the Upgraders Against Saskatchewan Policy Objectives	193
5.3.1	Assessing the Saskatchewan Benefits from the Upgrader Partnerships	193
5.3.1.1	Benefit: Saskatchewan Production of Heavy Crude Oil	194
5.3.1.2	Benefit: Internal and Export Markets for Saskatchewan Crude	194
5.3.1.3	Benefit: Provincial Government Revenues	195
5.3.1.4	Benefit: Employment Impact	196
5.3.1.5	Benefit: Security of Refinery Feedstock Supply	197
5.3.2	Assessment of the Public Costs of the Upgraders for Saskatchewan	197
5.3.2.1	The Financial Impact of the NewGrade Investment	199
5.3.2.2	The Financial Impact of the Bi-Provincial Investment	201
5.3.2.3	Other Costs to Saskatchewan from the Upgrader Partnerships	202
5.4	Assessment of the Impact of the Upgraders on Private Sector Partners	203
5.4.1	Security of Supply and Pipeline Capacity	203
5.4.2	Upgrader Expansions Without Public Participation	204
5.4.3	Long-term Impact of Bi-Provincial on Husky	205
5.4.4	Long-term Impact of NewGrade on CCRL/FCL	205

5.5	Concluding Observations	206
	References	206
<b>Chapter 6:</b>	<b>The Partnerships Interpreted: Synergy and Discord in the Public-Private Dynamic</b>	<b>209</b>
6.1	Introduction	209
6.2	The Basis of Synergy	211
6.2.1	The Public Contribution to Synergy: Capital on a non-commercial basis	213
6.2.1.1	Types of Public Participation in the Partnership	214
6.2.1.2	Transparency and Obfuscation in Forms of Public Participation	216
6.2.1.3	Impact on Government of Different forms of Project Financing	220
6.2.1.4	Evaluation by Policy or Commercial Criteria	222
6.2.2	Particularistic Synergy and the Erosion of Trust	223
6.3	Impacts Arising from the Different Nature of Private Sector Partners	226
6.3.1	Impacts of Different Corporate Cultures and Decision Making Processes	226
6.3.2	Impact of Occupying Different Positions on the Petroleum Value Chain	227
6.3.3	Impact of Different Perspectives on Loss and Gain	228
6.4	Impacts Arising from the Different Number of Partners	239
6.5	Impacts of Operating Environment on Partnership Success	231
6.6	Concluding Observations	233
	References	236
	<b>BIBLIOGRAPHY</b>	<b>241</b>

## LIST OF TABLES

2.1	Summary Comparison of the NewGrade and Bi-Provincial Upgrader Agreements	75
3.1	FCL Petroleum Division Annual Gross Margin, Expenses, and Net Savings 1980 to 1996	104
4.1	Financial Scenarios for the NewGrade Upgrader	137
4.2	Categorization of letters regarding NewGrade received by Premier Romanow from the introduction of Bill 90 until the agreement on the Settlement Principles with FCL	154
4.3	Summary of Proposals for Restructuring NewGrade	161
5.1	Financial flow between NewGrade Energy Inc. and Saskatchewan, 1987-2007	200
5.2	Financial flow between Bi-Provincial and Saskatchewan, 1989 to 1999	202

# Chapter 1

## P3s as the Pursuit of Synergies between the Public and Private Sector

### 1.1: Continuing Legacy of P3s

Public-private Partnerships in Canada are as old as Confederation. The construction and operation of trans-continental railways are the pre-eminent example. In the case of the Canadian Pacific Railway and the Canadian Northern Railway, governments partnered with the private sector to stimulate economic development and protect Canada's territorial sovereignty. In exchange for substantial public assistance, the railways' owners allowed their construction and operating decisions to be influenced by non-commercial factors. The form of public assistance differed, which contributed to different outcomes. One partnership resulted in a strong and prosperous private sector company,<sup>1</sup> the other in a publicly owned Crown corporation.<sup>2</sup>

In recent years, the discussion of partnerships between the public and private sectors has been a persistent feature of debate on public policy and of the method governments are using to achieve policy objectives. Entering the term *public-private partnership* (P3) in the Government of Canada's website search engine yields 999 hits. The partnerships being discussed cover activities ranging from the construction of public infrastructure to delivering public health services. An identical search in the Government of Saskatchewan's site yields 244 hits, with partnerships also being highlighted for a wide range of government policy and program areas. In the federal government, Treasury Board guidelines explicitly direct departments and agencies to explore partnerships with the private sector for any capital project of over \$100 million with a life expectancy of over 20 years. Departments are also encouraged to explore partnerships for smaller capital projects and procurement of services.<sup>3</sup> A federal Crown corporation known as PPP Canada was established in February 2009. In addition to providing information on public-private partnerships and compiling best-practices documentation, PPP Canada administers a five-year \$1.25 billion fund to provide support for infrastructure projects built by other levels of government using a partnership model.<sup>4</sup> As a matter of policy, the federal government makes the way an infrastructure project undertaken by another level of government is completed a more important criterion for support than what the project is or why it is being pursued. With this emphasis on partnerships by government, study of the circumstances in which P3s are appropriate, the factors

that contribute to their success or failure, and even the criteria for measuring that success or failure assume particular salience.

## 1.2: P3s Conceptualized

Despite, or perhaps because of, the importance being placed on P3s, the term itself has had a certain amount of ambiguity in its use.<sup>5</sup> The ambiguity comes both from the term partnership and from the limiting descriptor of public-private.

A partnership involves a legal relationship between two or more parties that involves co-operation with a specified allocation of rights and responsibilities.<sup>6</sup> Wright and Rodel suggest that partnerships can be categorized by the nature of what is being shared, the scope of the arrangement and the manner in which decision making is distributed.<sup>7</sup> Just one of these variables, what is being shared, yields the typologies of consultative partnerships (information being shared), contributory partnerships (money or other resources being shared), operational partnerships (work being shared) or collaborative partnerships (power being share). These, of course, are not mutually exclusive since partnerships can, and usually do, involve sharing of more than one thing.<sup>8</sup> The danger with this approach is that everything becomes defined as a partnership. To create a definition with more operational usefulness, partnership can be conceptualized as both a state of being and a relationship. This introduces a temporal aspect. Partnerships are not single encounters or transactions but rather a relationship that lasts for a period of time but is dissolvable.<sup>9</sup> Partnership implies a sharing of at least some goals and objectives between the parties.<sup>10</sup> Finally the use of terms such as *relationship* and *cooperation* implies that each party retains a separate existence with an autonomist decision making structure.<sup>11</sup> Taken together, a partnership is more than a single transaction (or even a series of discrete transactions) but less than a merger. Two or more independent parties with their own objectives and decision-making process have agreed to share responsibilities and resources for some specified, mutually agreeable purpose while retaining their own autonomy in other areas.

In some senses, partnerships can be viewed as a mid-point between a series of market transactions and the creation of a newer, larger firm comprised of the partners. Hayak argued that market transactions and the price system represents the most efficient way of dealing with the knowledge needed to co-ordinate production.<sup>12</sup> Coase, on the other hand, argued that when the transaction costs of sharing information were significant or uncertain, it could be more efficient to

replace the price mechanism with an integrated firm.<sup>13</sup> Partnership offers a third approach by establishing a mechanism that is contractually defined rather than governed either by price or hierarchy.

The addition of the descriptors *public-private* narrows the range of partnerships under consideration. At least one partner must be a public (or state/governmental) organization and at least one must be a privately-owned organization. The latter suggests ownership and control by individuals involved through voluntary choice and pursuing of self-chosen goals rather than membership by right of citizenship or goals based on some conception of the common good. Private organizations can be for-profit or non-profit and can have commercial or altruistically defined goals.<sup>14</sup> As a result, P3s can range from a government organization working with a commercial corporation to construct and maintain a piece of infrastructure to a government organization working with a group of individuals motivated by a horror of a disease or social problem in order to eliminate or ameliorate its effects. What defines it as a partnership is the maintenance of organizational autonomy of the partners; the sharing of resources, risk, and responsibility to achieve agreed upon objectives; a sharing of the benefits arising from achieving the objectives of the partnership; and a temporally grounded relationship that lasts for a period of time, whether specified or indefinite.

There are two features of the state in a society with a market-based economy that need to be noted when examining the motivations of government decision-makers when entering into partnerships to achieve public policy objectives. The first is that the state is not vertically integrated. In a market economy, it will not be able to produce in-house all of the goods, services, and behaviors it requires in order to meet its objectives. Instead, it will rely on some combination of commercial, for-profit enterprises and voluntary, not-for-profit organizations to help meet them. The second is that the state and its governmental decision-makers have a wide array of alternative methods of securing goods and services from other organizations or influencing their behavior in order to meet public policy goals. Governments can decide to purchase goods, contract for services, and control behavior with legislation or regulation, use coercive measures to compel behavior, and distribute grants or subsidies to bribe organizations to act in specified ways. Consumption, investment, saving, and allocation decisions can be influenced by taxation. Governments can also decide to take legal possession and control of another organization, thereby making it part of the state. In what Trebilcock and Prichard called the calculus of instrument choice,<sup>15</sup> negotiating a partnership arrangement is only one option available.

When a government enters into a partnership, it is making a voluntary decision to surrender some sovereignty. Public policy objectives have to be negotiated rather than imposed. Decision-making

becomes shared.<sup>16</sup> This can be uncomfortable behavior for governments and can place some awkward strains on customary lines of accountability and responsibility.<sup>17</sup> Therefore, for a government to choose the policy instrument of a partnership, there must normally be a compelling reason to do so. Government must anticipate some gain that it could not achieve on its own.

Some argue that this gain comes from an intrinsic superiority in efficiency in the private sector. Thus, for example, PPP Canada states that “our mandate is to improve the delivery of public infrastructure by achieving better value, timeliness and accountability to taxpayers, through P3s.”<sup>18</sup> In this view, private sector modes of operation are intrinsically superior to those directly operated by departments and agencies of the state. In commercial organizations the profit imperative creates efficiency, while in the non-profit sector a sense of mission and commitment by staff and volunteers can have the same salutary effect.<sup>19</sup> P3s provide a way to allow the public sector to reap the benefits of improvements in efficiency. The reality is probably somewhat more nuanced.<sup>20</sup> While private sector organizations may or may not be more efficient than those in the public sector, it is probably safer to assert that they are different from each other. These differences can come in the form of incentives, accountability, technical knowledge, and resources available for mobilization to achieve an objective. Partnership offers a way for these differences to be exploited for a common benefit. A successful partnership will result in the strengths of each organization, both public and private, to be mobilized for maximum collective benefit. The result can be what Huxman and Vangan call a “collaborative advantage”<sup>21</sup> and McQuig describes as “the potential for synergy of some form, so ‘the sum is greater than the parts.’”<sup>22</sup> The incremental benefits come from the differences between public and private. European history provides an analogy. In the Seven Years War the combination of the maritime, trans-continental strength of England joined with the land-based European strength of Prussia was able to defeat the combined might of France, Austria, and Russia. In terms of available resources, the latter combination was much superior. However, alliance between the three land-based empires was not as effective as that created by the synergistic effects of an alliance between two powers that were profoundly different. Such is the potential benefit of a public-private partnership.

While the synergistic effect of the difference between public and private can generate the benefit of a P3, it can also create the basis for failure. Differences in objectives, processes, incentives, and processes can lead to distrust, to discord, and to a failure of the partnership to achieve success. In a less spectacular way, the resources committed to maintaining the relationship can outweigh the benefits created. With this scenario, the partnership can successfully achieve its objectives but at a cost

higher than would have been the case if either partner had acted alone. Finally, different objectives of the public and private partners can lead to a situation where the partners' goals are achieved with differential satisfaction.

While it is not entirely clear whether the actual practice of P3 in Canada and around the world has increased, the utilization of this policy option by governments has become more clearly articulated, and P3s have received significant academic, political, and media attention since the 1980's. Much of this has been ideological in nature, with always-good<sup>23</sup> or always-bad<sup>24</sup> conclusions being asserted more than proven. Others argue that P3s are more efficient at delivering services but at a potential cost to public accountability and control. Those taking this position can be generally favourable<sup>25</sup> or more skeptical of the trade-off.<sup>26</sup> Despite this, significant work has been sought to identify what the features and conditions for successful or unsuccessful P3s are. Success, or lack thereof, is generally viewed against the twin prism of (a) whether the partnership has met its objectives more completely and efficiently than it would have if either partner went it alone, and (b) whether the partnership was able to function at all with conflict and discord held to tolerable levels.

### **1.3 Factors contributing to the success of P3s**

The literature examining P3s has come to some general conclusions about factors that lead to their success or failure. These can be summarized in terms of motivation, risk, objectives, sacrifice, and trust among the public and private sector partners.

***The benefits from P3s arise from the motivational mechanisms in the private sector and its more flexible operating practices.*** In for-profit private firms, the pursuit of profit provides a mechanism to create motivation for efficiency.<sup>27</sup> With non-profit firms, a sense of mission and attachment to the goals of the organization can create a similar motivation for efficient operations since any waste is a diversion from achieving the goals of the organization.<sup>28</sup> By contrast, motivating mechanisms in the public sector are more diffuse. Governments cannot measure success in terms of profit, and the broad range of activity governments engage in lessens the impact of a particularistic sense of mission as a motivating factor. In addition to differences in these motivating factors, private sector organizations do not have intrinsic inflexibilities arising from public principles such as equality of opportunity in procurement, staffing processes based on principles of fairness, and rigid accountability regimes. In addition to the potential of specialized technical knowledge and the ability to mobilize resources not

easily accessible by the public sector, differences of motivation and procedures can be the basis for synergistic benefits.<sup>29</sup>

***P3s offer the potential for government to offload some kinds of risk.*** Because partnerships involve a sharing of risk and responsibility, a P3 offers government the opportunity to offload some of the risk of a venture onto its private sector partner. Both the governmental and private sector partner will attempt to minimize their exposure to risk, particularly risk that arises from factors over which they have no control. In general, it has been suggested that the private sector partners are more likely to accept technical, operational, and performance risk, since these are factors generally considered to be within their control. Private sector partners have been reluctant to accept revenue risk. Where partnerships have been based on assumptions of particular revenue levels, the private partners have been aggressive about seeking changes in the terms of the agreements when revenue shortfalls have occurred. This reluctance by the private sector to accept revenue risk stems from the fact that revenue is heavily dependent upon the public policy decisions of the governmental partner rather than on market response or operational decisions. Regardless of the cause, attempts to have private partners accept utilization or revenue risk have generated more conflict than success in Canada.<sup>30</sup>

***Each partner must be able to achieve its objectives from the partnership.*** For a partnership to work, government must, in fact, achieve its public policy goals. In the same way, if the motivator for a commercial private partner is profit, the partnership must allow for the possibility of attaining at least a normal commercial rate of return and to retain at least a portion of any profits arising from good performance. If the motivator for a non-profit private partner is its sense of mission, the partnership must allow for progress in achieving particularistic goals related to its self-defined mission rather than changing its focus to meet government objectives. In order for all partners' objectives to be met, they must be clearly articulated and defined. To the extent possible, progress towards objectives should be measurable.<sup>31</sup>

***Partnerships involve sacrifices and trade-offs.*** Working towards mutually agreeable objectives means that, except in the most extraordinary circumstances, no partner will be able to define its objectives unilaterally. For governments, partnerships result in changes in customary accountability, loss of some of the rights and protections inherent in sovereignty, and an abandonment of some of its normal mode of operation. For example, if one potential benefit of a partnership is greater flexibility in staffing, then achieving this requires that the government give up its own staffing rules and procedures for this sphere of its activity. Further, the governmental decision-makers will find themselves held

responsible for decisions that have been delegated to the partnership. William Tecumseh Sherman described the situation of political leader as one where they “may become at any moment tempest-tossed by perfidy, the defalcation, the dishonest or neglect of any single one of a hundred thousand subordinates utterly unknown to him.”<sup>32</sup> With a partnership, this peril is intensified because governmental leaders become politically responsible for the actions of their partner – over whom they have no direct control – in addition to the activities of public employees. Similarly, the private partner may be required to give up some autonomy, submit to a higher level of official and unofficial scrutiny, or conform to some government policy directives such as local procurement preference.<sup>33</sup>

***Some level of trust between partners is a pre-condition for success.*** P3s tend to be long-term and often involve significant expenditures of capital. This opens the door to opportunistic behaviors, which will vary in direction depending upon the stage of the partnership. For a P3 to function, there must be some level of trust that commitments will be honoured, changes in circumstances dealt with in good faith, and the interests of the each partner respected by the others. Achieving a level of trust can be complicated by the different operating imperatives, norms, and expectations found in the public and private realms. Some observers argue that trust must exist prior to the partnership being formed, while others suggest that it is something which develops through action and can be created by the experience of the relationship. All agree that absence of trust leads to significantly higher relationship costs such as increased monitoring and adjudication of disputes. In some cases, an absence of trust can create conflict sufficient to destroy the viability of the partnership and prevent partners from achieving both their individual and collective objectives.<sup>34</sup>

#### **1.4: P3s in Activity Normally Private**

The debate on P3s has tended to focus on governmental use of the private sector to deliver services or create infrastructure that the governments are responsible for providing. PPP Canada defines these partnerships as “a long-term performance-based approach to procuring public infrastructure.”<sup>35</sup> A skeptic of P3s, John Loxley, confines his analysis to the provision of public infrastructure or services with a “sharing of risks, investments and rewards.”<sup>36</sup> As a result, in his inventory of P3s, Loxley suggests that they have not been utilized extensively in Saskatchewan and ignores major partnerships such as the two upgraders, Crown Life, Saskferco, and the Meadow Lake pulp mill.<sup>37</sup>

Vinning and Boardman define infrastructure created by partnerships as “public infrastructure,”<sup>38</sup> while Allan speaks of partnerships being used to deliver “public goods and services.”<sup>39</sup> One problem arising from this starting point is that the assessment of what is in the realm of the public tends to be either normative or descriptive. The reality in Canada, along with most countries based on a market economy, is that the boundaries of what is public vary both geographically and temporally.<sup>40</sup> At the current time, for example, basic auto insurance is public in Manitoba, Saskatchewan, and British Columbia. The provision of electrical power is public in most provinces, but not in Alberta. In most cities, public transit began by being considered in the realm of the private but moved to the public. Inter-city bus service is public in Saskatchewan, but not in other provinces.

Complicating the picture even further is that sometimes the same service will be delivered by both the public and private realms in the same time and place. The delivery of internet services, wireless phone service, and long distance telecommunications in Saskatchewan are both public and private, as are the operation of hockey arenas in the city of Saskatoon. The provision of ice surfaces to hockey players and recreational skaters there is a mixture of civically-owned public, for-profit commercial private, and community-based non-profit private organizations. One result of this diversity is that an electrical co-generation plant at an industrial plant which sells electricity to the power grid will be a P3 in Saskatchewan and most of British Columbia (Kootenays excepted), but not in Alberta. Another result of this diversity is that description drifts into an implicit normative assessment. If a P3 is entered into, it is viewed by both supporters and opponents as an extension of the realm of the private into something **normally** public.

Savas provides one analytical framework for assessing whether the provision of a particular good or service is more likely to be within the realm of public or private. He argues that goods and services can be ranked according to two axis. These are the extent to which goods and services are consumed individually or collectively and the extent to which it is possible to exclude people or groups from consuming.<sup>41</sup> Goods or services that are individually consumed and from which exclusion is possible will more likely be provided by private-sector firms responding to market signals, while those that are collectively consumed and/or from which it is difficult to exclude consumers of any type will more likely be provided by public sector organizations on a non-market basis. Thus food and clothing will likely be provided by the private sector, while national defense and imprisoning criminals will generally be provided publicly. Goods and services consumed collectively but from which exclusion is

possible, such as the use of telecommunications infrastructure or piped water, are described by Savas as a tolled good which can be delivered by the public or the private realms.<sup>42</sup>

This predictive typology of public and private does not mean that governments have no interest in the goods and services provided by the private sector. The consumption of merit goods, such as automobile liability insurance, that yield both a private and public good may be encouraged, even if provision remains private.<sup>43</sup> For example, all provinces in Canada mandate that automobile drivers carry liability insurance. Provision is either public or private, depending upon the province. Governments may seek to ensure adequate supply of particular goods, ensure that products are not harmful, prevent the externalization of costs such as environmental damage, or seek to achieve a wide range of public policy goals through the operations of the private realm. As noted above, the state and governments have a wide range of instruments with which to influence the behavior in the realm of the private. Partnership is one such tool. The result could still be described as a P3. This partnership results in an entry of the public into a sphere that is more suited to the private and has been, at the time and place of the partnership, normally within the realm of the private. In these cases, partnership can be seen as the private inviting or accepting a public role in its affairs rather than the opposite.

For the purposes of the remaining discussion, we will focus on potential partnerships with for-profit private organizations that are motivated by commercial objectives. Despite, and with the exception of, this early nation-building example, little attention has been paid to Public-private Partnerships in Canada. Where the partnerships have been noticed, the emphasis has been on failure. The narrative has been told as a cautionary tale.<sup>44</sup>

When a government chooses to enter into a P3, it is making two fundamental decisions about policy instruments. First, it is deciding that the tools of regulation, taxation, procurement or exhortation are not sufficient to achieve its public policy objectives. Second, it is deciding to forgo ownership and control that would be created with a publicly-owned corporation. In so doing, the government is not just sharing control but is also relinquishing a number of concrete benefits of sovereignty. In the case of a Canadian provincial government, entering a partnership results in forgoing the benefits arising from exemption from federal taxation and some federal regulation, crown immunity from some statutory provisions, restrictions in liability, and priority status as a lender.<sup>45</sup> It is both entering the foreign territory of the private realm and giving up a number of its powers and prerogatives that could be available to it when so doing. Partnership with a private organization can offer a two-fold synergistic gain. The first is a general one, with government taking advantage of the motivational and

organizational characteristics of a private organization. The second can be specific synergies arising from the nature of the partnership venture in relation to the private partner's normal operations. Special needs and requirements can dictate the choice of a specific partner.

While there are potential benefits from a government choosing to use the instrument of a partnership when it attempts to achieve public policy benefits in an area more suited to private operation, there are also dangers. These stem from the fact that, if the venture was commercially viable for the private partner, it could do it alone, and the government would yield the public policy benefits without investment or effort. Logically, there are three reasons why a government would make a rational choice<sup>46</sup> to partner with a private organization for a common purpose. These are:

1. The private partner could not pursue the project or initiative on its own, as it lacks resources or expertise that can be provided from the public sector partner;
2. The private partner chooses not to pursue the project or initiative on its own. The venture is within its capability but does not fit with its normal business plan, objectives, or commercial criteria; or
3. The private sector partner would go alone, but the government wishes to change the way the venture is built or operated in order to create or maximize some public policy benefit.

These three reasons can co-exist and intertwine with one another. For example, in the case of an early Canadian partnership, the consortium that formed the Canadian Pacific Railway lacked the resources necessary to construct a transcontinental railway. To do so, it required a partnership with the public. With this partnership, the Canadian government of the day caused the route to be changed in order to meet public policy objectives rather than commercial ones. Based on commercial criteria, the private sector partner wanted to build south of the Great Lakes. The public partner insisted upon a northern route for national sovereignty reasons. In passing through the western mountains, the Yellowhead route was rejected by the government because it was too far from the American border to be of use in maintaining national sovereignty in the southern part of the Canadian prairies. The Crow's Nest Pass route was rejected because it was too close to the border to be defensible in the event of an armed conflict. Like the baby bear's porridge, the Rogers Pass was "just right" from a public policy perspective, even though it was the least attractive option commercially.<sup>47</sup> For the private partner, the necessity of accepting a public-private partnership in order to make the project possible meant also accepting the primacy of some policy goals over commercial ones. This came with a commercial cost.

Each of the three reasons for a government choosing to enter into a public-private partnership carries unique implications. If the government wants to change the venture in order to obtain additional public policy benefits, these changes may come with a commercial and financial cost, which the private partner will expect the public to bear. The more non-commercial objectives are added to the venture, the greater the risk of sacrificing, completely, its commercial viability. If the private partner could proceed with the venture alone but chooses not to, the possibility exists that its refusal was strategically intended simply to obtain public support and an offloading of expense and risk. In cases where the company could not proceed alone, issues are immediately raised about the venture's commercial viability. The project might be beyond the capacity of the private sector to handle, or resources may not be available because the venture does not meet normal commercial risk/reward criteria. Just as teenagers sometimes cannot buy a car because potential lenders are skeptical about their ability or willingness to make payments, financial institutions and investors will be unwilling to advance funds to a project that appears either too risky or not profitable enough or some combination of the two. Just as a parent's co-signature for a loan makes the purchase possible, so too can public support for a corporate initiative make its feasible. The parent and the government will both have a direct interest in the affair, thereby creating the grounds for a partnership.

## **1.5: The Case Studies**

Saskatchewan in the 1980s provides a fascinating laboratory for the study of public private partnerships. The province had long had a history of public investment.<sup>48</sup> In 1944, Finance Minister Clarence Fines set out two objectives justifying public ownership and investment. These were the provision of essential goods and services "at a cost that does not involve exploitation" and "to promote the greatest possible diversification of the economy."<sup>49</sup> In the 1970s and 1980s, the government administrations led by Allan Blakeney and Grant Devine focused new public investment initiatives on achieving the second of these objectives. In the 1970s, the Blakeney administration tended to favour direct ownership and operation in the form of a provincial Crown corporation. New Crown corporations were formed to become active in the production of mineral resources such as potash, uranium, and oil and gas. It should be noted, however, that in some cases these Crown corporations were the vehicle for private public partnerships. For example, the Crown Saskatchewan Mining Development Corporation (SMDC) was one partner in the Key Lake uranium mine. As we shall discuss later, the provincial Crown SaskOil was involved in an attempted partnership venture known as the Plains Consortium, which had

the goal of constructing and operating a heavy oil upgrader. During the tenure of the Devine administration, the aggressive use of public investment to spur economic development and diversification continued. There were, however, two departures from the policies of the Blakeney administration. First, the emphasis shifted from primary resource extraction to secondary processing. Second was a move away from wholly-owned Crown corporations to the policy instrument of public-private partnerships. As a result, the Saskatchewan government divested the three Crown corporations (i.e., Potash Corporation of Saskatchewan (PCS), SaskOil, and SMDC), but created partnership ventures to upgrade heavy crude oil, transform natural gas into nitrogen fertilizer, and process poplar trees into pulp. In addition to a number of smaller scale ventures, towards the end its second term, the Devine administration also entered into a public-private partnership to bring a life insurance company to the province and an ultimately uncompleted attempt to use a partnership with the Belgium company Promavia to cause the construction of military training aircraft in Saskatchewan.

This was probably the most concentrated use of the public-private partnership policy instrument by any governmental administration in Canadian history. Despite this, most political and academic attention has been directed towards the divestitures rather than the new investments.

### **1.5.1: Selection of the case studies**

In this study, we shall examine the formation and operation of two public-private partnerships entered into during the tenure in the Devine administration. We shall then examine the activities of its political successor, the Romanow administration, in working to change the terms and conditions of each of these partnerships.

The NewGrade Energy Inc. and the Bi-Provincial Upgraders have been selected for examination for two reasons. First, by any criteria, their operations are purely in the realm of what is considered private in Canada and America north of the Rio Grande River. The input of heavy oil upgraders is heavy crude oil and their output is synthetic crude. Using the Savas categorization of individual/collective consumption and degree of exclusion/non-exclusion, it is difficult to imagine a good that meets more completely the criteria making production in the realm of the private more likely. Further, in Canada and the United States, the historical norm for oil production and processing has been for this activity to be in the realm of the private sector.

During the 1970s, this historical norm was briefly challenged with the creation of Petro Canada by the federal government and SaskOil by Saskatchewan, but this encroachment by the public sector was

short-lived. As both governments were partnering in the two heavy oil upgraders, they were also divesting themselves of ownership in these petroleum Crown corporations, and successor governments have shown no inclination to re-enter the sector. Indeed, in the case of SaskOil, the Romanow administration in 1997<sup>50</sup> sold the government's remaining shareholdings, and in 2001 the Calvert administration repealed governing legislation to remove residual restrictions on SaskOil's successors.<sup>51</sup> The Devine administration's upgrader partnerships represent a relatively pure example of government using this policy instrument to achieve public policy objectives arising from activity normally within the realm of the private. Further, the political decision to enter these partnerships was supported by the opposition New Democratic Party (NDP). In a very real way, the strength of the public policy argument in favour of these partnerships is demonstrated by political consensus in the province about both the need for public intervention and the choice of policy instrument. As a result, these twin case studies provide the basis for exploring the opportunities and challenges arising from the use of this policy instrument.

The second reason for examining these two public-private partnerships over others entered into by the Devine administration is that they provide the basis for a comparative study of the factors affecting issues such as the nature of the relationship between public and private partners within the same jurisdictions at approximately the same time. As will be demonstrated in subsequent chapters, the Saskatchewan government entered into discussions with its eventual partners at approximately the same time for identical reasons. One upgrader was constructed more quickly, but both came into production during a long-term depression in oil markets. As a result, the financial performance of both upgraders was very unsatisfactory during their early years. However well they achieved public policy goals, both upgraders failed to meet commercial criteria for viability in early years. Further, it was generally believed that this unhappy state of affairs would be long-lasting or permanent. As a result, in the Romanow administration's first term, the government attempted to negotiate fundamental changes in the nature of the structure of the ventures and relationships between partners. In one case, these negotiations were relatively cordial. In the other, the level of conflict between the public and private partners was long-lasting, vitriolic, and public. Indeed, this conflict threatened to destroy the viability of the venture. The differential experience allows for an exploration of some of the factors that contribute to making a public-private partnership work or not work.

### **1.5.2: The case studies and the analytic framework**

As conceptualized above, the proper focus of analysis for P3s stems from the differences between the public and private partners. For the partnership to be successful, the synergies arising from

the differences between the partners must be greater than the challenges and costs that arise from the same differences. With this conception, partnerships are a dynamic process. The decisions and accommodations made during the negotiation of the partnership agreements will have ongoing effects during the development of the partnership. The task in this thesis is to identify the factors leading to either synergistic benefit or partnership cost.

## **1.6: Methodology**

This thesis is an analysis of inter-organizational partnerships with a special focus on the negotiation and renegotiation of agreements, the content of the agreements and the implementation of the agreements. This section will outline the data sources and the issues arising from these sources, the major methodological decision and the reason for it, and the ethical issues arising from the personal involvement of the author in the events being studied.

### **1.6.1: Data Sources and issues of access**

The initial data source informing the study was a collection of documents that was tabled in the Saskatchewan Legislature. These documents primarily consisted of ministerial correspondence relating to the renegotiation of the upgrader agreements. Because these documents were tabled in the Legislature, they were available for public access and inspection under the rules of the Assembly. Because of the passage of time between the events, they were now in the physical possession of the Saskatchewan Archives Board (SAB). There were, however, no restrictions on access.

The Hon. Grant Devine and the Hon. Roy Romanow were asked, in writing, for permission to access their ministerial papers for this study. The initial request letter set out the scope and objectives of the study. Both former Premiers generously granted permission. According to the rules governing restricted access collections held by the SAB, permission was initially granted to a finder's guide for each collection. This was reviewed, and a list of relevant files was provided to Mr. Devine and Mr. Romanow. They, in turn, granted specific permission for access to these files. The documents were then examined by staff at the SAB to ensure that the release was in accordance with the *Freedom of Information and Protection of Privacy Act* and the *Health Information Privacy Act*. Upon the completion of this review, the files were released to the researcher. Upon completion of the manuscript, Mr. Devine and Mr. Romanow were provided with a review copy. According to the terms of access, each individual had the

right to strike any reference from their papers that they wished to remain confidential. Neither of these individuals exercised this right or expressed any reservations about quotes or inferences drawn from their ministerial papers.

In addition to the ministerial papers of these two former Premiers, access to specific documents were requested from the Crown Investments' Corporation (CIC). Permission was generously granted by the Hon. Donna Harpauer, Minister Responsible for CIC. Physical possession of these documents was with the SAB. These documents were also subject to review by SAB staff to ensure compliance with provincial privacy legislation.

In addition to the archival collections, extensive use was made of public primary sources such as the Debates and Proceedings of the Saskatchewan Legislature and the annual reports of the corporations involved. Secondary sources included newspaper and magazine articles, journal articles and books.

#### **1.6.2: Review of the manuscript**

Following the completion of the manuscript, the a draft of the thesis was provided to the Hon. Grant Devine and the Hon. Roy Romanow for review in accordance with the terms proposed for access to their ministerial collections. In addition, copies were provided to key individuals who were involved in the events being studied with a request that they provide correction of fact or interpretation. These individuals were Don Ching and Jack McPhee from the Government of Saskatchewan; Harold Empey, Vern Leland, Joe Dierker and Brian Dykes from Federated Co-operatives Limited and a reviewing group led by Justin Steele of Husky Oil. Feedback was provided in writing, with verbal comments also being provided by Mr. Romanow, Mr. Ching and Mr. Leland. The only significant change arising from this review process was a more detailed explanation of the reasons for CCRL/FCL's risk aversion in the negotiation of the project and operating agreements for NewGrade. This was provided in a written comment from Mr. Empey with input from Mr. Dierker and Mr. Dykes.

Each of the individuals reviewing the draft thesis and providing comment is or was a holder of "a position of power, or routinely engages in communicative interactions similar to those involved in the research by virtue of their position or profession."<sup>52</sup> As a result, their consent could be inferred from their agreement to "interact with the researcher for the purpose of the research".<sup>53</sup>

### **1.6.3: Methodological Issue: the Decision to be Document-Based**

In approaching this study, the use of interviews with participants was considered and rejected. In part, this was a decision made because of the richness of the primary and secondary documents available. Quite simply, it was deemed that the story could be told and the issues analysed on the basis of the documentary evidence alone. Given the passage of time since the events, concerns about the accuracy of unassisted recall from participants contributed to the decision to rely on the written evidence.

Concern about the reliability of memory was buttressed by psychological research into memory. Memory is fallible, and in specific ways.<sup>54</sup> Of relevance to this study is the “fuzzy trace” theory of memory, which suggests that people store memory in two processes, one dealing with “gist” and the other with “verbatim”.<sup>55</sup> Roughly speaking, “gist” memory corresponds to understanding while “verbatim” memory corresponds to the accurate depiction of events. “Gist” memory is more easily accessible to the individual and can cause distortions in verbatim recall.<sup>56</sup> In this study, we were attempting to extract understanding from the detailed and accurate depiction of events. If this theory of memory is correct, interview subjects would tend to do the opposite, that is, use a memory of general understanding to recall detailed incidents of the specific. It was concluded that interviews had the potential to introduce as much confusion as clarity. The conduct of the study was therefore exclusively documentary based.

### **1.6.4: Position of the author: ethical considerations**

The author was personally involved with the events described. From May, 1992 until May 1993 I served as Deputy Chief of Staff to the Premier of Saskatchewan. From then until June of 1995 I was the Director of Communications at the Crown Investments Corporation. In both of these positions, I was involved in the discussions about the Saskatchewan government’s strategy and in the development of the province’s position regarding the renegotiation of the two upgrader projects. As such, I was “in the room” for many of the meetings being described, and have some vivid recollections, both gist and verbatim.

Every effort was made to ensure that these personal recollections do not appear in this thesis. During this period, I served in a position of trust and confidentiality. I attended, as staff, many meetings of the Saskatchewan cabinet and the Board of Directors of the Crown Investments Corporation (which functioned as a committee of cabinet) and am bound by an oath of confidentiality about what I saw and

heard during these proceedings. This oath and obligation is a serious one. As a result, there is no part of this thesis that is based on personal recollection. My memory sometimes guided my search for documents, but unless documentary evidence was located, the incident, event or issue is not discussed. In part, this accounts for the number of footnotes in this thesis since these were used as a device to ensure that personal memory did not creep into the narrative. In the end, I believe that this commitment to honour an ethical code of confidentiality was positive for the final product since it forced the creation of a narrative supported in detail from documentary sources.

## **1.7: Research Objectives, Questions and Conclusions**

### **1.7.1 Research Objectives**

Most of the literature on P3s examines partnerships wherein the private sector has become a partner in providing goods, services or infrastructure that was previously seen as a public responsibility. The objective of this study is to add to the knowledge base of P3s by examining two examples of partnerships that occurred in an activity that has traditionally been the preserve of the private sector in North America. By examining the origins, operations, and renegotiation of these two partnership arrangements, the study illustrates how the processes leading to P3s in commercial activity can create challenges for both the public and private partners and some of the factors that determine how the partners respond to the challenges they face. The findings can help inform both governmental and non-governmental policy decisions about the use of partnerships for economic development purposes in the future.

### **1.7.2 Research Questions**

In the cases of the two Saskatchewan upgrader P3s, in the 1980's, there was a general political consensus that:

- Saskatchewan needed to create upgrading capacity if the province's oil industry was to grow and prosper;
- The cost and risk profile of upgraders was such that provincial government involvement was necessary if the upgraders were to be built; and
- The lead operational role should be played by private sector operators in partnership with government rather than through other policy instruments such as full public ownership.

Once built, each upgrader experienced significant financial stress arising from market conditions in the oil sector. Despite these common features, the two upgraders had very different histories. With that in mind, the study will seek to answer the following questions:

1. What were the imperatives on both public and private sector partners as the project agreements were being negotiated, and how were the resulting agreements both similar and different?
2. How did both external pressures and the structure of the agreements influence the partnership during the construction and operation phases? What contributed to partnership success or failure?
3. What provoked the Saskatchewan government to seek to change the terms and conditions of both project agreements, and why did the renegotiation process take different trajectories?
4. How well did the renegotiated agreements meet the objectives of partners? Overall, what were the costs and benefits of Saskatchewan's participation in these partnerships and to what extent were policy objectives met?

To the extent that the answers to these questions offer generalizable insights, the findings can help inform the development of these types of P3's in the future.

### **1.7.3 Major Research Findings**

The study concludes that Saskatchewan's involvement in upgraders consistently took the form of a partnership with a lead private-sector partner. However, the number of governments involved and the different position of the upgraders in the respective partners' value chain resulted in the NewGrade agreements being reached more quickly than those for Bi-Provincial. Bi-Provincial's delay in the context of a slump in oil prices led to a change in financing arrangements. As a result, NewGrade was financed largely by government-guaranteed third-party debt while Bi-Provincial was equity financed. Further, in order to achieve significant operational synergies, the NewGrade governance model was much more complicated and almost intrinsically conflictual.

Because of the difference in the length of time it took to negotiate the project agreements, NewGrade was first on-stream. It was therefore the first to be negatively affected by on-going low oil prices and the resulting squeeze on the differential between light and heavy crude oil. Ongoing financial losses were intensified by the project's highly leveraged financial structure. At NewGrade, the ongoing financial problems combined with the governance structure led to a serious deterioration of trust

relations between the partners. The Bi-Provincial partnership was also subjected to financial pressure arising from construction cost overruns and low oil prices, but the different financing arrangements and a simpler governance structure lessened the impact of these problems on relations between the partners.

When the Saskatchewan government started renegotiating the project agreements in the early 1990's, the debt financing of the NewGrade upgrader combined with the lack of trust between the partners resulted in a very acrimonious and public battle. Both the Saskatchewan government and its private sector partner viewed the upgrader simply from the perspective of a potentially cataclysmic loss. At Bi-Provincial, the different financial structure lessened the intensity of disputes between Saskatchewan and its private sector partner, while the existence and behavior of the two other governmental partners allowed for coalition building and a diffusion of conflict. The renegotiation resulted in a strengthening of partner relations rather than on-going conflict.

The renegotiation of the agreements met the Saskatchewan government's objectives of limiting and containing financial losses. When oil prices finally recovered at the end of the millennium, both upgraders became financially profitable. The Saskatchewan government achieved its long-term public policy objectives for the partnerships, albeit at a significant financial and political cost. The extended period of low oil prices from the mid-1980s to the late 1990s placed both upgrader projects in significant financial stress, while the financial tools the government used to participate were ill-suited for the situation. In the case of NewGrade, a complicated governance system arising from the combination of the engineering of the project and the risk-aversion of the private sector partner resulted in a loss of trust between the partners and significant discord.

These findings could assist both public and private sector organizations structure potential P3s in a way that increases public transparency and facilitates harmonious partner relations.

## **1.8: Structure of Thesis**

Chapter 1 grounds the study in the literature in the discussion of why P3s are utilized as a policy tool by government, and what factors have been identified as contributing to the success or failure of P3s. It is noted that most of the literature deals with P3s entered into for the provision of goods, services or infrastructure generally considered as being the responsibility of government to provide. In

the case of the two upgraders, partnership was used by government to promote economic development in a sector normally private and commercial.

Three narrative chapters then outline the history of the two upgrader projects. A description of each project during the stages of agreement negotiation, construction/operation, and agreement renegotiation is provided, followed by a discussion of the similarities and differences of both projects at each stage. The narrative is presented in this sequential manner because different results at earlier stages result in different trajectories and outcomes at subsequent stages. While the projects were similar in conception at the beginning, differences in financial structure, governance arrangements and trust relationships grew wider at each stage.

Chapter 2 provides a narrative of the negotiation of the agreements and contracts governing the upgrader partnerships. It seeks to address the question of how the agreements differed, and why these differences emerged despite the similar policy objectives on the part of government for both upgraders.

Chapter 3 outlines the operational history of the upgraders from the reaching of the original agreements until the beginning of negotiations for changes to those agreements. This period includes construction and early operation of each upgrader. This chapter seeks to address how the differences in nature of the two upgrader agreements had on both the ability of the upgrader to achieve its objectives and on the nature of relations between the partners.

Chapter 4 provides a narrative of the attempts by the Saskatchewan government to change the terms and conditions of the agreements governing both upgraders. It then provides an analysis of how well both these renegotiations and the upgrader projects overall achieved the objectives of both public and private partners. The primary question addressed in chapter is why the two negotiation processes took such different paths.

Chapter 5 assesses the effects of both the initial partnerships and the re-negotiated partnerships on the policy and financial goals of each partner.

Chapter 6 ties the three narrative sections together by identifying the common elements that shaped the structure and dynamics of partnerships at the negotiation, construction, operational and renegotiating phases. This Chapter also devotes some attention to the lessons to be drawn from these cases studies that can be applied to current and future negotiations and operations of P3s within and beyond the natural resources sector.

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## Chapter 2

### The Partnerships Established:

### Negotiating the Upgrader Agreements

#### 2.1: Introduction

This chapter describes the negotiations that resulted in the reaching of the project and operating agreements for both the NewGrade and Bi-Provincial upgraders. It begins with a discussion of the conditions that led both the New Democratic Party (NDP) and the Conservative Party to adopt the public policy goal of causing the construction of upgrading capacity in Saskatchewan. It then briefly examines the attempt of the NDP administration led by Allan Blakeney to construct an upgrader, and outlines the political and policy legacy of this attempt. The negotiations leading to the agreements governing the two upgraders constructed during the Conservative administration led by Grant Devine are examined in detail. The chapter concludes with a comparison of the two agreements and a discussion of why they differed.

The chapter reveals that both the NewGrade and Bi-Provincial partnerships were governed by complex and detailed agreements that were arrived at only after lengthy and difficult negotiations. In the case of NewGrade, the agreement-in-principle was reached fairly quickly, but the negotiations for the detailed implementation agreements were lengthy and acrimonious. Bi-Provincial was the opposite. The agreement-in-principle took over five years to negotiate. Once this was completed, the detailed agreements were finalized quickly and without controversy. In part, this different path was the result of the different nature of the projects. The NewGrade upgrader's physical integration into the existing Consumers Co-operative Refinery lowered the capital costs of the project significantly, but also introduced a great deal of complexity and potential conflict into the partnership.

## 2.2: Why Saskatchewan Needed Upgrading Capacity

Not all oil is created equal, nor is there a single price for crude oil. While the price of oil is usually quoted according to the generally accepted industry benchmark (primarily West Texas Intermediate in North America), the actual price a producer will receive is based on the quality of the crude and the ease with which it can be turned into a desirable suite of petroleum products in refineries.<sup>1</sup>

The specific gravity of the crude and the amount and type of contaminants are the most important criteria in determining value. Lighter, cleaner crude oils are best suited for producing high value products such as gasoline and diesel fuel. The cost of production of heavy crude from the Kindersley area is 10% to 50% more expensive than that of average light crude from western Canada. Production from the Lloydminster area is 30% to 75% higher.<sup>2</sup> The oil flows into the well more slowly and, when conventional recovery techniques are used, recovery rates drop more quickly resulting in poorer returns. A conventional crude oil well will be depleted in 5 to 7 years, while similar wells producing light crude have an expectancy of 15 to 20 years of production.<sup>3</sup> With conventional production techniques, an average of 7.5% of heavy oil is recoverable, while that figure is 18% for medium crude and 22% for light.<sup>4</sup> Heavy oil is also more difficult to transport to refineries and is only capable of producing a more restricted range of products in comparison to light crude. In order to render heavy crude transportable in a pipeline, it must be mixed with a diluent to reduce its viscosity. The most effective diluent is pentene plus, a by-product of natural gas production.<sup>5</sup> Even with diluent, the shipment of heavy crudes slows pipeline throughput, with one barrel of heavy crude displacing the capacity required to ship three barrels of light.<sup>6</sup> As a result of these physical characteristics of heavy oil, it costs more to produce and transport than light crude. However, the greatest impediment to the production of heavy crude oil is restricted markets. Most refineries are configured to handle light crudes and are therefore incapable of accepting deliveries of heavy crude oil. Within refineries that are capable of processing heavy crudes, the primary products that can be made from this feedstock are the lower-value products of asphalt and bunker heating oil.<sup>7</sup>

In the 1980s, technical solutions such as steam injection were developed to improve the recovery rates from heavy oil wells. Collectively, these techniques were described as Enhanced Oil Recovery (EOR). However, without improving the marketability of heavy crude oil, there was little point in increasing production. The technical solution on the marketing side was to “upgrade” the heavy crude

oil into lighter, cleaner synthetic crude capable of being used by more refineries for high value products. Upgrading involves adding additional hydrogen atoms to the oil molecules to decrease the product's specific gravity and removing contaminants such as sulphur and nitrogen. Broadly speaking, two different approaches were developed for upgrading. Coking (carbon rejection) reduces the number of carbon atoms in the oil molecule while hydrocracking (hydrogen addition) adds hydrogen atoms. Coking carried less operational risk, while hydrocracking had the potential for higher yields and economic returns.<sup>8</sup> Hydrocracking also requires the use of substantial volumes of natural gas as the source of hydrogen atoms, thereby introducing more volatility into a project's economics.<sup>9</sup> Both processes are capital intensive, and the economic viability of both approaches is dependent upon the difference between the price of the heavy crude oil feedstock and the price that can be obtained for the upgraded synthetic crude.<sup>10</sup> This is referred to as the "differential." In general, the upgraded synthetic crude receives a small premium from refineries over the price of light crudes,<sup>11</sup> but the price an upgrader receives for its product is directly related to, and limited by, the price of light crude oil.

These characteristics of heavy crude oil established the parameters for the Saskatchewan public policy dilemma of the 1970s and 1980s. Saskatchewan has massive reserves of heavy crude oil. However, development of this resource was limited because the incremental costs of producing and transporting heavy crudes made exploitation uneconomic. Following the two major rounds of increases in the world price of oil arising from the Arab Oil Embargo of 1972/73 and the turmoil associated with the Iranian revolution in 1979/80, an expansion in the production of heavy crude oil was becoming economically possible. However, the market restrictions on heavy crude oil impeded this development. With the exception of a few small refineries for the production of asphalt, there were no Canadian refineries able to accept heavy crude oil for processing. Almost all heavy crude oil had to be exported to refineries in the mid-Western United States. The Canadian asphalt market was seasonal. The American market was more stable, since the demand for asphalt and heating fuels peaked in offsetting seasons.<sup>12</sup> However, the long-term prospects for both these uses were bleak. A major national road infrastructure program in the United States was scheduled to expire in 1986, and the long-term demand for heating oil was declining with improvements in insulation and the conversion of heating sources to natural gas and electricity. Further, the supply of diluents such as pentene plus was projected to shrink, reducing the ability of pipeline companies to transport heavy crude. In 1984, the National Energy Board was projecting that the Alberta production of pentene plus would decline by 28.6% by 2005, with Saskatchewan production declining by 50% in the same period<sup>13</sup>. Continued reliance on American markets would result, the Board projected, in supply not meeting demand by the late 1980s or early

1990s. Thus, just as it was becoming economically feasible to increase the production of Saskatchewan heavy crude oil, the existing markets were shrinking, and it was going to be physically impossible to transport some of the supply to these markets.<sup>14</sup> For the Government of Saskatchewan, the creation of upgrading capacity in the province began to be seen as a precondition for the expansion and long-term viability of the oil industry in the province. Construction of an upgrader became a matter of public policy in order to spur investment and create jobs in the oil patch and to obtain the revenue arising from the royalties on increased oil production.

### **2.3: Preliminary Initiatives: The Plains Consortium**

The NDP government led by Premier Allan Blakeney organized the first major attempt to construct a heavy oil upgrader in the province. A group of five oil companies formed a consortium (The Plains Consortium) with the announced intention of constructing an upgrader. Husky Oil was to have a 25% ownership share and serve as operator. The provincial Crown corporation, SaskOil, committed to a 25% ownership share. Gulf (20%), PetroCanada (15%) and Shell (15%) were the remaining partners.<sup>15</sup> Prior to the 1982 provincial election, the Plains Consortium announced its intention to build an upgrader, opened an office, and took out options on two possible sites. The Archydal site was located 15 km northwest of Moose Jaw, while the Cloan site was 20 km north of Wilkie. Archydal was located along the main East-West oil pipeline, while Cloan was close to the Lloydminster heavy oil fields. As a result, the Cloan site concentrated oil patch impacts in the Lloydminster area, where Husky was the dominant producer, while Archydal would allow for the utilization of crude produced in the Swift Current area as well as from Lloydminster.<sup>16</sup> There was immediate acrimony over the site selection process, with Conservative opposition members and communities in the Lloydminster area accusing the provincial government of influencing the ultimate decision in favour of Archydal, thereby delivering jobs and economic impacts to the Moose Jaw/Regina area that supported the NDP at the expense of the west central part of the province that was predominantly Conservative.<sup>17</sup> The Conservatives also questioned whether the plan to build an upgrader was real or merely a pre-election gimmick. There was some basis for this skepticism, since basic questions involving technology, scale of the project, and financing had not yet been agreed upon. Further, the participation of the private sector companies was predicated upon their expectation of changes to Saskatchewan's royalty structure for heavy oil, but substantive discussions on this question had not yet begun.<sup>18</sup>

The Plains Consortium disintegrated shortly after the April 1982 election, won by the Conservative Party under the leadership of Grant Devine. The operating partner, Husky, withdrew from the consortium and quietly began talks with governments (Saskatchewan, Alberta and Canada) for the construction of an upgrader at Lloydminster.<sup>19</sup> The other members initially indicated an intention to carry on without Husky.<sup>20</sup> However, a short time later, Shell withdrew from the consortium, and the venture simply faded away.

Although it ultimately disappeared, accompanied by much less fanfare than its launch, the Plains Consortium episode had a number of long-term effects. Politically, the ability to deliver a heavy oil upgrader was established both as a public policy objective and as a litmus test of the government's ability to spur economic development.<sup>21</sup> The goal of creating upgrading capacity became one held by both of the parties represented in the provincial legislature. In addition to unanimity on the question of whether the province needed an upgrader, the NDP government also created precedent for how the provincial government should achieve this goal. The option of a Crown corporation to build and operate the facility was rejected in favour of having a private sector company serve as operator. At the same time, it was recognized that the combination of huge capital outlays and a high degree of risk – both technological and economic – required a substantial level of government participation. In short, the NDP approach to achieving the public policy goal of getting a heavy oil upgrader built led directly to a private-public partnership model. This approach was adopted without any visible debate by the new Conservative government. The result was the building of the NewGrade Upgrader in Regina and the Bi-Provincial Upgrader in Lloydminster.

## **2.4: Negotiating NewGrade**

When the Plains Consortium was being put together, the Consumers' Co-operative Refinery Limited (CCRL) was invited to participate. Its representatives attended a few preliminary meetings but quickly decided not to participate in the venture. When the Plains Consortium disintegrated, CCRL was immediately thrust into the centre of efforts to achieve the public policy goal of building an upgrader.<sup>22</sup>

### **2.4.1: CCRL as a Project Partner**

The genesis of CCRL can be traced back to the 1930s. In 1931 a consolidation of oil refineries in Saskatchewan resulted in higher wholesale prices and hence lower retail margins for retail co-operatives

selling gasoline and diesel. Three years later, a group of co-operators began the process of organizing to form a co-operatively owned refinery. Production began on May 27, 1935, with a plant capacity of 350 barrels per day (bpd).<sup>23</sup> In 1944 CCRL and the Saskatchewan Co-operative Wholesale Society (the forerunner of the Federated Co-operative Limited – FCL) created both the skeleton of today’s co-operative retailing system and Canada’s first major vertically integrated co-operative.<sup>24</sup> By the 1980s, the CCRL was the sole survivor of Saskatchewan’s refineries. A series of expansions resulted in the refinery having a capacity of close to 50,000 barrels per day.<sup>25</sup>

The CCRL refinery was (and is) the key to the ongoing financial success of Western Canada’s co-operative retailing system. Retail co-operatives are created and operated in specific geographic areas. These are democratically controlled commercial operations. Each member is entitled to one vote in the organization. However, financial attachment is based on the level of purchases. Savings (profits) are divided amongst the members based on the dollar volume of their purchases. Part of the savings are returned annually to members in the form of a dividend, with the remainder being treated as an equity investment that can only be withdrawn when the member dies, leaves the geographic area or, in some cases, reaches a certain age. These local co-operatives, in turn, own FCL, which serves as a wholesaler to the local member co-operatives. CCRL, as a subsidiary of FCL, supplies petroleum products and contributes its savings (profits) to FCL. Just as the local co-operatives return the savings to the membership in the form of dividends and a long-term equity investment, so, too, does FCL in relation to the member co-operatives that own it. As a result, profits made at CCRL flow through FCL into the member co-operatives. These FCL dividends are used to assist with operating costs, building equity, and contributing to dividend payments to individual members.<sup>26</sup> Over the decades, CCRL has been the financial cornerstone of this co-operative retailing edifice. From 1970 to 1982, 76.2% of FCL’s total savings (profits) came from CCRL and the petroleum wholesaling it supplied.<sup>27</sup> In addition, the creation and ongoing success of CCRL was central to the sense of identity for co-operative leaders and active members. In 1960, for example, the 25<sup>th</sup> anniversary of the refinery attracted 40,000 people to a commemorative event. Hard-nosed FCL managers described the refinery in terms such as it being “the heritage that was given to us by the pioneers of 1934.”<sup>28</sup>

CCRL’s owner, FCL, is a major commercial entity in Western Canada. As noted above, it is owned by its member co-operatives. Local co-operative boards elect delegates to both regional meetings and the annual system-wide annual general meeting. FCL’s board is a large one consisting of directors elected on a regional basis. Major decisions flow both ways through this structure. Central initiatives are

transmitted through the directors to regional meetings and are debated by local boards. Membership concerns and opinions flow in the opposite direction, so that the concerns facing the membership of a small co-operative in rural Manitoba (for example) can make their voice heard at the FCL Board. At the same time, while FCL is owned by its member co-ops and must remain responsive to their collective wishes, it also exerts significant central control over member co-ops. Marketing strategies, human resource policies, management training, audits, and other operational issues of the member co-ops are strongly influenced by FCL. Career progression for co-op managers within the overall system is guided by FCL centrally. Fairbairn argues that the co-operative retail system operates with dual systems of governance embedded in its structure – one elected and one composed of professional managers. These dual paths of authority are interlocked, and both are based on extensive discussion so that “if there is a problem not being resolved, it can be approached either through the elected or management side.”<sup>29</sup>

In addition to being parts of a commercial entity, committed co-operators see themselves as parts of an ethical, non-exploitive, democratic, and socially just movement. Every member has an equal voice, should they choose to use it, while at the same time the economic rewards of the organization are distributed according to economic participation. Profits are paid out to those seen as generating the profits. Thus, observes Fairbairn, “in the view of many co-operative thinkers, this meant that the self-interest of the members of a consumer co-operative was very nearly identical with the general interest of the community as long as the co-operative was open and did not discriminate in its membership (the first ICA principle).”<sup>30</sup> During the long period of rural depopulation and consolidation of communities that occurred in the Canadian prairies through the last half of the twentieth century, the local co-ops were businesses most likely to survive in a small community the longest, thereby reinforcing the perception of a convergence of self- and public interest on the part co-operators. This mission-based aspect of the co-operative movement also led it to be inward-looking and suspicious of more traditional capitalistic enterprises. In Saskatchewan politics, it also resulted in a general affinity with the CCF/NDP. While the co-operative retailing system was not organizationally affiliated with the political party in any way, there was a broad overlap of membership. Lipset shows that in the mid-1940s, almost three-quarters of the delegates to CCF conventions held posts within the broad co-operative movement.<sup>31</sup> For many individuals, the co-op movement was the economic mechanism and the CCF/NDP the political way of achieving the same broad goals of social justice.

In the early 1980s, as CCRL and FCL were about to be drawn into being part of achieving the Saskatchewan government’s public policy goal of building a heavy oil upgrader, times were tough for the

co-op movement. Between 1982 and 1984, 36 member retail co-operatives were in serious financial trouble. One cause of the financial problems facing the co-operative retailing system was a wave of mall construction undertaken by member co-operatives in the 1970s. These had been financed with loans secured against the co-ops' accumulated equity in FCL, resulting in a 272% increase in retail debt from 1974 to 1981.<sup>32</sup> The high interest rates of the early 1980s both placed the retail co-operatives under financial pressure and increased the importance in these co-operatives' equity in FCL and the CCRL refinery that anchored its value.<sup>33</sup> Within FCL itself, the only consistently profitable division was petroleum. Cost-cutting measures within FCL included employment cuts of 20% (250 positions); closing the retail development division, closing a sawmill in Revelstoke, British Columbia, and a manufactured homes plant in North Battleford, Saskatchewan; and closing the newspaper *The Co-operative Consumer*, which had been published since 1939.<sup>34</sup> FCL was promoting similar cost-cutting in the local co-operatives that were its owners, in many cases presenting these co-operatives with detailed cost-cutting plans. This resulted in some tensions between FCL and some local co-operatives such as the Saskatoon Co-operative. In 1982, FCL turned to the Government of Saskatchewan for a \$25 million loan to support the restructuring activities.<sup>35</sup> Such was the partner selected by the Saskatchewan government to launch a massive and complicated technical investment in order to achieve the public policy objective of providing a stable market for the province's heavy oil and to increase the value-added processing of this resource within the province. Significant numbers of the co-operative movement's membership were political supporters of the governing party's political opposition.

Saskatchewan Energy Minister Colin Thatcher opened negotiations by summoning senior FCL and CCRL management to the Legislature for a meeting in 1982.<sup>36</sup> He informed the co-operative management of the province's determination to build an upgrader. At the initial meeting, Thatcher told FCL representatives he wanted the upgrader built in his home city of Moose Jaw. Describing the CCRL existing refinery as "rusted out", Thatcher proposed building a new integrated upgrader/refinery.<sup>37</sup> Subsequently, government studies showed that an upgrader integrated with the existing refinery and utilizing some of inherent excess capacity of a refinery could cut the capital costs of a 50,000 bpd upgrader from \$1.2 to \$1.4 billion to somewhere in the range of \$700 million. The use of the existing refinery meant a partnership with FCL for the public policy goal of promoting the development of heavy oil through the creation of an upgrader cut the potential price tag almost in half<sup>38</sup> and directed the discussion towards integration with the existing CCRL refinery in Regina. However, the denigrating of the existing refinery and the stated preference for Moose Jaw caused concern amongst FCL leadership and

contributed to their desire to ensure that there was contractual protection for the integrity of the refinery.<sup>39</sup>

In addition to the policy goal of promoting the development of the province's heavy oil industry, the government had the secondary objective of helping to ensure the long-term survival of the only remaining refinery located in the province. The CCRL refinery used Alberta light crudes as a feedstock. Given the way established oil fields experience gradual declines in production, the supply of this feedstock was projected to diminish. The National Energy Board was predicting that production of light crude oil in Western Canada would decline from 200,000 cubic metres per day in 1983 to 19,000 in 2005.<sup>40</sup> Potential new production of light crudes was dependent on an unpredictable and volatile combination of price, technology, and geology.<sup>41</sup> Saskatchewan government officials were keenly aware of this threat to CCRL's viability, and believed that an upgrader created the possibility of changing CCRL's source of feedstock to an apparently inexhaustible supply of heavy crude. FCL and CCRL officials acknowledged the benefit but did not see it as a core, survival issue for their refinery. CCRL was developing a coker and sulphur plant that would allow the refinery to process approximately 5,000 bpd of the heavy/medium crude from the Fosterton field near Swift Current, and were planning a gradual conversion to synthetic crude produced from oil sands plants near Fort McMurray, Alberta as a replacement for declining supplies of light conventional crude.<sup>42</sup> CCRL/FCL argued that the benefit of long-term security of supply created by an upgrader was offset by a corresponding decline in CCRL's ability to take advantage of favourable spot market prices when these arose.<sup>43</sup> In attempting to assist CCRL to solve the long-term supply issue before FCL and CCRL had identified it as a survival issue, the Saskatchewan government was akin to an over-eager boy scout doing his good deed for the day by helping the little old lady cross the road before ascertaining that she actually wanted to be on the other side.

FCL leadership – both managerial and elected – responded to the government's proposal by undertaking an extensive consultation with their membership. Through the spring of 1983, the upgrader proposal was debated in depth at regional meetings and by the boards of local co-operatives throughout Western Canada.<sup>44</sup> In the context of the times, the overwhelming reaction amongst the leadership of member retail co-operatives was one of caution. The proposed upgrader was seen as a risk to the survival and integrity of the refinery, and not as a key to its long-term survival. Four specific risk factors were identified. These were:

- The fundamental technological risk. CCRL/FCL management noted that the technology was known and used elsewhere, but never on crude with the characteristics specific to western Canadian heavy crude oil, and never to produce the specific slate of products produced by CCRL's refinery.
- The complexity of operations. The integration of the upgrader with the refinery would significantly increase the complexity of the operations. In particular, the upgrader would involve the introduction of high pressure units into the complex.
- The risk of potential third-party liability from operations. Given the integrated nature of the complex, any potential liability claims against the upgrader had the potential to impact the refinery as well.
- The risk of shut-down. The entity operating the upgrader was being granted the right of free occupancy to CCRL's property. In the event of a total failure and shut-down, the existence of the upgrader facilities would affect the future use of CCRL's own property.<sup>45</sup>

The financial and operational risks inherent in taking on the project were apparent to board members in the remotest local co-operative, while the risk of non-participation (no security of feedstock) did not resonate. At the end of the consultation process, FCL leadership reported back to the government that they had obtained a very conditional permission to proceed. The co-operative retailing system was willing to allow CCRL to proceed as a partner subject to four conditions:

1. The Co-op refinery, its operations, and assets must not be placed at risk.
2. System dollars must not be used for the upgrader project.
3. There must be no risk of direct financial loss.
4. Consumer's Co-operative Refineries Limited (CCRL) must manage the facility.<sup>46</sup>

In short, FCL leadership was told by its membership that it could participate in building the upgrader only if FCL/CCRL was immunized from risk, that it invest none of its own money, that there be no risk of loss, and that CCRL must be the operator in order to ensure that the upgrader did not result in a loss of control over the refinery. If this had been the opening position for a normal, commercially driven, partnership arrangement, this position would have inevitably been interpreted by the Saskatchewan government as a fairly simple and straightforward no. The co-operative retailing system was saying, emphatically and from top to bottom, that it had no interest in sharing the risk inherent in proceeding with the partnership envisioned by the provincial government to build the upgrader. Significantly, the

conditions were silent on the question of allocation of benefit. Clearly, the FCL/CCRL leadership saw the upgrader proposal as a potential threat to their corporate interests, rather than as a source of future reward. It was something to be guarded against rather than an opportunity to be exploited.

The Saskatchewan government did not interpret the terms and conditions outlined by FCL/CCRL representatives as a no. From the point of view of achieving the public policy benefits of getting an upgrader constructed and operational, FCL/CCRL's rejection of a sharing of risk was an issue to be resolved through contractual wording rather than as a rejection. The proposed upgrader was projected to generate a rate of return of approximately 20%, which was seen as sufficient to proceed while meeting FCL/CCRL's terms of participation. An agreement in principle was announced by Saskatchewan Energy and Mines Minister Paul Schoenhals, Canadian Energy Minister Jean Chretien, and FCL President Vern Leland on August 23, 1983.<sup>47</sup> It provided a way for the Saskatchewan government's determination to have an upgrader built to be reconciled with FCL's reluctance to participate unless it acted as the operator of the integrated facility, invested no money, and bore no risk. In describing the benefits of the project, Leland, while acknowledging the benefit to the refinery of secure supply, said, "the project, in allowing the refinery to accept a wider variety of crude oils, will make it a vital element in Saskatchewan's energy industry."<sup>48</sup> From the initial press announcement, FCL leadership defined the primary benefits of the project as going to the province, with the co-op movement's participation as an act of contributing to the public good.

The timing had been auspicious for getting federal support for the loan guarantees. The upgrader aligned with the Canadian government's strategies for increasing Canadian participation in the oil industry and developing energy self-sufficiency.<sup>49</sup> The federal government was also eager to show it could make the National Energy Policy work by entering into agreements with companies in the oil and gas industry for specific "mega-projects," defined as projects with a capital investment in excess of \$100 million.<sup>50</sup>

#### **2.4.2: The 1983 Agreement-In-Principle**

The agreement divided the proposed project into three phases. Phase 1, with a budget of \$10 million, involved conducting the detailed economic and technical studies over a period of 12 to 18 months. At this point, the partners would individually make a go or no-go decision based on these findings. Phase 2 was to be the detailed engineering design and actual physical construction of the upgrader. This was projected to cost in the range of \$635 million and take between two and three years.

Phase 3 was the operation of the upgrader. A new corporate entity, NewGrade Energy, Inc., would own the upgrader. Thirty per cent of the capital cost of the upgrader was to come in the form of equity, split equally between the Government of Saskatchewan, FCL, and a yet-to-be located third private sector equity partner. The remaining seventy per cent of project costs were to come from borrowing, with the loans being guaranteed by the federal and provincial governments on an equal basis. Saskatchewan agreed to lend FCL the funds required for its share of the equity investment, with repayment to come from 40% of FCL's share of upgrader profits and 5% of refinery profits. Competitors of CCRL were ruled out as the potential third party. NewGrade was to be responsible for all costs associated with the upgrader as well as for capital improvements to the refinery made necessary in order to accommodate the upgrader and the use of syncrude as refinery feedstock. This would result in approximately \$60 million in capital improvements to the CCRL refinery, paid for by NewGrade. CCRL committed to purchase NewGrade syncrude as the refinery's feedstock at a formula-generated price based on the market price of a specified grade of light crude oil. Excess upgrader production would be sold on the open market. The MOU specified that NewGrade would have equal representation amongst the owners on its board and would have a small staff. However, if the upgrader project proceeded, CCRL would be contracted as the operator in exchange for an operations fee of \$9.5 million (adjusted for inflation).<sup>51</sup>

Phase 1 work began with dispatch. NewGrade Energy Inc. was incorporated<sup>52</sup> and established an office in unused space at the CCRL refinery.<sup>53</sup> A project manager was seconded to NewGrade from CCRL, and four other NewGrade staff members were hired. The detailed economic and technical studies were commissioned, and three technical approaches were pilot-tested for the upgrading of Saskatchewan heavy crudes.<sup>54</sup> A letter of intent between the two governments and CCRL dealing with the non-financial issues of industrial benefits, human resource planning, and environmental impact assessment process was signed on August 24, 1984.<sup>55</sup> The government began exploring options for the third equity partner, ranging from developing a broad-based public equity offering to offering a share in the project to the mining company, Teck Corporation.<sup>56</sup>

It was over the negotiations for the detailed agreements that the first signs of discord between Saskatchewan and CCRL/FCL representatives began to emerge. In early 1985, Premier Devine was informed that the negotiations were expected to conclude by the end of the year, with the major outstanding issues being "accounting for and sharing benefits related to integration of existing refinery and upgrader" and the "role of third-party investors and control of NewGrade."<sup>57</sup> The Premier was unhappy with this projected time-line for an agreement. He wrote "too late. What's the hold up!" on the

memorandum and directed his staff to pursue the question with SEM officials.<sup>58</sup> Subsequent briefings to the Premier moved the projected completion date to “mid-1985,” but no progress was reported on resolving the outstanding issues.<sup>59</sup>

To assist with the detailed negotiations, Saskatchewan nominated consultants who had substantial experience in managing major refining operations. For example, early in 1984 Phil Gordon, a retired Senior Vice-President of Shell, was added to the board in a move that government officials told their political masters would bring “instant credibility” to the government side of the table.<sup>60</sup> The government also engaged the law firm of MacPherson Lesley Tyreman (MLT) to provide legal advice. The team Saskatchewan assembled was experienced in negotiating major commercial partnership agreements.<sup>61</sup> As a result, their natural inclination was to attempt to define and allocate risk in a way consistent with a normal commercial partnership agreement. To CCRL/FCL negotiators, this represented an attempt by the government to renege, in detail, on the broad agreement that CCRL be immunized from risk.<sup>62</sup> The problem was compounded by the fact that much of the negotiations were being conducted by individuals who had been nominated by their respective sides as their representatives to the NewGrade Board. As a result, the differences of opinion on the allocation of risk were transported into the Board itself. These board representatives could not build a collective identity representing NewGrade. Instead, the board was divided into two factions, each of which saw its primary task as the custodian of their principle’s interests rather than developing a sense of fiduciary duty towards NewGrade.

#### **2.4.3: Deteriorating Economics and FCL’s Decision to Withdraw**

Notwithstanding these festering disagreements, the project proceeded on schedule. By the spring of 1985, Phase 1 was close to completion. The government was turning its attention from the implementation of the public policy objective to the managing of a commercial investment. Officials at the Department of Energy and Mines, who had been leading the initiative, began to brief officials at the Crown Investments Corporation (CIC) with the intent of transferring responsibility.<sup>63</sup>

CIC officials took an initial look at the file and were appalled. Defined strictly as a commercial investment, the proposed upgrader project did not meet their benchmarks for viability. While the detailed technical study suggested feasibility, the financial studies were projecting an increase in the capital costs of about \$100 million combined with deterioration in the projected differential. The result was a decline in the nominal rate of return from 20% to somewhere between 12% and 14%.<sup>64</sup> This, said

CIC officials, did not meet normal commercial standards for a project with this risk profile. However, CIC's even more significant objection was the capital structure. They argued that the project's 30/70 equity/debt structure meant that the upgrader was overleveraged compared to the industry's average of 80/20<sup>65</sup> and faced a 50% chance of experiencing a cash shortfall in its early years and a 40% to 50% chance the loan guarantees would be called.<sup>66</sup> In a meeting with Premier Devine on April 15, 1985, CIC President Colin Hindle said that, with the proposed financial structure, there was a "significant likelihood" that the guarantors would either have to honour their loan guarantees or another \$350 million in equity would have to be injected by one or more of the owners.<sup>67</sup> CIC staff recommended that the province should provide for the likely event that future funds would be required, consider reducing the size or increasing the equity in the project, and insure that appropriate control mechanisms were in place to monitor the investment.<sup>68</sup>

Meanwhile, CCRL/FCL raised new demands that would have had the effect of changing the substance of the project parameters. These proposals included an increase in the management fee and changes to the pricing formula governing the sale of syncrude to CCRL.<sup>69</sup> Acceptance of the CCRL/FCL proposals would result in the guaranteed debt repayment being pushed back from 2000 to 2001 in an optimistic scenario for differentials. However, in the event of a more pessimistic scenario (\$4.00/barrel differentials), the CCRL/FCL proposals would have the effect of increasing the maximum project debt from \$585 million to \$1.629 billion and transforming the projected date of full debt repayment from 2012 to never.<sup>70</sup> In addition to changes to the financial terms, CCRL/FCL requested that NewGrade have a Board of Directors for setting a broad policy framework with only limited powers of supervision and control.<sup>71</sup>

Before the government could develop a position on these new demands or respond to CCRL/FCL, on June 19, 1985, FCL CEO Wayne Thompson telephoned Saskatchewan Energy and Mines Deputy Minister, Bob Reid, to inform him that CCRL/FCL would not proceed with the project. FCL's reasons were outlined in a six-page letter from Corporate Secretary and lead upgrader negotiator Harold Empey dated June 2.<sup>72</sup> The letter begins with a lengthy history of the CCRL Refinery, concluding that "our system will not put CCRL at risk. It is a part of the heritage that was given to us by the pioneers of 1934. A main concern for FCL in the upgrader feasibility studies has been to assure the integrity of the refinery for future generations of co-op members. We would not contemplate participating in an upgrader project that had the potential of leaving CCRL in a worse position than if it had not participated."<sup>73</sup> The avoidance of risk to the refinery is thus explicitly set out as the fundamental objective of CCRL/FCL.

Empey acknowledged that the upgrader would provide CCRL with an assured long term supply of feedstock, but discounted this by adding, “it would also lock CCRL into buying the most expensive feedstock, and would eliminate our ability to use alternative, cheaper crudes as well as precluding opportunities to take advantage of spot buys.”<sup>74</sup> At this point, CCRL/FCL clearly did not see the projected diminishing supply of light crude feedstock as a survival issue. As a result, it maintained that the primary beneficiary of the upgrader would be the province.

Empey explained that, when planning began, the projected differential was \$7.50 per barrel. Changing market conditions made a projection of \$6.00 per barrel reasonable. CCRL/FCL analysis suggested that, if the \$6.00 base case was adjusted for inflation over the life of the project, the project debt would peak in 2000 before declining. With a \$6.00 base case projection without the differential keeping up with inflation, project debt would reach \$2.351 billion by 2013 “with little hope of ever repaying the principal.”<sup>75</sup> Even with the more optimistic base case projection, a projected 16.1% nominal rate of return made the viability of the upgrader “not acceptable at best.”<sup>76</sup>

The economic projections led CCRL/FCL to conclude that the project economics meant that it would receive no revenue from the upgrader for “at least the first 12 years.”<sup>77</sup> Without a predictable economic benefit, CCRL/FCL saw no reason to proceed. Even though the project was structured to shield the refinery from risk, some assumption of risk was inevitable from “operating a much more complex and demanding operation than is now the case. While CCRL is confident of its ability to manage the project, the inherent complexity of the upgrader makes increased downtime inevitable.”<sup>78</sup> Empey also pointed to another inherent risk to CCRL/FCL’s control of the refinery operations, in that “Saskatchewan’s position regarding the managing of the operation places CCRL in a pressure position, having a watchdog second guessing decisions.”<sup>79</sup>

CCRL/FCL concluded that the project economics did not allow for a realistic prospect of an economic benefit that they could share in. This conclusion was very similar to that reached by the government analysts. Further, CCRL/FCL dismissed the significance of the benefit of security of supply, while recognizing that participation in a project of this size, complexity, and level of integration with the refinery would carry some risk to their operation and control over the refinery. After first signalling that it wanted to transfer value from NewGrade to itself, CCRL/FCL indicated it would not proceed. The decision was reached and conveyed at the appropriate time (i.e. after the completion of Phase 1) in accordance with the terms of the Memorandum of Understanding.

Notwithstanding the concerns being expressed within government about the economics of the project, the CCRL/FCL decision was greeted with dismay by the Premier and cabinet ministers. A group of five senior ministers met with the Premier shortly after being informed of the telephone call from Thompson to Reid. Energy and Mines Minister Schoenhals prepared an analysis of why CCRL/FCL had chosen to withdraw.<sup>80</sup> Schoenhals explained that:

- The loan issued to CCRL to pay for its equity in NewGrade was to be repaid from 40% of FCL's NewGrade dividends and 5% of CCRL's refinery profits. Original projections suggested that the remaining 60% of dividends would more than offset the payment of 5% of upgrader profits, thereby allowing FCL to realize an immediate profit. The newer financial projections made any dividend payments unlikely for several years, thereby reducing FCL's income from the CCRL refinery by 5% per year for the foreseeable future.
- FCL/CCRL had not anticipated the increased level of monitoring and rigor inherent in entering a project of this size and complexity. This would impact their "informal way of doing business." Proceeding with the project would lead to increased demands from government, lenders, and the potential third party investor.
- It was becoming clear that the integration of the upgrader to the refinery would inevitably lead to close scrutiny of the operations of the refinery. NewGrade, said Schoenhals, had to monitor refinery operations because some of the units necessary for processing the heavy crude would be located in and paid for by NewGrade. As a result, "CCRL may feel their independence is threatened." Schoenhals added that "CCRL is not used to dealing with the type of people Saskatchewan has representing them on the project or the people hired by NewGrade. In general, they may believe confrontation and disagreement is abnormal and therefore not desirable. They may feel that questioning of their positions reflects lack of trust and therefore are uncomfortable about continuing the relationship."<sup>81</sup>

The government requested that FCL delay announcing its decision to terminate participation in NewGrade until after a meeting could be arranged between FCL senior managers and cabinet ministers in mid-July. It was agreed that engineering work would continue in the interim.<sup>82</sup> Energy and Mines Minister Schoenhals and Finance Minister Bob Andrew, assisted by Reid, met with FCL officials over the board table and at a fish fry at Empey's Blackstrap Lake cabin.<sup>83</sup> The government negotiators went into the meeting prepared to offer CCRL an increase in the management fee in order to provide an immediate profit incentive to CCRL/FCL and to allow for the possibility of deferral of payments on the

loan to FCL in the event that upgrader was not generating dividends.<sup>84</sup> The August 1983 Memorandum of Understanding was designed to protect CCRL from risk to its refinery to ensure that CCRL/FCL did not have to invest money not generated by the upgrader into the project and to give CCRL/FCL a share of the anticipated economic benefit. The government was now going further, indicating a willingness to ensure that CCRL/FCL had a profit incentive to participate whether or not NewGrade itself was profitable. The prospect of a guaranteed return for CCRL/FCL was added to the package.

#### **2.4.4: Changes to the 1983 Agreement in Principle**

The July 11/12, 1985 meeting did not yield an immediate resolution. On July 25, the province submitted a new proposal to CCRL/FCL.<sup>85</sup> The provisions reduced CCRL's equity investment from 10% to 5% with a corresponding increase in the province's share. CCRL would be granted veto rights over any third party equity investor. Payment to the FCL's loan would only come from upgrader dividends, with no portion coming from CCRL refinery earnings. CCRL's management fee was increased to a base of \$15 million, thereby building in a profit component. In addition, CCRL would receive the option of supplying natural gas to NewGrade at a price advantageous to the vendor. The province undertook to provide a royalty rebate on the natural gas used in the upgrader, thereby both funding FCL's profit on the transaction and improving the financial projections for NewGrade. The province insisted on a real board for NewGrade rather than one confined to policy direction. However, NewGrade itself would not have staff. All management functions were directly provided by CCRL, but each shareholder had the right to hire and pay for staff to evaluate CCRL's management decisions and report to the board members appointed by the hiring shareholder. These monitors had access to detailed management information.<sup>86</sup> The substance of the province's proposal was quickly accepted by CCRL/FCL. In this final agreement, the government resigned itself to the fact that CCRL/FCL's veto over a possible third party partner meant that there would not be one, as Saskatchewan agreed "to forego the terms in the original agreement providing for the conversion of 10% of the project debt to equity with the subsequent sale of the new equity to a third investor."<sup>87</sup> An announcement that the project would proceed to construction was scheduled for September 3, 1985, with a sod-turning anticipated for later that fall after the signing of the detailed agreements.<sup>88</sup>

The changes to the original financial structure of the project had a number of implications. For CCRL/FCL, the reduction of its required equity stake in the project from 10% of capital invested to 5% brought forward the date it could begin to share in dividends from the upgrader, if any were generated. This provision changed the financial terms between the two partners but did not intrinsically affect the

viability of the upgrader itself. Other provisions did not have a similar neutral effect. By increasing CCRL's management fee to include a profit component and by granting FCL the right to supply natural gas on vendor-favourable terms, the amendments to the agreement increased NewGrade's operating costs and reduced the amount of cash flow available for debt service. According to the government's projections, this would have a manageable effect in an optimistic scenario for oil prices and differentials, but a catastrophic effect in the event that more pessimistic scenarios unfolded. The government mitigated this effect by providing a royalty rebate for the natural gas used by the upgrader, thereby improving the prospects for the project at the expense of the general revenue fund. Given FCL's hostility to participation by any competitor, the granting of an absolute veto to FCL about any third party participation was acknowledged by government to mean the end of any hope of attracting an additional equity investor. This prospect had been growing more remote as the project's financial projections worsened. Because this 10% capital share was added onto the project debt rather than being made up by an additional equity investment by either partner, the effect was to worsen the proposed equity/debt ratio from 30/70 to 20/80. A project that advisors were warning was already over-leveraged became more problematic. Finally, the governance structure was modified to eliminate independent staff employed by NewGrade, thereby confirming CCRL's exclusive operational control. The government refused, however, to make concessions on the board's mandate and authority. The loss of independent NewGrade staff reporting directly to the board was offset by shareholders gaining the right to hire, at their own expense, project monitors with full access to the project's information and the right to advise that shareholder's board members.

Premier Devine, his Ministers, and staff were acutely aware of the economic challenges facing NewGrade and of the negative implications for the viability of the project created by the changes made to the agreement in 1985. These were balanced against the outside-the-fence benefits to the province that would arise from the project proceeding.<sup>89</sup> The Premier studied particularly closely a report on the tax and royalty implications for the province prepared by the Department of Finance.<sup>90</sup> This analysis suggested that over a 10-year period NewGrade would directly result in an additional \$3.089 million in corporate income taxes, \$15.805 million in personal income taxes, \$26.272 million in provincial sales tax, and \$449.398 million in oil royalties collected on the production of feedstock. The royalty revenue was based on the assumption that 50% of the upgrader's feedstock would come from new, incremental production. The royalty rate was based on that which would be levied on the production of heavy crude from conventional wells. Finance cautioned that "this rate may be overstated because as time progresses, more EOR oil which has a much lower royalty rate will be used in the upgrader."<sup>91</sup>

With a new framework agreement worked out between cabinet members and senior FCL management, detailed implementation negotiations returned to the lawyers, board members, and officials. Responsibility for the negotiations was transferred from the Department of Energy and Mines, which was responsible for promoting the development of the oil industry, to the Crown Investments Corporation, which had the mandate of managing government business as commercial investments.<sup>92</sup> The minister responsible, however, remained the Minister of Energy and Mines. The Deputy Minister and a few key officials from this department also remained involved in the negotiations.

Negotiators on behalf of government were discontented with the concessions granted to CCRL/FCL at the expense of both NewGrade and the government, with one government appointee to the NewGrade Board suggesting to Minister Schoenhals that “I believe that Federated’s demands have been excessive and unreasonable and quite out of line with anything one might expect to see negotiated between two parties in a similar situation in the private sector.”<sup>93</sup> The belief that the detailed project and operating agreements could be completed in six weeks proved erroneous. Nonetheless, if the project’s timelines were to be met, significant engineering design and site preparation work had to proceed through the winter of 1985/86. The government authorized NewGrade to proceed with this work and scheduled a ground-breaking ceremony for October 19, 1985. The federal government was now expressing concerns about its participation in the loan guarantees, with federal Finance Minister Michael Wilson telling his Saskatchewan counterpart on October 15 that the federal government wanted to introduce an element of lender risk into the guaranteed debt.<sup>94</sup> Saskatchewan Finance Minister Andrew responded that officials would make “best efforts” to secure lender risk but that Saskatchewan would not agree to any measure that resulted in an increased cost of borrowing for the project or a modification in the agreement between the shareholders.<sup>95</sup> The October 19 ground-breaking proceeded with the federal cabinet minister participating and publicly acknowledging his government’s loan guarantees.

#### **2.4.5: NDP Reaction to the Upgrader Agreement**

Following the announcement of the amendments to the original agreement, NDP Opposition Leader Blakeney requested<sup>96</sup> and received<sup>97</sup> the agreements that had been reached to date along with a detailed description of the financial structure for the project. In the fall sitting of the provincial legislature, the government introduced Bill 118 to provide legislative authorization for Saskatchewan’s commitments to the project. When introducing Bill 118, Energy and Mines Minister Schoenhals emphasised the construction, operational, and oil-patch jobs to be created by NewGrade; the reduction

of Saskatchewan dependence on out-of-province oil; and the improved long-term viability of the CCRL upgrader.<sup>98</sup> Blakeney responded on behalf of the NDP Opposition, saying “I know that everybody in Saskatchewan will welcome the proposal” and that NewGrade “is a happy project in its conception.”<sup>99</sup> Blakeney expressed concern about the financial structure of the project, since there was “no direct participation in any risk taking by anybody else but the Government of Canada and the Government of Saskatchewan. If the project fails, then 100 per cent of the cost of the failure will be borne by the taxpayers...none is being borne by any private sector company or co-operative company.”<sup>100</sup> In the past, Blakeney suggested that “government guarantees were structured so that private sponsors would lose money as well if they failed. And those projects didn’t fail.”<sup>101</sup> Blakeney noted that there were two major hazards for the project, technology and economics, with the economics being dependent upon the differential.<sup>102</sup> Schoenhals provided the Legislature with the anticipated differentials as projected by both NewGrade and Saskatchewan Energy and Mines.<sup>103</sup> Despite these reservations, Blakeney and the other members of the NDP Opposition voted in favour of Bill 118.<sup>104</sup> The position of the legislative opposition thus closely mirrored the internal position within government. The public policy gains of proceeding with the project outweighed the recognized problems with the structure of the deal itself and the inherent risks of the project.

#### **2.4.6: Negotiating the Detailed Project Agreements**

Following the ground-breaking ceremony and the passage of Bill 118, the NewGrade project assumed a split personality. In the actual work of development such as the detailed engineering work, the selection of a contractor, and site preparation, work proceeded relatively smoothly, on schedule, and on budget. By contrast, the ongoing negotiations to reach the project and operating agreements were stalled amidst acrimony and distrust between CCRL/FCL and government officials. In the summer of 1986, FCL CEO Wayne Thompson complained to Ministers that “the finance officials are ignoring the September 3, 1985 agreement and are attempting to change a number of the very critical components of the project.” He attributed this in part to the government’s change in the location of the negotiations, since the different officials “will never understand the effort, discussion and understandings that were required to develop the agreements.”<sup>105</sup> Thompson accused provincial officials of using discussions with the federal government over the loan guarantees as a method of attempting to re-open the September, 1985, agreement. “This situation has gotten completely out of hand and it is essential you first bring your Saskatchewan people on side with the September 3, 1985 agreement and then ‘deliver’ Canada on

the guarantees in accordance with our agreement. It would be completely futile for us to have to sit down with Canada and go through all the same discussions we had with you,” concluded Thompson.<sup>106</sup>

Finally, just before the expected issuing of a writ of election in the fall of 1986, CCRL/FCL brought matters to a head. It presented draft agreements and demanded resolution before the election.<sup>107</sup> FCL President Leland told the Premier that “[w]e are adamant that these agreements must be signed prior to any election call. We have co-operated fully with yourself and your people to give your government the desired publicity. The current level of advertising is resulting in pressure from our retails to the effect that the agreements are not signed and we are just being used by the government for political purposes.”<sup>108</sup> Government officials urged the Premier to stall, saying that “[we] recommend delaying the conclusion of the project agreements until after an anticipated election.”<sup>109</sup> Instructions to negotiate with a mandate for immediate resolution would result in a resolution unfavourable to the government:

Due the significance of the areas remaining in dispute, we recommend against initiating mandated negotiations to resolve these issues as this time (negotiations with a defined government position mandated to conclude an agreement). This recommendation is based on our view that mandated negotiations at this time would result in either:

1. A confrontation, with FCL threatening to pull out of the project based upon positions the government adopts, or
2. A large degree of government concession, jeopardizing the project’s chance for financial success and federal involvement.<sup>110</sup>

FCL negotiators understood the importance of the window of opportunity as well as the government officials did.<sup>111</sup> They reacted to the government’s delaying tactics by breaking off negotiations and issuing an ultimatum that the agreement must be concluded or they would publicly withdraw from the project.<sup>112</sup> Given that about \$80 million had already been expended in feasibility studies, engineering design, and site preparation, such an action would likely have been catastrophic for the government in the election campaign. The government signed the agreements.

The election ultimatum subsequently came to define, in political and media commentary, the nature of the negotiations. However, the issues in contention did not affect the financial contributions from each partner that had been agreed to a year earlier. Instead, they dealt with questions of risk and control. From the government’s point of view, three issues demanded by CCRL/FCL were “deal-breakers.”<sup>113</sup>

CCRL/FCL took the position that if there were a default on the government guaranteed loans, the ownership and control of the NewGrade would remain intact. FCL demanded full veto rights over any prospective new owner in addition to its existing right of first refusal of any offer. If the guarantors continued operating the upgrader, the management agreement that guaranteed CCRL a profit component would remain in effect. According to the government negotiators, "If governments are forced to write-off loans while CCRL continues ownership, CCRL will have no incentive for the project to succeed and indeed may be better off if the debts are defaulted, since after the debt is removed profits will be easier to achieve."<sup>114</sup> The CCRL/FCL provisions would have the effect of removing any risk of a competitor gaining a foothold into the upgrader/refinery complex and would ensure CCRL's operational control even if NewGrade defaulted on its loans. The guarantors, after paying down the debt, would have only the choices of continuing to operate on the existing arrangements or selling the upgrader for scrap with the attendant make-whole expenses for the refinery. Saskatchewan officials believed this limitation on the ability of the guarantors to recover the full value of the assets would cause the federal government to withdraw its support for the loan guarantees. The Saskatchewan team also reported to Premier Devine that "CCRL has stated this is fundamental to them and they will collapse the project if we do not agree to their position. While we tend to believe they will not ultimately take this action, there is a possibility that this will happen and a probability that they will force this issue as far as possible, including some form of public announcement that the project is in trouble. CCRL's negotiators have for the past many months agreed with the Saskatchewan position and this was not a contentious issue until the agreement was reviewed with Wayne Thompson."<sup>115</sup> Saskatchewan proposed to deal with this issue by proposing that CCRL could exercise its right of refusal for 50% of the shares of NewGrade and that the province would lend it the money, if necessary, to purchase the shares from the guarantors.<sup>116</sup>

The governmental view that CCRL/FCL could potentially benefit from the project collapse was not shared by CCRL/FCL management. As noted above, they envisioned a situation where their refinery site was obstructed by a derelict upgrader, and were simply attempting to protect themselves from this possibility. They also believed that a bankruptcy of the upgrader would place the refinery at risk since it was impossible to predict what rights a court might give a Trustee in Bankruptcy for NewGrade.<sup>117</sup>

The second issue was CCRL/FCL's demand for a guarantee that the integrated upgrader/refinery would be able to produce the full range and quality of products produced by the refinery as currently configured. If modifications involving further capital expenses were required, CCRL/FCL insisted that

NewGrade pay all costs. This provision would remove any technical risk to CCRL arising from the change in feedstock. Since CCRL was both the designer and the operator of the integrated facility, it also had the effect of removing any risk to the refinery from CCRL's own performance in planning for the transition in feedstock. In effect, NewGrade was being asked to guarantee the results of decisions made by CCRL. The government negotiators noted that this "would make NewGrade liable to further capital expenditures in the refinery...[which]...cannot be determined in advance and could amount to many millions of dollars."<sup>118</sup> They also noted that there appeared to be a split in the CCRL/FCL team on this question, with the technical people at CCRL being willing to accept the risk arising from their design decisions but with the senior management being unwilling to do so.<sup>119</sup>

The final perceived deal-breaker was a request from CCRL to remove any risk from the natural gas concession it had obtained in the 1985 revision to the original agreement. FCL now wanted this right to be on an interruptible basis, with NewGrade being forced to turn to other sources of supply if FCL could not provide the required gas at the vendor-favourable specified price.<sup>120</sup>

Thus, the issues the provincial government's negotiating team perceived as deal-breakers all arose from CCRL/FCL's attempts to avoid risk rather than anything else that changed the financial structure of the project. There were also a series of issues dealing with the allocation of costs or benefits between NewGrade and CCRL such as whether CCRL would be able to use the new DHU unit being built by NewGrade by paying only variable costs or whether the refinery should pay a portion of the capital costs.<sup>121</sup> These, however, the government negotiators believed were resolvable through negotiations rather than ultimatum and confrontation.

The FCL leadership thwarted the government's attempts to delay the signing of the project and operating agreements by withdrawing from negotiations and telling the government it would be announcing a withdrawal from and the resulting collapse of the project. The government quickly capitulated and signed the new agreements, which were, however, conditional upon federal approval of the loan guarantees within thirty days. This deadline was extended.<sup>122</sup> The agreements then lapsed. However, when the federal government agreed to participate, the provisions CCRL/FCL had insisted upon were included in the final agreement. From the Saskatchewan government's point of view, these were gains extorted by ultimatum. From the CCRL/FCL perspective, they were simply implementation items to fulfil the general no-risk condition of participation. The September 1986 agreement essentially completed negotiations between Saskatchewan and CCRL/FCL. However, before the project could take final form, negotiations had to be completed with both the federal government and potential lenders.

As predicted by the Saskatchewan negotiators, the federal government responded negatively to the limitations on its ability to realize on NewGrade's assets in the event of default. In a letter from the federal Finance Deputy Minister, Saskatchewan was told "CCRL may have been left, during a portion of the discussion, under the impression that the Government of Canada was disinterested as to the final commercial contents of that agreement. This is not in fact the case."<sup>123</sup> Concerns about commercial viability of the project, the degree of lender risk sharing, project management structure and senior staffing were identified as needing resolution before Canada would commit to the loan guarantees.<sup>124</sup>

With Saskatchewan caught between CCRL/FCL demands for control and relief of risk and the federal government's concerns about economic viability, the allocation of risk and the governance structure of the project, it appeared that the project would not proceed. Premier Devine began exploring ideas for an exit plan, including the possibility of launching a public inquiry. His assessment of why the project was on the verge of collapse was blunt, "They [co-op] are preventing us from building the best project in W. Canada" since "Mgmt – covering their ass – in front of their memberships."<sup>125</sup> Premier Devine stressed the need for proper controls and the "prudent" use of "taxpayers funds," suggesting that "If that means we have to delay, postpone or cancel a project – we're prepared to do it."<sup>126</sup>

Saskatchewan and CCRL/FCL were able, however, to bring the federal government on board relatively quickly. Risk sharing was addressed by the province, which agreed to indemnify the federal government for a portion of the loan guarantees in the event of a call. Concerns over management structure and monitoring were addressed by the addition of a federal government nominee to the NewGrade Board, with a corresponding increase in CCRL/FCL representation to maintain a 50/50 split between governments and the private sector partner. Saskatchewan also agreed to relieve Canada of its loan guarantees if, at some point in the future, the federal government wanted to discontinue operations but Saskatchewan did not.<sup>127</sup>

#### **2.4.7: Negotiations with the Lenders**

The final step in the development of the agreements was negotiating with lenders for financing. In the financial discussion below, all dollar figures are expressed in Canadian currency except where specified. A *Confidential Offering Memorandum* was issued on behalf of NewGrade by Goldman, Sachs & Co. and McLeod Young Weir, Limited on May 27, 1987.<sup>128</sup> A \$335 million Construction and Term Loan Facility (Series B) and a \$225 (US) million Long-Term Loan Facility were proposed to pay for the

construction and initial projected operating shortfalls. It was also proposed that NewGrade would have some project-risk financing that would also be used for inventory (Series A). Potential investors were informed that “the price differential between light and heavy crude oil is the most important factor in NewGrade’s financial performance.” It was acknowledged that “in 1986, differential ranged from \$2.56 bbl to \$5.39” but that “NewGrade expects that differentials will widen on average during the life of the Project in response to a relatively higher increase in consumer demand for light products as compared to heavy products at a time when worldwide crude oil supply is gradually becoming heavier.”<sup>129</sup> Investors were being told that the project, under then-current market conditions, was not economically viable but that there were hopes for the future. The financial projections for NewGrade reveal the financial precariousness of the project. While the project was projected to generate positive earnings before interest and depreciation by 1990 (the second full year of operations), the Upgrader was projected to be in a loss position until 1998. Cash flow deficiencies of \$35.205 million in 1989; \$10,791 million in 1990; \$31.568 million in 1991; \$39.066 million in 1992; and \$15.325 million in 1993 were projected. It was proposed that these shortfalls would be covered by rolling over debt to a Series C instrument that would also be covered by the loan guarantees up to the specified ceiling. It was projected that this Series C debt would peak at \$180.601 million in 1997. Total debt would peak at \$650.755 million in 1993 with \$69.201 million still owed in 2004, the date when the financial projections ended.<sup>130</sup>

Even with the government guarantees, the offering was a tough sell in the financial community. CIC officials explained to the Crown Management Board that “[t]he financial advisors solicited interest in that financing plan during the first months of 1987. During that time it became evident that some aspects of the financing plan were not acceptable to the banking community and accordingly significant revisions in detail were made to some of the financing characteristics proposed in the original term sheet.”<sup>131</sup>

With amendment, the loan issue was successfully floated to two consortiums. To reach this point, NewGrade paid its financial advisors \$3,950,000. Bank fees in addition to interest totalled \$1,606,875.<sup>132</sup> The Series B Canadian loan was available for up to \$335 million, to be drawn down as needed for construction and operations. It carried a floating interest rate. The funds were provided by 14 Canadian banks and trust companies. RBC, the National Bank of Canada, and Toronto-Dominion were the largest lenders at \$39 million each. Credit Union Central of Saskatchewan was the fourth largest participant at \$25 million. The \$225 million USD (approximately \$300 million CND) Long Term Loan

Facility was funded by a consortium of 31 insurance companies, with Northwestern Mutual Life Insurance Company being the largest at \$25 million USD and the John Hancock Charitable Trust being the smallest at \$500,000 USD.<sup>133</sup> Because the federal guarantee was tied to an appropriations vote, it could only be expressed in Canadian currency. As a result, all currency risk for the USD loan was assumed by Saskatchewan as a unilateral commitment by CIC as a shareholder.<sup>134</sup>

It was projected that the construction of the Upgrader would utilize the entire amount of the equity injection and all but \$39 million of the loans provided under the government guarantees. In addition to non-performance, the trigger mechanism for the guarantees to be called was an Assumption Event, namely, the reaching of the maximum loan threshold. If NewGrade reached its \$635 million CDN loan ceiling, the guarantees would be called.<sup>135</sup> Since the \$39 million projected for remaining loan space under this hard cap was not projected to be sufficient to cover the projected cash flow from operations, let alone possible cost overruns or start-up problems, three project survival mechanisms were built into the financing agreements:

1. A Series C debt facility was established to roll over principal and interest payments up to the \$635 million loan guarantee limit. These loans would remain fully protected by the government guarantees.<sup>136</sup>
2. A Series A debt facility was established. This was essentially an operating line of credit secured by inventory. It was contingently covered by the loan guarantees only to the extent that the Series B, Long Term Loan, and Series C Loans were not fully utilized. The amount of Series A financing allowable was governed both by a cash-flow based formula and lender willingness to assume risk. It was anticipated that, for inventory purposes, this loan would normally be in the range of \$25 to \$30 million, but, according to the formulas and assuming lender willingness, it had the capacity to reach as much as \$230 million. The NewGrade Board was informed that “the significance of this loan can be demonstrated by the fact that if no Series A funding is obtained, using the present projection, the project would hit the maximum of the government Guarantees of \$635 million within two years or less from start up.”<sup>137</sup>
3. Finally, there was the possibility of direct cash injections by government. “The loan documentation expressly permits the governments to forestall a call on the Guarantees by reason of an Assumption Event (i.e. the reaching of the \$635 million government guarantee maximum) by providing further guarantee assurance. This would be a useful relief valve if, for

example, high construction costs or losses in early years caused the guarantee ceiling to be reached while at the same time the project seemed likely to be healthy over the longer term.”<sup>138</sup>

In summary, when the financing was arranged, it was projected that, even with rolling over principal and interest payments, the project would reach its maximum guarantee limit within two years of the commencement of operations. This event would trigger a call on the guarantees. In order to deal with this predicted catastrophic event, NewGrade was given authority to borrow, if it could find a willing lender, funds sufficient to meet its cash shortfalls on what was essentially an operational line of credit. Given that lenders were expressing some reluctance to participate even when fully guaranteed, this mechanism had dubious prospects of success. The remaining mechanism to avoid the project’s economic collapse in the event of the predicted shortfall was unilateral injections of cash by government, federal or provincial. Henry Kissinger once described the network of European treaties in the early twentieth century as a “political doomsday machine.”<sup>139</sup> In a very real sense, the NewGrade financing arrangements could be described, for the two governments involved, as an economic doomsday machine. Both CCRL/FCL and the lenders were contractually immunized against risk, default would trigger when the \$635 million loan guarantees were reached, and NewGrade was projected to reach this trigger threshold within two years. Since the original agreement had been signed in 1983, the project was projected to cost an additional \$100 million to construct, and there had been a significant and sustained drop in both oil prices and the differential, resulting in deterioration in the project’s economic projections. The long and acrimonious negotiations had increased debt ratio in the already highly-leveraged project and given CCRL an assured profit margin regardless of the upgrader’s financial performance. Both these changes further increased the likelihood of a call on the loan guarantees.

#### **2.4.8: Reaction of the NDP to the Final Agreement**

NDP Opposition reaction to the signing of the final agreement was muted. The party’s Deputy Leader told the Legislature that “the New Democratic Party members and the New Democratic Party caucus support whole-heartedly the involvement of Co-operative refineries in this project. We support it because it is a good example of a Saskatchewan company, with Saskatchewan people, using Saskatchewan talent, initiative and energy, to build in the interests of Saskatchewan people.” This, he said contrasted with government’s overall record, since “the government’s reliance on eastern and foreign private sector development capital has been a dismal failure. The upgrader that we talk about here today is proof of that in a very significant way. ... the government can only boast, as it did today, about a project which has no corporate money at all. Almost every cent of investment that is being put

in this project, the taxpayers of Canada and the taxpayers of Saskatchewan are bearing almost completely. It is a good project...but its success only underlies the dangers of this government's blind determination to privatization."<sup>140</sup> The NDP Energy Critic requested a full release of the project and operating agreements. This was denied by Energy Minister Pat Smith who, citing a precedent established by Blakeney when he was premier, refused to release the documents on the grounds that the action would violate commercial confidentiality and that CCRL had refused permission for the release. The matter was dropped, with the opposition member saying "I'm not going to belabour the point, but Madam Minister, I want to make it very clear and put it on the record that you cannot lay the blame on the third party or on the federal government because I don't think you made one ounce of effort to exclude that confidential material from the record, or form the agreement, because I believe that you didn't want to make it public."<sup>141</sup> CCRL/FCL officials have said they provided senior members of the NDP with a full briefing as to the terms, conditions, and contents of the project and operating agreements.<sup>142</sup> This assertion has never been directly denied.

Nonetheless, by the fall of 1987, all of the agreements and the financing were in place. It had taken four years from the signing of the original Memorandum of Agreement to the completion of the legal and financial arrangements, but design and construction was much more expeditious. The design work had been completed and construction was well underway. Completion of the NewGrade Upgrader was expected to be completed in another thirteen months.

## **2.5: Negotiating Bi-Provincial**

Negotiations for the Bi-Provincial Upgrader started even before those leading to the construction of NewGrade. The negotiations involved Husky Oil and the governments of Canada, Saskatchewan and Alberta. An agreement-in-principle reached in 1984 was repudiated by a new federal government, and the agreements leading to the project's construction were not reached until late in 1988.

### **2.5.1: Historical Background on the Bi-Provincial Upgrader**

Husky Oil was designated as the operating partner in the Plains Consortium that was proposing a heavy oil upgrader in Saskatchewan at the beginning of the 1980s. The company was quick to respond to new possibilities following the April, 1982, election of a new Conservative government led by Devine.

Less than a month after the election, Husky President Art Price was meeting with the new Energy and Mines Minister, Thatcher, to propose a different approach.<sup>143</sup> Husky quickly withdrew from the Plains Consortium and, without the knowledge of its former partners, proposed an alternative plan for an upgrader to the provincial government.<sup>144</sup> For Thatcher and the government, “the key thing” was “a definite willingness on the part of Husky to build an upgrader.”<sup>145</sup>

Husky Oil was a long-term operator in the heavy oil fields in Saskatchewan and Alberta. Originally formed in Wyoming in 1938, the company moved its refinery to Lloydminster in 1946 in order to produce asphalt and bunker fuel from the heavy oil being discovered in that region.<sup>146</sup> In 1953, the company’s Canadian operations were incorporated under the name of Husky Oil Ltd.<sup>147</sup> By 1982, Husky was considered a mid-sized oil company.<sup>148</sup> The company was western Canada’s largest producer of heavy oil and had a new 25,000 bpd asphalt refinery in Lloydminster.<sup>149</sup> The company had also operated a small refinery in Prince George, British Columbia, and owned a chain of retail gasoline/diesel service stations. The company had just begun exploration activity in the arctic and off Canada’s east coast.<sup>150</sup> Thus, although Husky was an integrated oil company involved in exploration, production, refining, and retailing, operational integration was lacking. Its primary oil production was heavy oil from the Lloydminster area of Saskatchewan and Alberta. However, its only refining capacity for this oil was for the production of asphalt so the oil it pumped was not and could not be used for the production of gasoline and diesel for sale in its retail service stations.

In the late 1970s, the federal Crown corporation, Petro Canada, had attempted a takeover of Husky. This was unsuccessful, and majority control of Husky was acquired by the Alberta Gas Trunk Line (renamed Nova – An Alberta Company) in 1978.<sup>151</sup> Under the leadership of Bob Blair, Alberta Gas Trunk Line was transforming itself from a quasi-utility gas collector pipeline company into a broadly based energy company involved in ambitious projects ranging from a proposal to build a natural gas pipeline to transport Alaskan and Canadian Arctic natural gas south along the route of the Alaska highway to a major investments in petrochemicals. Blair was considered a Canadian nationalist in the oil patch and a man adept at adapting his commercial interests to conform with Alberta and Canadian government policy objectives.<sup>152</sup>

Since Husky was the largest producer of heavy oil in Western Canada, the benefits it would receive from the presence of upgrading capacity would be an improvement in market access for its heavy crude. In addition to this general advantage, which would be satisfied by any upgrading project regardless of location or ownership, Husky would receive very particular synergistic benefits from an

upgrader it owned and operated in Lloydminster. Such an upgrader could be built on land already owned by Husky and adjacent to its new asphalt refinery. The company already had base management and technical infrastructure in Lloydminster. It was producing 32,000 bpd of heavy crude in the Lloydminster area,<sup>153</sup> and the existing system of collection pipelines could be used to transport feedstock to the upgrader. In addition, the proximity to oilfield production would allow for a recycling and re-use of expensive and scarce diluent. The upgrader and asphalt refinery could share desalting and fractionating facilities, and some of the by-product from the refinery could serve some of the feedstock requirements of the upgrader.<sup>154</sup> As much as anything, the size of the project required Husky to seek governmental support. In the absence of other partners in a consortium, the upgrader project was too big for Husky to handle. In 1984, as agreements for a \$1.4 billion upgrader and \$900 million in feedstock development were being nailed down, Husky's long-term assets totaled \$1.386 billion and shareholders' equity was \$909 million.<sup>155</sup> The company was planning a single capital project that would double its size. Working capital generated from operations totaled \$354 million in 1984.<sup>156</sup> The upgrader and associated feedstock development would thus have consumed every nickel of the company's internally generated capital for six-and-a-half years.

### **2.5.2: Reaching a First Agreement-in-Principle**

Husky's initial proposal was presented to Saskatchewan on August 11, 1983. It was a complicated one. Two companies, one in Alberta and one in Saskatchewan, would be formed with Husky's existing oil field, pipeline, and refinery assets along with production assets from other companies producing heavy oil in the area and be sold to these new entities (60% Saskatchewan, 40% Alberta) for \$790 million. The new companies would pay for these assets with \$180 million in government grants, \$385 million in government-guaranteed debt, and \$225 million in equity from Husky or other equity investors. These two companies would operate the oil production activities within their respective provinces and jointly construct an upgrader integrated with the asphalt refinery. The two provincially-based companies would further develop the Lloydminster area oil fields to provide feedstock to the new upgrader. Governments would provide another \$850 million in government-guaranteed debt for the upgrader construction. The two provincially-based companies would contribute \$50 million in equity and internally generated funds. These funds would be used for both upgrader construction and feedstock development. Husky proposed that the internally generated funds would be assured by a series of cuts in both federal and provincial royalties and taxes, allowing the two new entities to sell both "old" and "new" oil at world prices (a significant revenue increase under the

regulatory regime of the National Energy Policy) and a \$300 million federal grant in lieu of Petroleum Incentive Payments.<sup>157</sup> Alberta received the proposal on August 18, 1983.<sup>158</sup>

The Saskatchewan Energy and Mines officials suggested that “the proposal by Husky is one of presenting their most favourable terms and conditions. It is likely that significant modifications could be negotiated and still result in an economically viable project.”<sup>159</sup> The officials noted that the assets being offered to the new entities were likely overvalued. In addition to providing a potential windfall for Husky and others selling their assets, “the venture is inconsistent with our efforts to attract new money into the oil industry” and “it is possible [that] some or all of the equity holders would have little interest in making the project succeed once they received their initial payment for assets contributed.”<sup>160</sup> The immediate implementation in changes to the royalty/tax and pricing regimes would give an incentive to the operators to delay construction of the upgrader, while the continuation of these incentives until the project’s debt was paid off created a similar incentive to delay the full repayment of government-guaranteed debt.<sup>161</sup> Finally, the officials noted that many of the incentives “are largely federal responsibility and may not be forthcoming.”<sup>162</sup> The Premier had additional objections, writing on the briefing note that the proposal would force the upgrader to Lloydminster, thereby dividing employment and spin-offs with Alberta at the expense of other parts of Saskatchewan, would prevent SaskOil from participating, and would cost too much money.<sup>163</sup> Energy and Mines Minister Thatcher told the Premier that, “I continue to be troubled both by the technological questions and Husky Oil itself,” suggesting that “the entire question of a heavy oil upgrader in Saskatchewan is troubling me very deeply ... I have the feeling the timing is all wrong from an economic point of view, however, politically we may be trapped.”<sup>164</sup> The government continued with talks, but noted that “we are attempting to maintain a low profile publicly to minimize speculation in the press... Any further comments –especially with respect to specific details are likely to raise the public’s hopes. We feel this would be counter-productive.”<sup>165</sup>

On October 4<sup>th</sup>, 1983, Husky presented Saskatchewan, Alberta, and Canada with a new proposal. It was still based on rolling existing assets into two provincially based companies – now 50/50 between Saskatchewan and Alberta – and funding the construction through a combination of government-guaranteed debt and cash flow from operations enhanced by changes to the tax/royalty regime and pricing treatment. If the project generated a low rate of return, Husky wanted the ability to re-open the royalty/tax package, with a provision for arbitration in the event of an impasse. However, it dropped the attempt to receive payment for its existing assets and did not seek the tax, royalty, and pricing concessions until after the upgrader was constructed. The proposal for a \$300 million grant from the

federal government was dropped and replaced with the normal application of the Petroleum Incentives Payments program of the federal government. In general terms, the upgrader would be financed one-third by loans guaranteed by the federal government, one-third by loans guaranteed equally by Saskatchewan and Alberta, and one-third with an equity contribution from Husky and other heavy oil producers. The oil producers would also be assisted with concessions on the tax, royalty, and pricing treatment of oilfield production.<sup>166</sup>

The three governments jointly responded to Husky's new proposal with a counter-proposal that reduced the royalty and tax concessions and made Husky bear the risk of losses if the project did not proceed.<sup>167</sup> The possibility that this counter-proposal would lead to an end of talks was accepted by Saskatchewan, with Energy and Mines Minister Schoenhals noting that "clearly, if it should come to postponement or termination of the project talks, the three governments will act in concert and attempt to have Husky agree. If the governments terminate discussions without Husky's agreement, it would be on the basis of having made a reasonable offer (one that can be made public if need be) to the company. [It was] an offer that was not accepted."<sup>168</sup>

Husky refused to modify its October 4, 1983, proposal and insisted it wanted a go or no-go on the basis of that proposal. In reporting to the Premier, Schoenhals noted that governments were exposed to more risk than Husky, that Husky was not putting any of its own money in except that generated by cash flow enhanced by the tax and royalty changes and pricing concessions, that the potential reopening of tax and royalty rates with the potential for arbitration was unacceptable, and that Husky was offloading risk onto government for expenditures in the event that the company cancelled or delayed the project.<sup>169</sup> Schoenhals was sanguine about the prospect of the project not proceeding, since "if Husky is canceling it will create an opening for the Murphy project and we would want to pursue it as soon as possible. Our reading is that Murphy is still interested although they are going slow, waiting partly for the outcome of the Husky project."<sup>170</sup> Schoenhals recommended against accepting Husky's proposal. However, the united front of the three governments was in some danger of fragmenting. Alberta also opposed the terms of the project because of the lack of a cash investment by Husky and concerns about the overall economic viability of the project. However, Alberta was very concerned about managing the break to ensure that the governments were seen as having done "all that can reasonably be done to advance the project is done and that if it cancelled Husky is very clear that the governments are not going to take the blame for the cancellation."<sup>171</sup> Schoenhals noted that Husky Board Chair Blair had requested a meeting with Alberta Premier Lougheed on the belief that the

Alberta Premier might be more “receptive” than the Saskatchewan Premier.<sup>172</sup> However, the real concern was the federal government. Schoenhals suggested that “[a]t the officials’ level they share the Alberta view. At the political level we believe they may be prepared to proceed anyway and hope for a turnaround in oil prices to make the project viable. They [the federal government] would give up almost all their revenues and assume in the downside [that] the provinces would be forced to do the same in order to try to save the project once it had started. In a political sense Mr. Chrétien may want to support the project for short-term reasons recognizing that the problems that occur in the future may not be his to solve.”<sup>173</sup>

Between the end of 1983 and June of 1984, the impasse was broken. Many observers suggested that the agreement announced on June 6, 1984, was primarily the result of federal Energy Minister Jean Chrétien’s desire to make inroads in western Canada for his bid for the leadership of the Liberal Party.<sup>174</sup> In addition to whatever aspirations were being entertained by the federal energy minister, the federal government was attempting to use individual agreements for particular major energy projects to demonstrate its ability to work with industry to develop supply, notwithstanding the frictions created by the National Energy Policy.<sup>175</sup> Indeed, Chrétien was explicit at the June 6 announcement, stating that the agreement “proves once again that the Government of Canada, the provinces and the oil industry can work together in a spirit of co-operation.”<sup>176</sup> While these political concerns may have had some impact on the federal government’s willingness to reach a deal, they do not explain continued negotiations by the two provincial governments or Husky. From the provincial perspective, a major development was an agreement between Alberta and Esso for a royalty regime associated with the intensive development of heavy oil reserves in the Cold Lake area. This was seen as providing a template for the treatment of Husky in way that offered some consistency across the industry.<sup>177</sup> Husky contributed to the process by starting to streamline and simplify its positions.<sup>178</sup>

The June 6, 1984, agreement left the corporate structure of Husky intact, abandoning the creation of two separate provincially-based companies. Husky would build a 42,000 bpd upgrader at a cost of \$1.4 billion and spend another \$900 million in the oil patch developing feedstock capacity. By including the expected operating costs for the first five years of operations, the project was pitched as a \$3.2 billion development.<sup>179</sup> Governments would guarantee up to \$1.56 billion in loans, with the federal government guaranteeing \$780 million and the two provinces sharing the other half equally. The loan guarantees were to be secured by the assets of the upgrader as well as by project land and by associated oil production and production assets including the existing asphalt refinery. In the event of

the loan guarantees being called, Husky would lose a significant part of its heavy oil production assets. The federal government also agreed to provide Husky with a \$50 million grant, to reduce the Petroleum and Gas Revenue Tax on the project's production, and to guarantee that the New Oil Reference Price would apply on all production once the upgrader began operations. Feedstock was to come equally from the Cold Lake (Alberta) and Lloydminster (Saskatchewan) fields.<sup>180</sup>

The commitment to provincially equal feedstock supply resulted in some nuance. Alberta's overall royalty rate was lower than Saskatchewan's, and a field-specific regime had been established for Cold Lake heavy crude. As a result, Husky took the position that, if they were to guarantee equal feedstock supply from each province, Saskatchewan's royalty rate for this oil would have to be lowered to match Alberta's.<sup>181</sup> This resulted in some differences in treatment between Saskatchewan and Alberta in the agreement. First, although the overall guarantee ceiling was the same for both provinces (\$390 million), loans guaranteed by Alberta could only be used by Husky for the construction of the upgrader, while loans guaranteed by Saskatchewan could be used for both upgrader construction and field development.<sup>182</sup> If this agreement had been implemented, the result would have been that Saskatchewan would have guaranteed a higher level of debt than Alberta. Saskatchewan provided a one-third reduction in royalties for production on lands designated for supplying the upgrader. This reduction took effect immediately. However, until the upgrader was complete, the funds generated by the royalty cut went into a trust fund to be released to Husky upon completion of the upgrader. This mechanism was designed to prevent Saskatchewan from paying for an upgrader but not receiving it.<sup>183</sup> However, the royalty cut had the potential for a long-term payback for the province. The cut was to remain in effect until the project's guaranteed debt was repaid and specified rates of return achieved by Husky. Once that occurred, the royalty cuts would terminate. At that time, royalties on Saskatchewan oil would be subject to royalties based on the price *after upgrading* rather than at well head.<sup>184</sup> In effect, Saskatchewan would eventually collect a royalty on the value created by upgrading. The more immediate revenue gain would come from increased production. Saskatchewan Finance officials estimated that the agreement and construction of the upgrader would result in additional oil royalty revenues beginning in 1988 with a total of \$78.5 million incremental royalties by 1994.<sup>185</sup>

The June 6, 1984, agreement represented a significant scaling back of Husky's requests from its original proposal. Instead of selling its heavy oil assets to new, government-assisted, corporate entities, it was putting both its income streams and ownership at risk in the new venture. While the government-guaranteed debt would provide the capital for the upgrader construction, a project default would mean

Husky would lose ownership and control of its core oil production assets, leaving the company only with its small Prince George Refinery, its retail gasoline and diesel sales outlets, and the interests it had in frontier exploration in the Arctic and off the east coast of Canada. It would be out of the oil production business in western Canada. The number and value of the royalty and tax concessions had been scaled back considerably, and the pricing changes would take place when the upgrader began construction rather than immediately. This removed financial incentives for Husky to delay construction. The combined upgrading and feedstock production complex would be highly leveraged with a debt equity ratio of 68:32, but the debt would be supported by both the income flows from oil production as well as the upgrading differential. Economic viability and the ability to service the debt would be dependent upon oil prices, but the effects of the differential increasing or shrinking would be, in effect, self-hedging. A shrinking of the differential would reduce margins at the upgrader but increase them on the production side. An increase in the differentials would have the opposite effect. For Husky, the agreement could be seen as a double-or-nothing (or triple-or-nothing) bet on the future of its existing heavy oil assets. For Saskatchewan, a maximum of \$390 million in loan guarantees would be put at risk. Even though the maximum guarantee ceiling had been established at \$1.56 billion, Alberta and Saskatchewan were projecting that the actual usage of the guaranteed government debt for the upgrader itself would be \$1.02 billion, meaning that each province's share would be \$255 million. Unlike Alberta, Saskatchewan had also allowed for additional guaranteed borrowing (up to the \$390 million maximum) to be used for feedstock development.<sup>186</sup> If the upgrader worked technologically and economically the province would gain several hundred jobs and approximately \$20 million per year in incremental oil royalty revenue with no current expenditure. If the project failed, the province would lose some proportion of the \$390 million in guaranteed debt, with the final amount depending on the nature of the failure and the ability to realize some return on the assets that provided security for the guarantees.

### **2.5.3: Reaction to the 1984 Agreement-in-Principle**

Reaction from the Lloydminster area and the business community was favourable, with the owner of a chain of Saskatchewan radio stations telling Premier Devine that "I used to say that I am on the band wagon, then I used to say I am jumping up and down on the band wagon, now I am really jumping up and down on the band wagon. You guys are doing a terrific job."<sup>187</sup> In the provincial legislature, prior to the announcement, Opposition Leader Blakeney had been asking for updates on negotiating progress, but stated, "I certainly don't want to do anything which could even indirectly or

peripherally hinder the minister with regard to these negotiations.”<sup>188</sup> Once the agreement was signed, however, criticism emerged from the NDP caucus. The Member from Shaunavon, Dwain Lingenfelter, pointed to the inherent risk of the loan guarantees by rhetorically asking “if it turns into an operation or a refinery that doesn’t work, who would be left holding the bag when you’ve signed the note for \$390 million?” Lingenfelter also questioned priorities, asking “why [do] you have \$390 million for Husky Oil to guarantee their loan and [but for] the small business men in Shaunavon you have no guarantees for them?”<sup>189</sup> He was joined by the Member from Assiniboia, who said the government “found hundreds of millions of dollars to provide iron-clad loan guarantees to Husky Oil...but what has it done for the farmers of Saskatchewan? Peanuts. Peanuts to the farmer.”<sup>190</sup> The government responded aggressively, with Justice Minister Gary Lane pointing to the Blakeney government’s inability to deliver an upgrader to Saskatchewan, jeering “they promised an upgrader in Moose Jaw. They promised one in Regina. They promised one in Saskatoon. And they promised one in North Battleford. They promised one in Lloydminster, and I think Cut Knife. I think the only place that didn’t get the promise of an upgrader was Shaunavon and only because they thought the member was going to make the promise[,] and he forgot.” The return of an NDP government would result in the failure to build upgraders, said Lane, since “they’re going to cancel them because they said you can’t give money to the big multinationals like Consumer Co-op Refinery, that you can’t give money to an Alberta oil company, even though Tommy Douglas is on the board of directors. The NDP will cancel the upgrader.”<sup>191</sup> The criticism of the terms of the Lloydminster upgrader agreement abruptly ended, and the NDP returned to the tactic of questioning whether the June 6, 1984, announcement would actually deliver an upgrader to the Lloydminster area.<sup>192</sup> As time passed, the NDP got increasingly vociferous with this line of attack. By 1987, the Member from Riversdale was saying “The upgrader up in Lloydminster, it’s not here... It’s a joke. It’s a joke, Mr. Speaker. But it’s not a funny joke, it’s a cruel joke that the Devine administration is making on the province of Saskatchewan.”<sup>193</sup> The NDP Energy Critic was describing the project as a “phantom upgrader.”<sup>194</sup>

Following the signing of the June 6, 1984, agreement, little work was done on the drafting of the detailed agreements needed for implementation. It was accepted by all of the partners that, because of the need to constitute a new government following the Liberal leadership convention and the impending federal election, the federal government would not be in a position to focus on this work for some months. In the meantime, Husky proceeded with engineering and design work on the upgrader and oil patch activity to increase the feedstock supply. Saskatchewan and Alberta focussed their efforts on negotiating an agreement about the jurisdictional issues arising from the upgrader’s location almost

straddling the provincial border. Agreement was quickly reached on the way to deal with environmental review and licensing, sharing of municipal revenue, sharing of corporate income tax, labour relations regime, manpower planning, and training.<sup>195</sup> The issue of “sharing of industrial benefits” (procurement) was more contentious. There appears to have been an initial understanding that “Husky should attempt to source approximately 50 percent of its goods and services in each province.”<sup>196</sup> After concerns were raised in Alberta about financially supporting a major project located in another province, Premier Lougheed directed that “his province’s policy from ‘equitable sourcing’ [would go] to sourcing according to ‘free market sources’.”<sup>197</sup> Based on the experience of Husky’s recent construction of the asphalt refinery, Saskatchewan officials believed that such a change would lower Saskatchewan’s share of procurement from about 30% to as low as 7%.<sup>198</sup> The issue threatened to escalate into a dispute between the two premiers at the annual late-summer premiers’ conference.<sup>199</sup> Instead, “senior officials” were dispatched “to put together a set of words that will describe a policy in this area deemed acceptable to both governments.”<sup>200</sup> The drafting solution centred around treating an area in a 50 km radius of Lloydminster as having a local preference and exemption from any provincial targets.<sup>201</sup> The issue most difficult to resolve was access to the project by truckers based and licensed in Alberta. The Saskatchewan Highway Traffic Board took the position that “continuation of existing inter-provincial regulatory policies is considered essential to ensure that an equitable share of current and potential oil field trucking opportunities are available to Saskatchewan firms.”<sup>202</sup> Saskatchewan quickly conceded that Alberta’s support of the upgrader itself meant that Albert truckers should be able to haul to the upgrader site but insisted that, since Alberta’s support did not extend to feedstock development, Alberta-based truckers should be prohibited from hauling in the oil lands designated as part of the project.<sup>203</sup> The dispute dragged on until the spring of 1985, when Saskatchewan decided that “while Saskatchewan could press Alberta for an agreement on trucking, it is felt that this approach might disrupt the ongoing productive consultations amongst the three governments and Husky.”<sup>204</sup> In the Saskatchewan Legislature, the Opposition joined in the political squabbling over the interprovincial division of economic impacts. Citing an internal government report, NDP MLA Lingenfelter broke out specific components of the upgrader where Saskatchewan content would be zero to accuse the government of failing to protect the province’s interests.<sup>205</sup> The government responded by arguing that the project needed to be evaluated as a whole, since “there will be elements in the engineering components, which is what he has referred to, where there is no opportunity for Saskatchewan content at this stage. There will be many other areas where there will be, and they will be packaged in such a way [as] to allow Saskatchewan content.”<sup>206</sup>

#### 2.5.4: The Mulroney Government Backtracks

The Mulroney government elected in the fall of 1984 took some time before turning its attention to the Bi-Provincial Upgrader File. In April of 1985, the other partners were told that a meeting could be organized quickly. This did not occur, however, until September 16.<sup>207</sup> In the lead-up to the meeting, the federal government attempted to forge a common governmental position by meeting with the provincial governments in the absence of Husky and by providing the provinces information in advance of sharing it with Husky.<sup>208</sup> The federal government informed Alberta and Saskatchewan that it supported the project but did not feel legally or morally bound by the June 6, 1984, agreement.<sup>209</sup> The provincial governments immediately informed Husky of meetings and general direction but honored the confidentiality of detailed information until the federal government was willing to share it with Husky.<sup>210</sup> Saskatchewan also declared its ongoing support for proceeding with the project on the basis of the existing agreement.<sup>211</sup> Since it was unilaterally expending money on both upgrader design and feedstock development, the delay and positioning by the federal government was making Husky increasingly nervous.<sup>212</sup> At the September 16 meeting, Finance Minister Wilson and Energy Minister Pat Carney told Husky that the federal government wished to obtain outside consultants to study the project. Husky responded by asking if it should suspend expenditures on the project and was told by the Energy Minister that any action to suspend or terminate the project would be “an act of the greatest corporate irresponsibility,”<sup>213</sup> and that a governmental decision would be made quickly after the conclusion of the studies. The Alberta and Saskatchewan Premiers attempted to gain support for the project directly with Prime Minister Mulroney at the First Minister’s Conference held in Halifax on November 28 and 29<sup>214</sup>. In requesting a private meeting between the Prime Minister and the two Premiers, Premier Getty wrote, “the Federal government appears to be reopening an agreement covering the construction of a Husky Upgrader Project to be built in the Lloydminster area on the Saskatchewan/Alberta border....its delay is clearly sending the wrong signals ... I urge your government not to break the agreement between us and to move quickly so that project can move ahead, thus allowing us to maintain our economic momentum.”<sup>215</sup> The Prime Minister avoided the proposed meeting and six weeks later told the Alberta Premier that “a very different fiscal, economic and political environment prevails today than during the electoral summer of 1984 when the Memoranda of understanding were concluded between Husky and the previous federal government and the governments of the Provinces of Alberta and Saskatchewan...under such new circumstances it is only prudent to consider the continued appropriateness of earlier arrangements for government support of the project.”<sup>216</sup>

The federal government commissioned two studies on the Bi-Provincial Upgrader Project which were completed late in November. A technical study by Joe Zink Consultants identified a few concerns but concluded there was no technical reason the project should not proceed.<sup>217</sup> A financial study conducted by Toronto Dominion Bank was less sanguine. While acknowledging that, if Husky's projections about oil prices are correct, the "project will be successful" and "the Federal Government will therefore have achieved its objectives at no direct cost, i.e. no direct funding," the bank pointed to the inherent risks of the loan guarantees and expressed doubt about Husky's projections. "There is no doubt that we regard the economic risks to be more substantial than does Husky. As the greatest example of this, we feel the risk of an oil price decline or collapse is higher than does Husky. Therefore the governments must be convinced of substantial benefits flowing from the provision of these guarantees, as we believe there is a high degree of probability that there will be events of default in the security and that additional concessions or costs through tax relief, grants, additional guarantees or direct funding, will be required to see the Project through."<sup>218</sup> The Toronto Dominion Bank was explicit that the adoption of its recommendation to deny the federal loan guarantees would result in the termination of the project. "We conclude that a private lender would not provide funding unless there was the basis of support as is available in the negotiated deal. This is likely not surprising to you, nor should it be to Husky. Indeed, from Husky's standpoint this is one of the major reasons why they believe the need for the loan guarantees. Aside from the cost savings in borrowing and ability to limit risk under the guarantee structure, they realize that funds simply would not be available without guarantees due to the marginal return and substantial financial risks."<sup>219</sup>

All of this resulted in two new proposals in January of 1986.

In the first, the federal government proposed a stand-alone upgrader project which would draw feedstock from both Husky and Esso. The level of federal loan guarantees would be reduced, with Husky becoming responsible for any cost overruns. There would be a cap on the payment under the guarantees, and two-thirds of the project would be unguaranteed. All project cash flow would be directed to service guaranteed debt and all feedstock providers would be required to contribute to any upgrader shortfalls.<sup>220</sup> In the opinion of Saskatchewan's officials, "the federal proposal falls well short of what one would expect from a government committed to the project. Husky's reaction was predictably negative."<sup>221</sup>

In the second new proposal, Husky suggested that an upgrader be constructed on "a utility model." The public sector would build an upgrader and lease it to a private sector operator, which

would receive a cost-based management fee. All producers of heavy oil would sell to the upgrader at a formula-based price.<sup>222</sup> Under this proposal, governments would assume all of the economic risk of an upgrader and receive in return all of the potential economic reward from upgrading. Husky and other producing companies would benefit from the increased security of the market demand for heavy oil.<sup>223</sup> Saskatchewan viewed this proposal as inconsistent with the main federal objective of reducing its risk exposure and did not discuss the concept with the federal government.<sup>224</sup>

By late January 1986 Saskatchewan government officials believed that “prospects for resolution at an officials’ level are dim.”<sup>225</sup> It is perhaps useful to summarize the positions of all four potential partners. Underlying the position of each partner is a common acceptance of the key finding of the Toronto Dominion report, which concluded that the risk/reward profile of the upgrader was such that normal commercial funding was unavailable to the project.

Canada’s main priority was to reduce its risk exposure from that contained in the June 6, 1984, agreements. This would have had the result of transferring risk to Husky, the provinces, commercial lenders, and other potential equity partners or some combination of them. The effects of the royalty, tax, and pricing concessions contained in the 1984 agreement had diminished in importance as a result of general energy policy changes and a movement towards deregulated prices. However, even as it attempted to reduce its exposure in the project, the federal government had a political reluctance to be seen as unilaterally causing the project’s collapse – thereby eliminating the option of a simple, straightforward declaration that the harsh light of day had fallen on the dream of an upgrader in Lloydminster.

Alberta, Saskatchewan and Husky wanted to proceed as quickly as possible upon the basis of the 1984 agreement, thereby accepting the status quo in the allocation of risk and reward. If it was not possible to convince the federal government to honour the agreement, each of these partner had a different position. Husky was very exposed. It had been spending an average of \$3 million per month on engineering and design work. By March of 1986, these expenditures would reach a total of \$60 million.<sup>226</sup> In addition, it had spent another \$200 million on feedstock development in anticipation of the market demand created by the upgrader.<sup>227</sup> The value of this investment would be impaired if an upgrader was not built. As a result, the company was desperate for quick movement on either proceeding on the basis of the 1984 agreement or along an alternative that would allow it to recoup its engineering investment and protect its feedstock development investment by seeing an upgrader – any upgrader, under any ownership – built.

Alberta wanted the upgrader built, preferably with an allocation of risk consistent with the 1984 agreement. However, if the federal government reduced its risk exposure, Alberta believed that Husky did not have the resources to increase its corporate exposure. As a result, it was reluctantly willing to increase its own participation in the project to compensate for a federal reduction.<sup>228</sup>

Saskatchewan also wanted the project to proceed but was unwilling or unable to increase its participation or shouldering of risk. For the province, an acceptance of the project's failure was preferable to an increase in its exposure. However, politically, it did not want to be seen as being responsible for the project's demise. Thus, this made Alberta's position very dangerous for Saskatchewan. Any public indication of Alberta's willingness to increase support for the project would be conditional upon an equal increase from Saskatchewan. As a result, Saskatchewan saw itself as the strongest proponent of the principle that "a deal is a deal." It needed to work closely with Alberta both to avoid any unilateral announcement from that province and to resist federal attempts to offload exposure onto the provinces. In addition, the two provincial governments had to coordinate efforts to prevent any bi-lateral agreement between the federal government and Husky that would be predicated upon increased provincial support. For Saskatchewan, the greatest danger was "a federal confirmation of project support followed by an Alberta announcement to increase support leaving 'the ball in our court'."<sup>229</sup>

Of the four partners, Husky and Saskatchewan were in the most precarious situation. Husky had been paying the bills for the engineering work and had based its heavy oil investment strategy on the premise that an upgrader would be constructed. Making matters worse, oil prices were beginning to slide in what would be a 50% drop in 1986.<sup>230</sup> The Saskatchewan government was entering into an election year with a significant part of its economic policy credibility tied to the promotion of the oil and gas sector in general and of the construction of heavy oil upgraders in particular. At the same time, falling prices for oil and other commodities, combined with the effects of budget deficits in its first term, meant that the government was facing a significant austerity regime which was restricting its ability to follow Alberta in being prepared to increase provincial contributions or exposure.<sup>231</sup>

Following the January presentation of new proposals by the federal government and Husky, negotiations again slowed, leading Husky in particular to plead for top level negotiating meetings and resolution.<sup>232</sup> The Premiers sought to impress a sense of urgency upon the Prime Minister.<sup>233</sup> Husky attempted to bypass the federal Ministers of Finance and Energy by presenting its case and articulating their frustrations to cabinet Ministers whose constituencies represented Lloydminster on both sides of

the provincial border.<sup>234</sup> Letter writing and lobbying was undertaken by members of the Lloydminster business community, blaming the federal government for the delays in the project.<sup>235</sup> The Lloydminster and District Chamber of Commerce began drafting a brief stressing the importance of the upgrader project.<sup>236</sup> The reaction from the Lloydminster area was intensified by the impact of rapidly falling oil prices on the community. The Chamber of Commerce reported that between December 1985 and June 1986, 25% of the staff of major oil companies operating in the area had been laid off or transferred, and 50% of employees of oil service companies had been laid off. Service industry revenues in the area had dropped from \$18 million per month to \$9 million per month, and many companies were reported as facing bankruptcy.<sup>237</sup> In this regional economic climate, the economic stimulus and jobs that would be created by upgrader construction were being more aggressively sought.

At the end of March, Husky said that delays from the federal government “have gone far beyond reason.” During this period, Husky asserted to the federal administration that it had “at your request” continued to expend funds based on the June 6, 1984, agreement, but, in the absence of a prompt response, “Husky and we understand probably the Provinces of Alberta and Saskatchewan will conclude that the Government of Canada has decided on its own to terminate its position and expects Husky to act accordingly.”<sup>238</sup>

The effect of the ultimatum was an agreement two weeks later of a commitment for the governments to share in the funding of the engineering and design work in proportion to their commitment level under the June 6, 1984, agreement.<sup>239</sup> That document said that “after extensive discussion” the three governments and Husky agreed to jointly fund “completing the engineering for the pre-construction phase which is expected to be concluded by March 31, 1987 at an estimated cumulative cost of \$90 million (including costs incurred to date).” Furthermore, the parties accepted that “after completion of the engineering for the pre-construction phase of each of the parties will decide whether and on what basis to further participate in the project.”<sup>240</sup> Of the estimated \$90 million cost, Canada agreed to fund \$36 million, with Saskatchewan and Alberta each paying for \$13.5 million. The contribution by all three governments would be in the form of adjustments to royalties and taxes “otherwise payable” by Husky.<sup>241</sup> This device would allow the funds to be made available to the company without a legislative appropriation or special warrant, and it would not show up on governmental books as an expenditure. The terms provided Husky with no assistance with any of the oil field development costs it had incurred in anticipation of the upgrader.<sup>242</sup> For the two provincial governments and Husky, the interim agreement had the advantages of securing federal support for the project, providing a way

to fairly fund the pre-construction engineering work, and establishing “recognition of the MOU as the basis for proceeding with the project, while recognizing some adjustments to the MOU may be required in light of lower oil prices during the project’s construction period.”<sup>243</sup> It also had the effect of postponing the difficult go or no-go decision (along with the question of how) by at least a year. For the two provincial governments, this had the favorable result of moving these negotiations and decisions from the provincial pre-election window to the beginning of the federal one.

One result of the delay in making a final decision was a continued weakness in oil prices and a resulting deterioration in the financial position of the two western provinces and Husky. The average price received for a barrel of Saskatchewan crude dropped from \$30.88 in 1985 to \$13.35 by 1988.<sup>244</sup> Overall production volume stagnated as companies slashed their development budgets because of shrinking cash flow. The heavy oil fields around Lloydminster were particularly hard hit as production from these fields dropped by 10.8% from 1985 to 1989.<sup>245</sup> Husky’s ability to carry on with the upgrader project came into question, since their corporate cash flow was insufficient to provide the required equity and the “returns from oil production were reduced, eliminating the ability for production profit to provide sufficient subsidy to carry the project.”<sup>246</sup> Difficulties notwithstanding, Husky persevered. When the engineering work was completed at the end of March 1987, Husky attempted to secure Ministerial level meetings to proceed to a decision as provided for in the April 1986 MOU. Again, it experienced difficulty in getting the attention to the federal ministers. Husky’s Board Chair told Premier Devine that “I do not know if this may be just a matter of greater priorities for Ottawa,” but “this project comes far closer to commercial terms financing, with lesser government involvement, than any of the alternative automotive/tractor fuel schemes being sponsored by Governments in Canada” and “this is the only real major regional development project in Western Canada to start construction in 1988 as far as I know.”<sup>247</sup> Blair admitted that neither of these were sufficient reasons to proceed but should be sufficient to have the four parties work towards a decision.<sup>248</sup>

### **2.5.5: The Drive for a New Agreement**

Husky took the lead by presenting a new proposal to the governments in August 1987. The governments, in turn, presented a counter-proposal in December.

Both the proposals recognized the changed economic circumstances. Husky and the three governments recognized that the “project economics are very marginal” and that the upgrader could be expected, at best, to pay operating costs and pay down project debt of about \$600 million.<sup>249</sup> Given that

the projected cost of a 50,000 bpd upgrader was in the range of \$1.2 billion, half of the capital costs of the upgrader could not be supported by the project itself.

At a meeting with the three energy ministers on December 15, 1987, Husky made the case for proceeding despite these project economics. If the project was viewed as “a traditional private sector oil production project,” there was no question that “Canadian upgrader investments by the private sector would be deferred.” The industry and country would wait until a large regional surplus of heavy oil existed that would be “not marketable except through heavy discounts of heavy oil prices.” Even then, the project would be delayed while industry and governments waited to see if the surplus was sustained and while debates were conducted as to “who should solve the problem.” Each individual producer would have little incentive to contribute to a solution, since the surplus would only be a fraction of the total production capacity. It was similar to the situation for pipelines, except no regulatory regime existed to impose a sharing of both capacity and the cost of additions to the system. As a result, there was a tendency for nothing to be done. Husky and possibly a few other producers were willing to invest in the project even in the absence of a commercially acceptable rate of return as a form of insurance that their heavy crude would be able to find a market. However, “if the cost of that insurance is too high, we will wait and take the market risk as part of the industry.” If the criteria for economic viability were the achievement of a normal commercial rate of return, then “it [the upgrader] is not,” since “this project does not meet traditional Canadian oil production private sector tests today.” Husky noted that “governments have known this from the start.” Just as Husky was evaluating its participation from broader criteria that dealt with overall corporate objectives and strategy, so, too, should government evaluate the project against its public policy objectives and in comparison to other means of achieving these objectives. With this approach, Husky suggested the upgrader project would become attractive, especially when measured against “other alternative transportation fuels projects, such as propane, compressed natural gas, methanol and ethanol, and [it would] result in justification of financial support much greater than ever suggested for the upgrader project.” Husky said that it had designed its proposal for simplicity, presenting the upgrader on a stand-alone basis. With the exception of the need for some congruence in provincial royalties if feedstock was to be equally sourced from the two provinces, the proposal was stripped of all production royalty and tax components. This was designed to allow government to make a relatively simple cost/benefit analysis. “In this unique case, Husky Oil and I believe [that] to a lesser extent two others are willing to take less [sic] returns out of this project than would normally be acceptable for broader but still private sector reasons. The question is: Are there broader government reasons that justify the government taking less out of this project (under the Husky

proposal, by accepting a specific form of downside risk) than would be normal to cause the project to proceed now?"<sup>250</sup>

Husky's proposed mechanism for bridging the economic gap was for governments to establish a floor price of \$25 per barrel for the upgrader's output. In this way, governments would be assuming the downside risk of continued low oil prices. If the prices at the end of 1987 did not move, the result would be a government subsidy to the project of about \$800 million over its life.<sup>251</sup> Governments and Husky would share in the project's equity, and government would guarantee \$700 million in project debt. However, the price guarantee would both effectively remove the risk of the guarantees being called as a result of market conditions and be sufficient to assure equity holders (both government and Husky) a 6% rate of return. As operator, Husky would receive a \$6 million per year management fee.<sup>252</sup>

Prior to the ministerial meeting with Husky on December 15, the three governments developed a collective counter-proposal and presented it to Husky at the meeting. This treated the \$100 million in design and engineering costs as being paid according to the April 1986 MOU. This lowered the remaining cost of the upgrader to \$1,100 million, of which Husky was to contribute \$275 million and governments a total of \$175 million. Economic projections were that this equity would not yield a return. The remaining \$550 million was to be debt financed, with half covered by guarantees and half subject to lender risk. Husky, as operator, was to be reimbursed actual costs.<sup>253</sup> This proposal would mean the government subsidy was limited to, and in the form of, an equity investment of \$175 million that was not expected to generate a profit. Debt financing would be lowered to a level that the financial projections indicated the project would be capable of supporting, with risk shared equally between governments and lenders.

Neither of the proposals dealt substantively with governance issues.

Husky rejected the government's December 15 proposal as containing insufficient public support to make the project viable. The governmental united front fractured. Ottawa returned to the sidelines. Alberta presented a proposal suggesting that the \$800 million subsidy for the upgrader should be funded by a ¼ cent per litre special federal excise tax on retail sales of gasoline.<sup>254</sup>

Saskatchewan and Husky traded proposals in mid-March.

Husky proposed to invest a total of \$275 million in equity (including the \$100 million already expended). It believed it could attract between \$225 million and \$325 million in additional private sector

equity by making equity participation a condition of feedstock supply. While it hoped to raise the full \$325 million privately, it suggested that government might need to contribute as much as \$100 million to bring the total equity amount to \$600 million. The remaining \$600 million would be debt-financed. However, instead of government loan guarantees issued to private sector lenders, governments would lend the project the funds directly at an interest rate of 5%. This discounted interest rate would be the mechanism through which governments subsidized the upgrader to meet their public policy objectives. In return for this subsidy, governments would have the option of converting these loans to equity once the original equity holders were achieving a rate of return in excess of 15%.<sup>255</sup>

Saskatchewan objected to the proposal on the grounds that the interest charges on the loans would only begin when the upgrader began operations and proposed that interest during the construction period be capitalized. It also wanted firmer completion guarantees from Husky.<sup>256</sup> While Saskatchewan was willing to accept the Husky proposal, subject to those issues being addressed, it was not as optimistic as Husky about the prospects for other private sector equity investment. As a result, Saskatchewan presented Husky with an alternative proposal for consideration. This proposed increasing equity to \$700 million, with Husky being responsible for half. Canada would assume \$150 million of remainder, with the two provinces each taking \$100 million. The balance of the financing would come from direct government loans bearing interest at the government's cost of borrowing, with the interest capitalized during the construction period. These loans would be converted to preferred shares upon completion of the upgrader and repaid as cash flow permitted. With this, government assumed the risk of the loans, but the subsidy mechanism was to be through the increased government equity that was expected to be non-performing for the foreseeable future.<sup>257</sup>

Both proposals abandoned the involvement of third-party lenders and government guaranteed debt. Instead, the governments' financial participation was to be direct. Project subsidies were to be in the form of subsidized interest rates or equity that was not expected to generate any returns for the foreseeable future. Based on current interest rates at the time, the Husky proposal would result in a public subsidy to the upgrader of \$40 million per year, divided amongst the three governments. The Saskatchewan alternative would result in a subsidy of \$30 million annually.<sup>258</sup> With this direct assumption of immediate financial obligations, however, mechanisms began to be built in for government to receive some upside economic advantage, should any be eventually generated. Saskatchewan and Husky each generated proposals that were conceptually similar, while Alberta was developing a proposal that would offload the anticipated public subsidy to taxpayers across Canada and

the resulting political responsibility to the federal government. Canada effectively withdrew from the discussion for this period. The December 15, 1987, proposal by the three governments was the last expression of any support for third-party loans to the upgrader, with or without government guarantees.

Notwithstanding its alternative proposal, Saskatchewan began working to convince the other two governments to accept the essential features of Husky's proposal, starting with Alberta. Premier Devine told Premier Getty that "I am of the opinion that the current situation represents the best window of opportunity we will have for seeing this project proceed. As well, this proposal, because of its simplicity, represents the best option at this time to take to the private sector. I therefore think it would be very advantageous for us to accept the proposal, with an adjustment to include capitalized interest, and provide the Federal Ministers with a common provincial/Husky position to take to their federal colleagues."<sup>259</sup>

By the beginning of April, 1988, Alberta and Canada were on the verge of signing on. While Saskatchewan had been concerned about the subsidy issue of capitalization of interest during the construction period and risk avoidance in the form of a completion guarantee, the other two governmental partners were focussed on sharing of potential profits. Husky had proposed that the loans be convertible to equity and share in profits once the original equity holders achieved a 15% rate of return. Officials told the Premier Devine that "Saskatchewan has taken the position that the upside sharing, as proposed by Husky, is, because of the level, the economics of the project[,] and complexity in measuring project rate of returns, not achievable during the 20 year term of the loan and therefore is meaningful only from a public profile point of view."<sup>260</sup> However, "the federal and Alberta governments continue to believe there may be considerable upside potential in the project and, as a result, they want to restructure the proposal so as to make the upside sharing level realistic and meaningful."<sup>261</sup> Saskatchewan argued that changing the upside provision would be financially meaningless to governments but would make it more difficult for Husky to attract other private equity investors, or, at worst, cause Husky to withdraw.<sup>262</sup> Saskatchewan was also preparing the other governments for the possibility that Husky would be unable to attract other private equity investors, even with the quasi-coercive mechanism of tying feedstock supply contracts to equity participation. Canada was taking the position that a failure to attract other equity holders would mean the project was finished, while Saskatchewan was arguing that it's proposal was a viable potential alternative.<sup>263</sup>

The three governments agreed to compromise on the upside issue by proposing 13% as the conversion trigger. Husky's structure was accepted, with the governments proposing that Husky commit to \$292 million (including the previously expended \$100 million) and attract or commit another \$344 million in private equity for a total of \$636 million. The governments would match this with 5% loans, with Canada taking \$254 million and the two provinces \$191 million each.<sup>264</sup> The offer was presented to Husky on April 18, 1988, and was generally acceptable to the company with only two issues needing to be resolved.<sup>265</sup> The first dealt with design and construction risk. Saskatchewan's energy minister explained, "Husky continues to take the position that while they will be the managing contractor for the project they are not prepared to provide the governments (lenders) with a 'money back guarantee' that the project will be built on time, on budget and on spec. As discussed with you before such a guarantee was part of the '84' deal. The lack of such a guarantee risks leaving the governments in a position where, if the upgrader does not get built, governments will have invested \$600 million in a 'white elephant'. I consider the political and financial downsides of this position to be unacceptable."<sup>266</sup> The second issue was Saskatchewan royalties. "Husky wanted to have at least the basic outlines of the royalty agreement with Saskatchewan in place before they agree to the overall deal"<sup>267</sup>

The Saskatchewan royalty issue was unrelated to the financing of the upgrader but intrinsic to Husky's commitment to source feedstock equally from both sides of the border. Saskatchewan's royalty regime would have resulted in upgrader feedstock being assessed royalties averaging 13.6% of the value of heavy crude oil, while Alberta's regime would cost Husky 6%. At very low price levels, Saskatchewan's royalty rates were approximately equal, but, as prices increased, so, too, did Saskatchewan's rates. When oil was valued at \$25.00 per barrel, "where the upgrader becomes successful," Saskatchewan's rates were significantly higher.<sup>268</sup> In this environment, the provision for equal supply of feedstock from both provinces was a significant financial issue. For Saskatchewan, royalty rates also had economic implications and maintaining them higher than Alberta did was a political issue. The province's bottom line was a royalty regime yielding an average rate of 8.8%.<sup>269</sup> Husky required equality, but it was important for Saskatchewan to maintain rates that were higher than its sister province. The solution to the problem lay in \$20.4 million in royalty payments held in trust as a result of the original 1984 upgrader agreement. As described above, Husky had received an immediate royalty reduction to assist with the construction of the upgrader. To ensure that the company had no incentive to delay construction, these funds were placed in trust pending the upgrader's completion under the terms of the 1984 MOU. In 1986, when the federal government had unilaterally declared the 1984 agreement to have no legal effect and it appeared that the upgrader would not be built through no fault of Husky's,

the company had requested that consideration be given to the province allowing these funds to be applied to feedstock development expenditures that had been made in anticipation of the upgrader. Saskatchewan had responded with a vague letter indicating the proposal would be considered with some favour if it became necessary. The Premier had been more definitive in verbal discussions with Husky. The honouring of these commitments became the mechanism for bridging Husky's need to have the equal production provision be cost-neutral with Saskatchewan's need to have a royalty rate higher than Alberta's. Saskatchewan agreed to pay interest on these trust funds and pay out at the time of signing definitive project agreement.<sup>270</sup>

The construction guarantee issue was papered over with artful language, and the four partners signed another agreement on April 22, 1988. The final major hurdle for the forward movement of the project was Husky's ability to secure additional private sector equity financing. While the project was not expected to provide equity holders with a commercial return for a significant time, if ever, Husky believed that, by making feedstock agreements conditional upon equity investments, support for the upgrader could be obtained. The timing could not have been worse. The fifty percent drop in prices received by Saskatchewan producers in 1986 had been followed by a slight recovery in 1987. This proved, however, to be a dead skunk bounce. Prices in 1988 dropped to a low of \$13.35 per barrel.<sup>271</sup> Cash flow for investments of any type became very scarce within the industry.<sup>272</sup> In searching for private sector equity partners, Husky had the equivalent of a dry well. Had the federal government maintained its position that this would mean the end of the project, the quest to build an upgrader in Lloydminster would have been over. However, a federal election was quickly approaching. The federal government had granted concessions to allow the development of the Hibernia field off the east coast of Canada and was under pressure to see western projects through to completion.<sup>273</sup> In the absence of other private sector equity partners, Saskatchewan's alternative proposal was now the basis of ongoing discussions.

An agreement was reached quickly. The third and final framework agreement for the Bi-Provincial Upgrader was signed and announced on September 2, 1988.<sup>274</sup> There was an urgency to the announcement. Premier Devine's speech writer dropped his draft announcement speech in his home mailbox after midnight for him to retrieve as he left for Lloydminster. In apologizing for the lack of time for review, she explained, "I only got the material at suppertime."<sup>275</sup> In his speech, the Saskatchewan Premier said, "Husky saw an opportunity to do what they do best – to develop a tremendous resource, employ a lot of people, and make some money for everyone in the process. But they needed help for a project of this magnitude. So they turned to the governments of Canada and two provinces to help them

make it work.” The Premier focussed on the jobs and investment that would flow from the upgrader project, and concluded by predicting “This project will go down in history as a stellar example of what governments and industry can accomplish together – in the spirit of enterprise and cooperation.”<sup>276</sup>

At the signing in Lloydminster, Canada was represented by senior federal Conservative cabinet ministers whose ridings encompassed the border city, while provincial representation was from Premiers and responsible Ministers. The Alberta constituency was represented by Deputy Prime Minister Don Mazenkowski and the Saskatchewan one by Western Diversification Minister Bill McKnight.

Other than having the same mix of partners and the objective of building an upgrader, the final agreement bore little resemblance to the one signed four years earlier. Instead of treating oilfield production and the upgrader as an integrated entity, the upgrader was now treated as a stand-alone project. Royalty, tax, and oil pricing considerations had been stripped from the deal. There was no provision for third-party lenders, government loan guarantees, or, indeed, debt of any kind. The project was financed on the basis of equity contributions alone. As a venture, it was prohibited from borrowing money.<sup>277</sup> Ninety-five percent of the equity was in the form of Class A shares (Canada- 30%, Husky- 25%, Alberta – 22.5%, and Saskatchewan - 17.5%). The remaining 5% of equity was in the form of Class B shares divided equally between Canada, Husky, and Alberta.<sup>278</sup> These shares received priority treatment in the allocation of dividends over the Class A shares. Saskatchewan had a ten-year option to purchase the same number of Class C shares (as the other partners Class B) at an equivalent price and with equivalent treatment.<sup>279</sup> In total, Canada’s share was \$400 million, with \$340 million for Husky, \$305 million for Alberta, and \$222 million for Saskatchewan. No interest was to be paid on the investment, with the distribution of economic benefits coming from dividends arising from positive cash flow. Husky received priority in payout of dividends until it achieved a rate of return of 10%.<sup>280</sup> Partners were required to contribute to operating losses according to their ownership share up to a limit of \$50 million,<sup>281</sup> but no provision was made for the funding of construction cost overruns. Feedstock was to be paid for at market prices and sourced equally from Saskatchewan and Alberta.<sup>282</sup> Upgraded synthetic crude would be sold on the open market. If a partner was dissatisfied with the price Husky as operator was obtaining, it could opt to sell its share itself.<sup>283</sup> Husky was to serve as construction and operations manager,<sup>284</sup> with the entity being governed by a 12-person board. Each partner would appoint three board members, of which only one could be an employee of the partner. Board members’ fiduciary duty was to be to the upgrader rather than the appointing partner.<sup>285</sup> In the event of disputes, an arbitration

process was specified.<sup>286</sup> Existing partners had the right of first refusal for any share sale by another partner, except when a government sold shares through a general public participation offering.<sup>287</sup>

In stark contrast to the time it took to reach the agreement in principle, the detailed project and operating agreements took very little time to negotiate, and the agreements were concluded without dispute or controversy amongst the partners.

### **2.5.6: Reaction to the 1988 Bi-Provincial Agreement**

The 1988 Bi-Provincial Upgrader deal received mixed reviews. In general, the further away from Lloydminster a commentator was, the more critical the reaction. Media outside of Saskatchewan and Alberta attacked the deal as irresponsible pre-election pork-barrelling.<sup>288</sup> In and around Lloydminster, the reaction was rapturously enthusiastic. The President of the local Chamber of Commerce told Premier Devine that “[t]he announcement that was made here that Friday morning in September has made Lloydminster a very happy city.”<sup>289</sup> On behalf of the City of Lloydminster, the Mayor thanked the Premier “for the important role you played.”<sup>290</sup> In the pre-federal election atmosphere, the NDP and Liberals “tacitly accepted” the upgrader deal, while the emerging Reform party opposed it, with its leader, Preston Manning, saying, “the Husky Lloydminster oil upgrader project is just the latest example of western Canadians being lulled into submission with their own money.”<sup>291</sup> Prior to the September 2, 1988, announcement, opposition parties in both Alberta<sup>292</sup> and Saskatchewan attacked their respective governments for failing to deliver an upgrader. The Saskatchewan NDP Energy Critic said “they call Lloydminster ‘the promised land’ because they’ve been promised this thing so often by all three levels of government.”<sup>293</sup> He also expressed a preference for equity investments over loan guarantees so that the province could receive “some of the profits from this large project for the taxpayers.”<sup>294</sup> After the announcement, the opposition was silent in Alberta and largely silent in Saskatchewan. In the 106 sitting days of the Saskatchewan 1989 legislative session, the Bi-Provincial Upgrader was not raised in Question Period. In the spending estimates debate for the Department of Energy and Mines, the NDP critic questioned whether Saskatchewan would get its share of economic benefit from the project and whether the equity investment in the upgrader would be profitable. He attacked the preferential treatment for dividends that Husky was accorded in the agreement.<sup>295</sup> In reply to a question as to whether Bi-provincial was a good investment, the Minister cited employment and feedstock development as the benefits. She said, “[w]e believe that in fact this is a long time investment” but refused to provide any projections for the financial rate of return on the project.<sup>296</sup>

## 2.6 Comparison of the two Upgrader Agreements

The objective in this section is twofold. The first objective is to provide a comparative overview of the key characteristics of the partnerships that were negotiated. The second objective is to provide a brief explanation on why the two upgraders had such different negotiating paths and what the substantive differences in the agreements were. Although government loan guarantees were originally the cornerstone of public support for both projects, ultimately the key difference between the two projects was that NewGrade was highly leveraged with third-party debt guaranteed by government while Bi-Provincial was funded by equity contributions from the partners. The differences in the agreements are largely attributable to the effect of time on the negotiating process, the different nature of the private sector partners, and the effect of the number of partners involved in the negotiations.

### 2.6.1: Comparison of Characteristics of Two Upgrader Agreements

The similarities and differences related to eighteen different characteristics of the two upgrader agreements are outlined in Table 2.1.

**Table 2.1**

**Summary Comparison of NewGrade and Bi-Provincial Upgrader Agreements**

	<b>NewGrade Energy Inc.</b>	<b>Bi-Provincial JV Partnership</b>
Design capacity of Upgrader	50,000 bpd	50,000 bpd
Projected Construction Cost	\$750 million	\$1,267 million
Shareholders	Saskatchewan, CCRL/FCL	Canada, Husky, Alberta, Saskatchewan
Saskatchewan Exposure	\$589 million+ from: \$154 million (equity) \$360 million (loan guarantees) \$75 million (potential federal indemnification) *Unquantified (currency exchange risk) *Unquantified (CCRL make whole provisions)	\$222 million (equity)

Private Sector Partner Exposure	\$0	\$340 million
Debt/Equity Ratio	80:20	0:100
Cash flow required to cover	Operating expenses, interest, debt repayment	Operating expenses
First priority for positive cash flow	Debt repayment	Shareholder dividend with some priority for Husky at lower levels
Provision for capital cost overruns	\$39 million "room" under guaranteed debt ceiling	None
Provision for operating cash shortfalls	\$39 million "room" under guaranteed debt ceiling. Unguaranteed Series A loans if obtainable. Provision for cash injection from shareholders.	Up to \$50 million cash injection from shareholders divided according to ownership share.
Primary location of cost of capital	NewGrade	Shareholders
Governance	CCRL to operate, board appointed by partners to oversee.	Husky to operate, board appointed by partners to oversee.
Dispute Resolution Procedure	Arbitration if requested by 75% of board members.	Arbitration if requested by any shareholder.
Mechanism to price product	Formula for sales to CCRL, Open market for disposal of surplus	Open Market
Direction of Integration of partner's operations with upgrader	Upstream	Downstream
Public policy benefits to Saskatchewan	Increased oil patch activity, royalties and jobs	Increased oil patch activity, royalties and jobs
Non-rate of return benefits to private partner	Long term security of supply for refinery	Increased markets for heavy oil production, assured market and diluent access, increase in value of existing heavy oil assets.
Complexity of integration and accounting	Integrated operation, complex accounting	Segregated operation, straightforward accounting.

## 2.6.2 The Effect of Time on the Negotiations

Discussions between Saskatchewan and the private sector partner began in the summer of 1982 for both upgraders. The signing of the agreement to allow for the construction of Bi-Provincial in the fall of 1988 took place only 70 days before the "Oil In" ceremonies marking the launching of operations of NewGrade. Construction of NewGrade had taken less time than the negotiations simply to reach an

agreement-in-principle for Bi-Provincial. In part, the differences between the final agreements were due to this different time sequence.

In the late 1980s, the passage of time was not the friend of upgrader development. In the first half of the 1980s, when the upgraders were being proposed and promised, the average price received for Saskatchewan oil increased every year. Prices collapsed in 1986, and, with relatively minor fluctuations, stayed depressed through the rest of the decade. In 1983, when the original NewGrade MOU was signed, the average price of a barrel of Saskatchewan crude was \$27.48. A year later, when the first Bi-Provincial MOU was signed, it was \$27.53. In 1987, when the NewGrade project and operating agreements were signed, Saskatchewan crude was receiving \$19.77 per barrel. In 1988, when the final Bi-Provincial agreement was signed, the price was down to \$13.35.<sup>297</sup> The price of oil was not directly correlated with the differential. However, lower prices for crude in general reduced the maximum price that upgraded synthetic crude could obtain, thereby capping the potential differential. Reduced netbacks and cash flow to producers impaired their ability to increase production, which would eventually lead to higher relative prices for heavy crudes. In effect, low oil prices created a scissors effect on differentials. The low crude prices did not directly affect the financial position of FCL, but negatively impacted directly and substantially the revenues and financial position of both Saskatchewan and Husky. Low oil prices, therefore, had the tendency to weaken the financial viability of the upgraders by putting pressure on the differentials while, at the same time, reducing the ability of most of the partners to deal with these additional problems.

Timing was directly responsible for one major difference in the structure of the two projects. In initial conception, for both, the majority of government participation was to be in the form of government guarantees of debt taken by third-party lenders. It was believed that the upgrader projects themselves would be able to internally generate enough positive cash flow to meet interest payments and pay down the debt in a timely fashion. NewGrade, as the first deal to be concluded, was based on this premise. However, because of project delays caused by the federal government, by the time the Bi-Provincial agreement was reached, it had become clear that the upgrader's capacity to support enough debt to build it was inadequate. Further, the ability of Husky and other heavy oil producers to provide adequate equity funding was impaired. This resulted in government participation coming exclusively in equity. The resulting stronger balance sheet for Bi-Provincial was the accidental by-product of delay, despair, and desperation rather than the result of prudence from the partners.

### 2.6.3: The Effect of the Different Nature of the Private Sector Partners

The second key difference between the two projects was the nature of the partners. Part of this difference was organizational. Husky had a highly centralized decision making-process with the President and Board Chair being able to speak for the company. FCL, on the other hand, had a consultative process amongst its member co-operatives for major policy decisions. After the upgrader project was proposed, this consultation process resulted in conditions for participation that the FCL management treated as absolute directives. However, the most important difference between the two private sector partners was their level of commitment to the project. For Bi-Provincial, Husky was clearly the project's proponent. In the case of NewGrade, Saskatchewan was the proponent with CCRL/FCL being a reluctant, hesitant, and cautious partner. The difference between the two companies is most starkly illustrated in the funding of detailed design and engineering work prior to the signing of the final agreements. In the case of Bi-Provincial, Husky wrote the cheques and was exposed to significant risk in the event the project did not proceed. In the case of NewGrade, it was Saskatchewan that paid the bills and was exposed to the financial consequences that would arise if the project did not proceed. Husky viewed the upgrader as core to the long-term security and prosperity of its overall corporate corporation and complementary to its decades-old commitment to developing heavy oil in western Canada. CCRL/FCL viewed the upgrader as something unnecessary in its ongoing business and as a threat containing risks to be managed rather than as the key to long-term survival and growth. This difference in orientation was likely the result of their different places on the petroleum value chain. Both companies integrated several components of this value chain – but they were at the opposite ends of the chain. The petroleum value chain normally presents as:

Exploration → Development → Crude Production → Crude Gathering and Transportation → Refining →  
Wholesaling → Retail Sales

A fully integrated oil company will own and control this whole process. Both CCRL and the western Canadian heavy oil operations of Husky were only partially integrated. CCRL/FCL was engaged in refining, wholesaling, and retail sales. Husky's heavy oil operations were engaged in exploration, development, crude production and crude gathering. It had refining capacity for this crude but only for the purposes of asphalt production. While the company had refining, wholesale, and retail operations, these were unrelated to the production and utilization of the heavy crude oil it produced in Saskatchewan and Alberta. In the case of NewGrade, the upgrader added a step in the value chain immediately before its original starting point of refining. In the case of Husky, the upgrader added a step

at the end of its segment of the value chain, right after the gathering of crude. After upgrading, the synthetic crude was sold and transported through pipelines owned by others to refineries owned by still others. By adding value and assuring markets for Husky's heavy crude, the upgrader increased the value and security of all of Husky's existing assets. This fact was clearly understood by Husky's management and was the source of their dogged pursuit of the project even when the upgrader, as a stand-alone entity, was not expected to achieve a normal commercial rate of return. From the perspective of CCRL/FCL, the upgrader added nothing to the value or security of their existing business and assets. Prior to the upgrader, they had purchased Albert light crude on the open market. Without the upgrader, they anticipated continuing to do so. While governments, both federal and provincial, were predicting that this source of supply would diminish, CCRL/FCL rejected this as a survival issue. As a result, the upgrader was seen as adding complexity and risk to their operation but bringing no value except for the economic returns it might generate as a stand-alone entity.

The governance and management structures of the two projects had some common features. Both upgraders were operated by the private sector partner in return for a management fee. Both upgraders were incorporated as separate entities with independent financial statements and were governed and monitored by a Board of Directors containing representatives appointed by the shareholders. Despite those similarities, there were some differences in some governance and management processes. While both upgrader agreements contained provision for arbitration in the event of disputes among the shareholders, at Bi-Provincial any single shareholder could initiate the arbitration process. In the case of NewGrade, both shareholders needed to approve the move to arbitration. The agreements for Bi-Provincial specified that the fiduciary duty of Board Members was owed to the upgrader venture rather than the appointing partner. The NewGrade agreement was silent on this particular issue of fiduciary duty. This difference was accentuated by the composition of the Boards. Only one appointee from each partner could be an employee of the parent corporations at Bi-Provincial. At NewGrade, the government appointed non-employee experts, while CCRL/FCL appointed its own management staff to the NewGrade Board. Most NewGrade board members had been intimately involved in the negotiation of the project and operating agreements as representatives of the shareholder that appointed them to the Board. As will be shown in the next chapter, this contributed to a division amongst the board members into camps representing the interests of partners rather than to a collegial group pursuing the interests of NewGrade as a separate entity. In the case of Bi-Provincial, Board members were appointed after the agreements were negotiated and did not carry a memory of negotiating disputes to the board table.

Both agreements contained the potential for conflicts of interest between the upgrader as a separate entity and the operating partner as a corporate entity. In the case of Bi-Provincial, the major potential conflict of interest was in the supply of feedstock to the upgrader. Husky was the largest supplier. However, the agreement specified that market prices were to be paid, and easily verifiable benchmark comparisons were available. The upgraded synthetic crude was sold on the open market to other refiners, so no potential conflict of interest arose. Decisions about the allocation of expenses to the upgrader were simple and relatively transparent. Since the upgrader was a stand-alone facility, if an expense was incurred inside the fence, it belonged to the upgrader. If they were incurred outside the fence, they belonged to Husky. The potential for conflicts of interest were much higher at NewGrade. Indeed, these conflicts were intrinsic to the project. There were few decisions that CCRL/FCL made that were free of a real conflict of interest. Unlike Bi-Provincial, the sourcing of feedstock for the upgrader was free of a conflict because heavy crude was purchased on the open market from other suppliers. However, a conflict of interest arose at the other end, since CCRL was the dominant purchaser of upgraded synthetic crude with the price being formula derived. Since synthetic crude had unique and alterable characteristics a simple and transparent observable benchmark did not exist. Further, there was no fence separating the upgrader from the other operations of CCRL/FCL. Indeed, the major synergistic benefit was derived from physical and operational integration with the CCRL refinery. As a result, CCRL management was in a conflict of interest position on almost every decision regarding the allocation of expense.

#### **2.6.4: The Effect of the Number of Partners Involved in Negotiations**

In reaching the final agreements, the negotiating process was very different. In the case of NewGrade, negotiations on the project's structure, financing, and operating agreements were conducted bi-laterally between the Saskatchewan government and CCRL/FCL. The federal government would become involved only after a shareholders agreement was reached. Its general response pattern was to raise some questions and concerns about the agreement but to acquiesce to the main terms of the shareholders' agreement fairly promptly and without any fundamental revisions. In the case of Bi-Provincial, the federal government played a much more active role and negotiated on the fundamental terms and conditions of the project. The timing of the two key project agreements in 1984 and 1988 coincided with the federal election cycle. Observers thus ascribed a high level of federal ownership of the terms of the agreements. The negotiations involved a dynamic process between the partners. Husky consistently served as the foremost project proponent. Prior to the 1984 agreement, Alberta and

Saskatchewan were working to restrain what they saw as the potential for the federal government agreeing to an excessive level of support. Following the 1984 federal administration change, the provinces then served as de-facto allies of Husky in attempting to get commitments from a reluctant federal government. At one point, Saskatchewan was simultaneously pushing the federal government for more governmental support while working to restrain the commitment level from Alberta. At key points, the three governments came together to present Husky with a unified governmental position. These moments of policy coordination tended to be short lived. Finally, in 1988, substantive negotiations were occurring almost bi-laterally between Saskatchewan and Husky, with the province then negotiating with the other two governments to forge a unified governmental position.

## **2.7 Concluding Observations**

The agreements governing both upgrader partnerships started from similar principles. However, by the time the final agreements were concluded, there were significant differences. In some cases, the path to these differences involved the interworking of a number of factors. For example, the increased number of partners involved in the negotiations was a significant factor in making the negotiations for Bi-Provincial last much longer. This delay, in turn, resulted in both revisions to the economic projections for the project and the fiscal capacity of the partners – particularly the private sector partner. In turn, this contributed to both the replacement of government-guaranteed third party debt with equity investments from the partners and in the change in the ownership of Husky. Both of these had impacts on both the construction/operation and renegotiation phases. In other instances, the relationships were more direct. The physical integration of the NewGrade upgrader with the CCRL refinery provided the basis of significant synergistic benefit, but it also made it much more difficult for the Saskatchewan government to monitor its investment. The result was both increased complexity in governance and the beginning of a cycle of escalating distrust amongst the partners.

The next chapter will explore the partnerships in the period of construction and initial operation. During this period, the partnerships were affected by environmental conditions, the differences in the nature and number of partners and the differences resulting from the project agreements such as the difference in financial structure and governance mechanisms.

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- <sup>283</sup> Ibid., Section 10.3.
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## CHAPTER 3

# The Partnerships in Action: Building and Operating the Upgraders

### 3.1 Introduction

Reaching agreements on the general terms and conditions of the partnerships for the NewGrade and Bi-Provincial upgraders was only the first major and difficult step taken by the various partners. Two other major and difficult steps involved building and operating each of those upgraders. As this chapter reveals those steps were undertaken during rapid and substantial changes to economic conditions. The challenges arising from the changing economic conditions, along with equally significant challenges emerging from changes to the composition of the partnership as a result of changes in governments and corporate leaders, and the inherent challenges of constructing and operating upgraders in a partnership context, all contributed to the eventual demands by the Saskatchewan government that the partnerships be restructured.

This chapter examines the unfolding of these issues up to the time of the decision to seek renegotiate of the agreements, which will be somewhat arbitrarily deemed to be the 1992 release of the *Report of the Saskatchewan Financial Management Review Commission*<sup>1</sup> in the case of NewGrade, and exhausting the funds available to cover operating losses in the case of Bi-Provincial. The chapter examines the critical issues, options and decisions related to each of those upgraders.

### 3.2: Building and Operating the NewGrade Upgrader

Under the terms of the NewGrade project and operating agreements, CCRL was to serve as the operating partner, with its activities subject to oversight by the NewGrade Board. The relationship was extremely complex because of the physical integration of the upgrader and the existing refinery. CCRL aggressively defended its right to operate the existing refinery without interference from government appointed board members or monitors, while representatives of the Saskatchewan government

attempted to actively monitor and influence CCRL's decisions. The result of the disconnect between the public and private imperatives was a cycle of mistrust and acrimony which was made worse by start-up operational difficulties and financial losses arising from low oil prices and the resulting compression in the differential between light and heavy crude.

### **3.2.1: Issues Related Managing Construction**

During the construction period, the partnership between Saskatchewan and CCRL/FCL effectively expanded to include the general contractor, Kilborn-Fluor. Saskatchewan was effectively responsible for ensuring that the project was funded while CCRL/FCL was responsible for the overall project and Kilborn-Fluor managed construction.

#### **3.2.1.1: Relationships with Contractors and Sub-contractors**

The ink was barely dry on the signatures of the 1983 Memorandum of Understanding for the NewGrade Upgrader, when corporations who were not partners to the agreement started positioning themselves for the major contracts to build it. The Montreal-based engineering firm, SNC-Lavalin, had been selected by the Plains consortium as the construction contractor for the upgrader it had envisioned. Upon the announcement of the potential NewGrade project, Lavalin's President requested a meeting with Premier Devine to convince him that his company should be contracted for the development of NewGrade.<sup>2</sup> A year earlier, the members of the Plains Consortium had complained to the new provincial government that the federal government had exercised "undue influence" on the choice of the Montreal-based company as a condition of potential federal support and that this would have a negative impact on Saskatchewan content.<sup>3</sup> The Premier refused the requested meeting, explaining that there would be a tendering process and that the Board of NewGrade would ultimately decide.<sup>4</sup> In 1985, SNC-Lavalin was one of the three companies invited to compete for the contract<sup>5</sup> and eventually received subcontracting work as designers and constructors of the hydrogen plant.<sup>6</sup> This early attempt to by-pass the normal procurement process by approaching elected government officials was a precursor of things to come. So, too, was the government's response to these attempts. These attempts increased dramatically with the signing at the ground breaking ceremony in 1985. The Premier and Cabinet Ministers were approached by people looking for construction employment,<sup>7</sup> seeking a role in arranging project financing<sup>8</sup>, seeking to be included in the allocation of engineering work,<sup>9</sup> and seeking contracts for the procurement of overhead cranes<sup>10</sup> and pipes.<sup>11</sup> The President of the Regina-based steel company, IPSCO, told the government that the actions of the contractor, Kilborn/Fluor, were "not

conducive to maximizing Saskatchewan content for the Regina upgrader. The situation regarding pipe borders on scandal.”<sup>12</sup> The indignant IPSCO President was protesting Kilborn/Fluor’s practice of purchasing pipe according to the specifications needed for the project rather than matching it to IPSCO’s product line.<sup>13</sup> In addition to such particularistic concerns, the government was lobbied for increased hiring of Aboriginal workers.<sup>14</sup> The negotiation of a project agreement with construction unions was protested.<sup>15</sup>

The government was usually disciplined in referring complainants to CCRL as the operator, Kilborn/Fluor as the contractor, and the NewGrade Board as the governors of the project and in defending the decisions made by those responsible. For example, one potential supplier was told his company was not selected on a tender because “the crane arrangement which you proposed was not sufficiently flexible to accommodate the additional uses they anticipate and your price was significantly higher than that of the successful bidder.”<sup>16</sup> However, such a response shows that an inquiry had been made to those building the upgrader by the Premier’s office. Replying would have been a distraction and the inquiry itself would create a sense of political oversight and potential interference in the project even when the purpose of the inquiry was to gather information to defend the operational decision that had been made.

However, sometimes the government had its own issues upon which it was prepared to be directive. The most important was the issue of Saskatchewan-based hiring. Quite simply, the government did not want to see a lot of out-of-province license plates in the construction parking lot. The contractor, Kilborn/Fluor, was primarily interested in quickly accessing qualified workers, which meant a project agreement with the building trades unions. As a result, union seniority threatened to trump local residence. In December of 1985, officials from the Department of Economic Development met Kilborn/Fluor to review the proposed labour project agreement with the building trades unions. The contractor was told “it was unacceptable” and “not to take it to the unions” until a strategy to maximize Saskatchewan labour content was developed.<sup>17</sup>

### **3.2.1.2: Due Diligence in Expenditure of Public Funds**

These external pressures on the government to monitor, influence, or overturn operational decisions by CCRL as the mandated project operator were less problematical in the grand scheme of things than the pressures created internally through a combination of the structure of the project and

the decision of government officials and Saskatchewan's representatives on the NewGrade Board to exercise due diligence in the expenditure of public funds.

During much of the construction period, the board position allocated to the federal government was left vacant. The Saskatchewan nominees and the Crown Investments Corporation finally requested that the Premier's office apply pressure on the federal government to nominate a member.<sup>18</sup> When an appointment was made, the federal government followed Saskatchewan's example by appointing a retired oil company executive with extensive experience in operating upgraders, in this case from Gulf Canada.<sup>19</sup>

### **3.2.1.3: Issues Related to Upgrades of the CCRL Refinery**

In the construction phase, the primary focus of contention was the upgrades to the CCRL refinery itself. Many components of the refinery had to be upgraded or modernized in order to accommodate the presence of the upgrader and the change in feedstock. As part of the general commitment to protect the refinery from any potential negative impacts from the upgrader, the project agreement specified that these changes would be paid for exclusively by NewGrade. At the same time, CCRL was taking advantage of the presence of the contractors to make a number of improvements and equipment upgrades that had no relationship to the upgrader. These were to remain the sole responsibility of CCRL. The initial decision as to which budget these expenditures should be allocated was in the hands of CCRL management as operators. The decisions were reviewed by the NewGrade Board. This created the dynamic of the government representatives questioning these decisions in order to assure themselves that NewGrade was not paying for any expenses that should belong to the refinery. The CCRL-appointed board members would defend the decisions they or their subordinates had made in their capacity as operators.<sup>20</sup> When CCRL-appointed board members agreed with the representatives nominated by the government, "CCRL found itself in the unenviable role of having to allocate certain costs to itself, each dollar of which would result in precisely an equivalent dollar savings for NewGrade."<sup>21</sup> The decisions were often complicated and nuanced. The government nominees to the NewGrade Board told their shareholder that, "CCRL would also have to exclusively declare whether the expenditure had been made at CCRL's request (for example to replace worn or obsolete refinery equipment or to bring the capability of the old CCRL units up to the level which they had warranted to NewGrade) or whether the expenditure was necessary simply to accommodate the new demands dictated by the complex design. In some cases, the expenditures were actually required by a combination of such factors."<sup>22</sup>

The NewGrade Board hired a consultant (Doug Sands) to work with contractor Kilborn/Fleur to review the allocation of the refinery refurbishment costs. He identified \$4 million in expenditures that had been allocated to the upgrader that he believed should have gone been assigned to the refinery. This represented only 4% of the \$100 million in expenditures associated with the commitment made that NewGrade would fund modifications to the refinery. The CCRL nominees to the Board initially rejected these findings, but after “lengthy negotiations” the majority of the reallocation recommendations were accepted.<sup>23</sup> In another instance, CCRL proposed modifications to one process within the refinery (“polymerization”) that would both improve refinery operations and eliminate the need for a proposed component of the upgrader (“Alkylation”). Polymerization had more capital costs than alkylation, so CCRL proposed that NewGrade support the polymerization upgrade by paying for the equivalent of what it would have paid for the alkylation unit. The government board representatives agreed, subject to CCRL’s being responsible for any additional costs if the alternative process did not perform as expected. The proposal was abandoned by CCRL.<sup>24</sup> Much more problematic was a similar situation involving the demineralization unit. The original upgrader design called for a unit with a capacity of 600 USGPM. In discussions with the contractor, CCRL management concluded that a 1,000 USGPM unit could also benefit the refinery operations on a shared-use basis, with the operational cost savings to the refinery resulting in a payback of the incremental capital costs in less than a year. In the fall of 1986, CCRL management ordered the installation of the larger unit with the intention of billing NewGrade only the portion of the costs equivalent to the smaller unit required by the upgrader. Since CCRL believed the decision would have no effect on the upgrader, the NewGrade Board was not informed until July of 1987. The information was not contentious. However, the expanded unit did not deliver the expected operational benefits to the refinery. The additional expenditure for the increased capacity was wasted. CCRL then assigned the full cost of the demineralization unit to NewGrade. The government representatives to the board objected, saying that they had not been consulted about the change and would not have agreed if they understood it would create the risk of incremental expenditure for NewGrade.<sup>25</sup> Subsequently, the government members “as a sign of good faith” proposed that NewGrade contribute \$500,000 of the incremental costs. The CCRL representatives countered with a demand that NewGrade pay half the \$2,200,000 incremental cost. The government nominees refused.<sup>26</sup> In the absence of an agreement by the Board, the original management decision that NewGrade pay remained in place with the issue continuing to be argued years later.<sup>27</sup>

Although the number of CCRL’s capital cost allocation decisions were contentious or challenged was relatively small in relation to the total number of these decisions, those in dispute generated a

remarkable level of hostility and distrust amongst the board members and the partners they represented. The Government nominees pointed to the fact that, in each case of disputed costs, CCRL took a position that favoured the refinery rather than the upgrader.<sup>28</sup> This was either disingenuous or naïve, since it overlooked the simple fact that when CCRL allocated to costs itself, the NewGrade Board had no reason to review the decision and there was, intrinsically, no dispute. More substantively, the government nominees noted that in the event of the dispute, CCRL staff was mobilized to defend the original decision. In its capacity as operator of the upgrader with a fiduciary duty towards NewGrade, CCRL “in not a single instance, at any stage from beginning to final resolution have CCRL in their role as NewGrade’s agent ever assigned a single individual in support of NewGrade’s interest in the dispute!”<sup>29</sup> The government nominees were acutely aware of the intrinsic conflict of interest position that CCRL was in as operator of the upgrader and were deeply suspicious of the motivations of CCRL senior management. For its part, CCRL management viewed the efforts for accountability from the government nominees to the board as bad-faith efforts being conducted by former employees of competitors who were attempting to force CCRL/FCL to “make us walk away from the agreement or re-negotiate to their liking” to undermine the upgrader.<sup>30</sup> The co-chair of the NewGrade Board representing CCRL/FCL said “the guy from Gulf and the guy from Shell, why would they do anything to help the co-op? They are raised with Shell and Gulf. If I live to be a hundred, I’m not going to fill my car with Shell gas. Nor is he going to fill his car with co-op gas.”<sup>31</sup>

#### **3.2.1.4: Issues Related to Staffing and Reporting**

In addition to the allocation decisions, disagreement about the need for separate staff for NewGrade continued to fester through the construction period and beyond. CCRL/FCL took the position that the co-ordination of staff with a single line of reporting was one of the major benefits of integrating the operations of the upgrader and refinery.<sup>32</sup> The government nominees to the Board argued that NewGrade needed separate management staff as the only way to eliminate the intrinsic conflict-of-interest arising from CCRL being the owner/operator of the refinery and the contractual operator of the upgrader in a facility that was physically integrated. A single management structure was seen as “totally incestuous.”<sup>33</sup>

The government nominees to the NewGrade Board defended this position on behalf of the province in 1984 and 1985 during the negotiation of the project and operating agreements. When CCRL/FCL moved negotiations to the Ministerial level following their threatened withdrawal from the project, the issue was resolved in favour of the CCRL/FCL position. This was enshrined in the final

agreements. NewGrade existed without any staff, with CCRL serving as operator and manager, and the government having both access to all information required for monitoring and the right to hire staff to advise its nominees to the Board.<sup>34</sup> The government nominees to the Board viewed the government's acceptance of CCRL/FCL's model as "the best we could salvage."<sup>35</sup> The government nominees continued to revisit the question, arguing that NewGrade needed separate management staff at meetings of the NewGrade Board,<sup>36</sup> in meetings with Premier Devine,<sup>37</sup> and in a report prepared for the new provincial administration elected in 1991.<sup>38</sup> Officials at CCRL/FCL became impatient with these ongoing efforts to change the governance of the project, stating that "it is indeed unfortunate that some of the NewGrade Board continue to raise the matter of NewGrade staff. This is a matter which has been agreed to among the owners of NewGrade and is not a matter which needs to be further considered by the Board and indeed is not within the control of the Board of NewGrade... In the future ... matters which have been agreed to by the owners, should not be matters for Board debate."<sup>39</sup>

Conflict and tension at the Board notwithstanding, construction proceeded relatively smoothly. Upgrader construction was completed on time and on budget with the Oil-In events initially scheduled for October 20, 1988, pushed back to November 9.<sup>40</sup> A public relations firm was contracted to organize a mobile exhibition to appear at 13 shopping malls and fairs throughout the summer of 1988 to celebrate the upgrader, and a great emphasis was placed on marking the beginning of upgrader operations including opening ceremonies and a civic luncheon.<sup>41</sup> Consideration was given to building an 8,000 sq. ft. interpretive centre near the refinery/upgrader complex at a cost of \$1,107,680 and with anticipated annual operating costs of \$154,000.<sup>42</sup> (Plans for the interpretive centre were quietly shelved as financial losses were incurred and operational problems became public). The *Regina Leader Post* published a special commemorative edition to celebrate the accomplishment.<sup>43</sup>

In this celebration, the upgrader was described as "the Co-Upgrader" rather than as the "NewGrade Upgrader." FCL President Vern Leland described the project as "the biggest project our system has undertaken." The upgrader "demonstrates our commitment to building a secure energy future for our co-op members and for all Canadians."<sup>44</sup> At the civic luncheon, Premier Devine focussed on the employment and economic development benefit of the upgrader and its impact on the province's oil industry. He also addressed the project's economics. The viability of NewGrade, said the Premier, was not dependent upon oil prices but "upon the price differential between light sweet crude and heavy sulphur crudes. It's a complicated business." Stressing that there was no direct correlation between oil prices and the differential, the Premier reassured the audience that "NewGrade's financing

has provided for start-up costs, two years of operating losses and other contingencies.”<sup>45</sup> This message, in a less reassuring form, was reiterated the following day behind closed doors by the government-appointed co-chair of the NewGrade Board, Ted Hanlon who told the Crown Management Board that differentials were the key to the economics of the project, but that “consistently weak differential prices could result in a refinancing proposal within two years.”<sup>46</sup>

The end of construction marked the end of construction jobs. In the Legislature, the NDP member representing the constituency that included the upgrader said “There was a job creation program in Regina, and it was the oil upgrader [which], created a good number of jobs...and my thanks for that, a good number of jobs....but I want to point out to the government that the upgrader, the construction program is essentially done this fall. You’re going to have 1,500 people out on the street looking for work. Think about it now.”<sup>47</sup> The Premier began to receive many copies of a form letter that began, “I am a Saskatchewan Tradesmen, who for the past while has been gainfully employed on the Upgrader project in Regina! As you know, recent news announcements tell me and others there is no other work readily available, and I will have to leave Saskatchewan to find employment. Do think this is fair, given [that] our Government told its people there would be more opportunity with your government in power?”<sup>48</sup> For the government, the political consequence of stressing the job creation aspects of the upgrader was to be held responsible for unemployment once the construction jobs were finished. It is also worth noting that the upgrader had never been a local electoral winner for the Conservatives. In 1985, with the upgrader project being confirmed and celebrated in a by-election campaign, a riding that had elected a Conservative candidate by a margin of 1,744 votes in 1982 elected an NDP candidate by a margin of 3,609 three years later.<sup>49</sup> In the 1986 election campaign, with site preparation underway and the promise of hundreds of jobs being accepted, the Conservatives lost 5 of the 7 Regina seats which they held when entering the election campaign.<sup>50</sup>

### **3.2.2: Issues related to the Operation of NewGrade**

If celebrations surrounding the successful completion of construction restored good will between the partners, this was quickly dissipated by start-up operational problems and financial losses.

#### **3.2.2.1: Start-up problems and environmental issues**

To the general public, a series of accidents, fires, explosions and emissions of harmful substances was the most visible manifestation of problems at the upgrader. In February 1989, the refinery/upgrader complex had significant spills of waste water and gasoline, and Department of

Environment monitoring stations detected higher than allowable levels of hydrogen sulphide gas in the surrounding area.<sup>51</sup> These problems did not initially receive public attention. Production difficulties and failure to operate at or near capacity were reported in March.<sup>52</sup> Then the trouble really started. At the end of February, a major emission of hydrogen sulphide gas caused children to experience health symptoms and force the evacuation of a school.<sup>53</sup> At the beginning of April, a major fire at the hydrogen plant could be seen from most parts of Regina,<sup>54</sup> followed a few days later by a black cloud of smoke that was also very visible.<sup>55</sup> This was followed by complaints about smells caused by sulphur releases,<sup>56</sup> a release of an oily vapour that covered North West Regina with droplets of oil, and public reporting of hitherto unknown hydrogen sulphide gas readings from the beginning of the year.<sup>57</sup> There was another explosion in June<sup>58</sup> and one in August.<sup>59</sup> In September, the City of Regina reported higher than allowable releases of contaminants into the city's sewer system<sup>60</sup> and company officials reported additional gas leaks.<sup>61</sup> The visible nature of these operational problems and the resulting media coverage combined to create a degree of apprehension amongst Regina residents.<sup>62</sup> The provincial government responded by laying charges against CCRL as operator<sup>63</sup> and introducing legislation to increase the penalties for violations of environmental standards.<sup>64</sup> Operationally, the fires and explosions meant that the new upgrader was either out of service or operating at reduced volume for most of 1989 and into 1990.<sup>65</sup>

In the Saskatchewan Legislature, the NDP opposition was initially highly critical of CCRL and the upgrader. One member told the house "we have seen, one after another after another, accidents with the potential for causing mass death and destruction in the north end of Regina. We have a facility constructed in this city in the north end, close to schools, close to residences, that contains hydrogen sulphide, a deadly gas that forms sulphuric acid in your lungs."<sup>66</sup> Within a day, however, the NDP began exempting CCRL from responsibility and attaching blame directly to the Environment Minister. Following the release of hydrogen sulphide gas, the NDP Deputy Leader said, "the company may be doing the proper thing, Mr. Minister, but I suggest that you have not been."<sup>67</sup> Another member told the Environment Minister "you're the Minister of the Environment now; you have to accept the responsibility for what is going on in the environment."<sup>68</sup> By 1990, the NDP was going even further in its implicit support for CCRL and its operation of the refinery/upgrader project. After another fire at the facility, the Environment Minister stated that he was referring the matter to the Department of Justice for prosecution. The NDP Deputy Leader and Environment Critic accused the Minister of "grandstanding." FCL and CCRL were described as "corporate companies who are acting in good faith and doing what they feel they need to do."<sup>69</sup> The NDP position was vindicated four months later when

the charges were withdrawn by prosecutors on the grounds there was insufficient evidence to proceed.<sup>70</sup>

The real acrimony arising from the incidents was amongst the members of the NewGrade Board and between the partners. CCRL management said that only three of the incidents were serious and only one threatened public health. The problems were described as being normal for the start-up of a major petroleum production facility, and refinery manager Bud Dahlstrom told the media that “[i]t’s almost a fact of life that in the first year of a refinery’s operation, you’re going to have some minor fires. It’s something the industry recognizes can happen in the first year of operation.”<sup>71</sup> The retired oil company executives serving as government nominees to the NewGrade Board were less sanguine, taking the position that while some problems could be expected, “the number and severity of those experienced by the upgrader/refinery complex, however, have been neither normal nor acceptable.”<sup>72</sup> An independent review of operations was ordered by the NewGrade Board.<sup>73</sup> It found the project was well designed and working within normal safety parameters. However, it also found that some safety systems had been by-passed and some supervisory staff required additional training.<sup>74</sup> The government nominees to the Board argued that lack of experience with operating “a modern, state of the art, world scale, highly sophisticated plant” as opposed to a “traditional small scale refinery” contributed to the problems.<sup>75</sup> “Clearly the people assigned by CCRL as the team to oversee design and construction were not given such responsibilities or did not detect irregularities that might normally be expected to be uncovered by an owners’ team,” concluded the government-nominated board members.<sup>76</sup> CCRL/FCL management interpreted this critique to mean “[s]o they think that we are just a bunch of hicks out here and that we don’t know how to build a refinery, or an upgrader, and run it.”<sup>77</sup> The FCL-nominated co-chair of the NewGrade Board told co-op delegates that “[w]e were criticized by Saskatchewan’s representatives on the board for our management ability. They went to great lengths to tell everyone that we did not have the skills to manage - and our training programs were insufficient.”<sup>78</sup> CCRL/FCL also argued that pressure from the guarantors (Saskatchewan and Canada) for cash flow to begin making interest payments contributed to the start-up problems. FCL CEO Wayne Thompson told the federal government that “the decision to commence operations of the upgrader facilities in November of 1988 was a joint decision of all the parties and the NewGrade Board of Directors. It was recognized that construction and testing of a number of areas remained to be completed. Start-up was proceeded with rather than having the facility stand idle during the 1988-89 winter period. The economic benefit of that earlier start-up was intended primarily for the benefit of the guarantors. With the benefit of hindsight, start-up should have been delayed.”<sup>79</sup>

### 3.2.2.2: Financial issues during operations

Relations were also increasingly strained as a result of the related questions of cost allocation and management judgement. The change in refinery feedstock from Alberta light crude to NewGrade's synthetic crude resulted in the refinery's diesel fuel congealing at cold temperatures. Given CCRL/FCL's customer base of prairie farmers, this was seen as an urgent issue requiring immediate attention.<sup>80</sup> According to the project agreement, the modifications to the refinery needed to adjust to the new feedstock were properly NewGrade's financial responsibility. When CCRL management proposed the purchase and installation of a DHU Splitter as a solution to the problem, the government nominees to the board requested the investigation of other, cheaper potential solutions.<sup>81</sup> Feeling the pressure of needing to solve the quality issue quickly, CCRL management proceeded with the solution it had identified. The issue became a dispute of considerable duration and acrimony, with the government nominees resisting payment "pending receipt of proof that no less costly alternatives were available"<sup>82</sup> and CCRL/FCL interpreting this desire for a fuller exploration of possible solutions as meaning "they did not give a damn about the quality of our fuel - they did not care about your tractor truck or the school bus that could be stranded."<sup>83</sup> The solution proposed and implemented by CCRL management resolved the quality problem, but the board dispute over payment dragged on for several years.

The pricing of refinery feedstock from the upgrader to the refinery was a major point of contention. This price affected margins at both the refinery and upgrader. With a design capacity of 50,000 bpd, a 10-cent-per-barrel change resulted in a \$5,000 per day difference in cash flow. Any upward movement in the price benefitted NewGrade at the expense of CCRL, while any downward movement had the opposite effect. In 1989, CCRL adopted an interpretation of the pricing formula that was contested by the government nominees. The NewGrade Board agreed to refer the contested interpretation to arbitration. The result was a ruling that benefitted NewGrade by an estimated \$1 million per year.<sup>84</sup> Subsequently, CCRL adopted a new interpretation of the pricing formula. In the opinion of the government-appointed members to the NewGrade Board, this had an impact that was even more negative for NewGrade than their original interpretation. Following this, the CCRL-appointed members of the NewGrade board refused to support a referral to arbitration, thereby blocking this process.<sup>85</sup> Like other disputes, this was noteworthy both for the relatively small amounts of money in dispute and for the level of acrimony that it generated. At full production, NewGrade was projected to have sales revenue in excess of \$500 million per year.<sup>86</sup> The amounts in dispute as a result of CCRL's interpretation of the pricing formula were thus less than one-fifth of one percent of revenue or 1.24% of

total NewGrade losses over the three year period of 1989 to 1991. Subsequently, Saskatchewan, in support of the contention that NewGrade was being unfairly treated by its operator/customer, pointed to the fact that surplus upgraded syncrude sold on the open market received a higher price than that sold to under the terms of the formula. CCRL/FCL responded by arguing that the surplus syncrude offered on the market had been upgraded to a higher standard than that needed by the CCRL refinery.<sup>87</sup> This demonstrated the complexity of the relationship and the intrinsic potential conflicts of interest. When producing for the open market, CCRL, as NewGrade's operator, upgraded crude to a point where it maximized NewGrade's returns. When producing for itself as the customer, CCRL chose a quality level that optimized refinery returns – in effect, capturing the additional value within the refinery rather than the upgrader. There was nothing illegal or unethical about this management decision, but to the government representatives, it was an example of CCRL putting its own interests ahead of NewGrade's. Similarly, by blocking arbitration, it was felt, the CCRL nominees were placing their fiduciary duty to the parent company ahead of their duty to the joint venture upgrader.

In addition to suspicions about pricing, the government came to believe that CCRL management was systematically misallocating expenses to NewGrade. This, along with the pricing issue, was believed to have resulted in an inappropriate transfer from NewGrade to CCRL of “tens of millions of dollars.”<sup>88</sup> The accusation was at first implied and private. It later became explicit and public. Government suspicions began as differences of opinion about complex questions. To government officials, CCRL/FCL's refusal to allow arbitration appeared to confirm suspicions about malfeasance by the operator. However, in retrospect, it would seem logical to assume that, if CCRL was, in fact, diverting gain from NewGrade to itself, this would show up on CCRL's books. Its overall profits would rise when the upgrader began operating. If this came from artificially suppressing feedstock prices to the refinery, the result would show up in the gross margin. If gain was been transferred by offloading expenses onto NewGrade, it would show up in decreased CCRL operating expenses. The actual results are presented in the next table. To make trends more apparent, the division of revenue and expenditure categories are presented in terms of percentages of total sales. The figures extend to 1996, since, if CCRL had been engaged in inappropriate activity, the margin should have dropped in 1994 following the introduction of a new, transparent pricing formula and operating expenses should have risen following the elimination of the CCRL's ability to prevent recourse to the arbitration process.

**Table 3.1**

FCL Petroleum Division Annual Gross Margin, Expenses, and Net Savings 1980 to 1996<sup>89</sup>  
Percentage of Total Revenue

	83	84	85	86	87	88	89	90	91	92	93	94	95	96
Margin	10.5	10.5	10.4	16.3	14.3	16.3	15.9	15.0	13.3	14.7	16.2	19.2	17.4	16.4
Op Exp	2.4	2.8	2.6	3.4	3.9	4.5	4.5	4.2	4.5	5.0	5.0	4.8	4.9	4.4
Overhead	2.9	2.7	2.7	3.0	2.2	2.3	2.3	2.2	1.7	1.9	1.7	2.9	2.2	2.2
Interest	0.9	0.6	0.7	0.4	0.2	0.3	1.0	1.6	1.5	1.5	1.2	1.0	1.1	1.0
Savings (Profit)	4.3	4.4	4.4	9.5	8.0	9.8	10.1	10.2	8.6	9.3	10.7	12.5	11.4	10.8

CCRL's financial performance shows no anomalies consistent with the accusation that it was inappropriately transferring economic benefit from the upgrader to the refinery. Any such transfer of a single of the "tens of millions of dollars" would have resulted an increase of about 2% in the margin between 1988 and 1990. If done as through the misallocation of expenditures, any diversion approaching that magnitude would have eliminated CCRL's reported operating expenses. Margins increased in 1986, largely as the result of the drop in crude oil prices. In addition, CCRL operated at closer to capacity and began selling more gasoline and diesel to customers who were not member retail cooperatives.<sup>90</sup> Margins actually declined as the refinery began to secure its feedstock from the upgrader, and increased after the implementation of the new, transparent pricing formula negotiated in the summer of 1994, primarily attributable to an increase in sales and therefore output at a level closer to design capacity of the refinery. CCRL operating expenses rose during the period the upgrader was constructed and became operational – both in dollar terms and as a percentage of revenue. This is inconsistent with the accusation that CCRL was reducing its own cost structure at the expense of NewGrade.

Because of the integrated nature of the complex, it was impossible for the government nominees on the board to evaluate the performance of CCRL management in operating the upgrader without this infringing upon the autonomy of their operation of the refinery. The government-nominated members proposed, and the CCRL-nominated ones rejected, "a complete review of CCRL's key management and operating personnel and structure."<sup>91</sup> The qualifications, training, and competence of CCRL management officials was challenged, as were the CCRL/FCL's compensation plan, recruitment strategy, succession planning, and corporate culture. The government nominees called for

an orderly transition from existing management with the imperative that “first class experienced replacement management must be located – even if from outside the CCRL organization.”<sup>92</sup> CCRL/FCL management replied bluntly that the board members “can’t hire and fire management. They have no say over salary ranges or organizational structure.”<sup>93</sup> The government’s fiduciary duty to actively monitor and protect its investment in the NewGrade upgrader conflicted directly with CCRL’s right of autonomy in the operation of its refinery. On the Board, the inherent conflict was worsened by a significant cultural gap. The NewGrade Board co-chair nominated by CCRL said, “they know very little about co-operatives.”<sup>94</sup> His government-nominated counterpart effectively agreed, observing that “I’m not saying I’m anti co-op, but they are a different breed of cat...they just don’t operate with the same business rules that we do.”<sup>95</sup> Amongst the things that created antagonism amongst government board appointees and staff towards FCL was the tendency of the co-op officials to by-pass normal lines of authority in order to resolve disputes by going directly to the Premier or other elected officials. In the opinion of government staff, this was often accompanied by denigration of the staff responsible for defending the government’s position and demands for individuals to be replaced.<sup>96</sup>

From CCRL/FCL’s perspective, “one of the most frustrating developments was that government players at all levels kept moving and we were constantly faced with new players.”<sup>97</sup> Indeed, in the eight years between the start of discussions leading to NewGrade and the defeat of the Devine administration, there were six different Energy and Mines Ministers responsible for the file.<sup>98</sup> Aside from the Premier, the only long-term constants on the Saskatchewan side were the board members so distrusted by CCRL/FCL officials. Further compounding the problem of a consistent response from the Saskatchewan government was CCRL/FCL’s belief that these board members received no direction from the government that appointed them.<sup>99</sup> This is a perception endorsed by those board members themselves, who in 1991 told the President of the Crown Investments Corporation that “[s]everal years ago, the NewGrade Board presented its shareholders various alternative mission statements for NewGrade. We thought it important that we receive clear direction from the shareholders as to the fundamental objective of NewGrade to guide us in the discharge of our duties. However, we received no response from the Saskatchewan shareholder in this regard. In the absence of contrary instruction from you, we have assumed that as directors we should seek to further the economic best interests of NewGrade in the same manner as directors would for any other profit orientated business corporation.”<sup>100</sup> As a result, the board members assumed there was “no special objective which you intend for NewGrade which supersedes or is paramount to the business objectives of a normal commercial enterprise.”<sup>101</sup>

Meanwhile, oil prices and the differential remained low. In 1989, there was a very slight recovery from the depths seen the year before, with a short-lived upturn amidst the uncertainty caused by Iraq's invasion of Kuwait and the resulting first Gulf War. By 1990, however, the average price received for Saskatchewan crude was back down to \$16.35 per barrel – 40% lower than it had been in 1983 when the upgrader project was launched.<sup>102</sup> Further, the start-up problems caused the upgrader to miss the modest, temporary spike in oil prices and expanded differential.

The result of the combination of operational problems and low differentials was that NewGrade approached the ceiling on government guaranteed debt by October 1989.<sup>103</sup> CCRL/FCL took the position that a potential default was an issue for the guarantors to deal with, while the federal government said it was a matter for the shareholders.<sup>104</sup> Saskatchewan was the only partner that was involved in both capacities. In November, the provincial cabinet authorized an additional injection of up to \$75 million into NewGrade in order to prevent the triggering of a call on the loan guarantees.<sup>105</sup> The CIC President attributed the need for additional funds to the delays in achieving full production resulting in “a \$700 million investment in something that isn't producing any revenue.”<sup>106</sup> He said that the additional cash was technically defined as equity but really part of the upgrader's debt which would be eventually repaid from upgrader earnings and that CIC was confident the upgrader would soon be operating. The Saskatchewan government also described the \$75 million as an “outside number” and predicted both that it would not be fully expended and that no additional cash would be needed.<sup>107</sup> CCRL/FCL said, “we knew right from day one that it would not have positive cash flow for the first two or three years” and also predicted the additional government funds would be repaid through upgrader revenues.<sup>108</sup> CCRL/FCL did provide some relief to NewGrade's cash flow by deferring a portion of its management fee as an interest-bearing note. This “subordination of the operating fee” was matched by a cash payment from CIC with the same interest and repayment terms.<sup>109</sup>

The optimistic predictions were partially correct. By early 1990, the start-up operational difficulties were overcome and full production was both achieved and maintained.<sup>110</sup> Economically, problems remained. NewGrade incurred an operating loss of \$59,655,000 in 1989 and \$102,283,000 in 1990.<sup>111</sup> More troubling for the guarantors, cash flow remained negative. By August 1990, \$74,484,000 of the authorized \$75 million had been expended, and NewGrade was projected to hit the default thresholds within the month.<sup>112</sup> A task force composed of representatives from the governments of Saskatchewan and Canada, CCRL, and the NewGrade Board “has estimated that NEI will experience an average annual cash deficiency of \$50 million for each of the next ten years.”<sup>113</sup> Once again, the federal

government took the position that this was a shareholder's issue, while CCRL/FCL argued that problems belonged to the guarantors, while it stood on its legal protections contained in the project and operating agreements. In this situation, Saskatchewan was faced with unpalatable options. The Crown Management Board was told that:

- Shutting the upgrader down would cost approximately \$795 million, consisting of a write-off of equity, honouring loan guarantees, costs associated with keeping CCRL whole, and indemnification to the federal government. Staff suggested "this is not considered to be a viable alternative for economic or political reasons."<sup>114</sup>
- Authorizing and guaranteeing more debt would result in another \$400 million to \$1.2 billion in loans. At the end of the upgrader's projected useful life in 2013, the province would still have outstanding loan guarantees of \$600 million to \$1.1 billion. Staff suggested that "[t]his is not considered a viable option for economic reasons."<sup>115</sup>
- An equity injection of \$320 million to \$370 million would reduce the debt to a level that the upgrader cash flow could support. It was estimated that this would result in the province being free of debt guarantee obligations by 2007.<sup>116</sup> Implicit in this recommendation was the acknowledgement that this additional equity would not yield any return at least until the guaranteed debt was retired.

In its decision among these options, Saskatchewan acknowledged the unassailable legal position of CCRL/FCL. While undertaking to work at trying to achieve management changes at CCRL, government officials stated that "we have no legal recourse if CCRL does not cooperate."<sup>117</sup> Efforts at securing a sharing of the required equity injection would be confined to attempting to convince the federal government to share in proportion to the division of the loan guarantees.<sup>118</sup> In the interim, incremental unilateral funding from Saskatchewan in tranches of \$25 million was authorized in order to prevent the triggering of a default.<sup>119</sup> It was acknowledged that "regardless of the funding source, it is unlikely that the interest incurred on the equity will be recovered."<sup>120</sup> Ministerial responsibility for NewGrade was also transferred from the Minister of Energy and Mines to the Minister Responsible for the Crown Investments Corporation.<sup>121</sup> This change in ministerial responsibility came four years after the transfer of staff responsibility. NewGrade was now to be treated, politically as well as administratively, as a commercial investment rather than as a public policy instrument.

In publicly explaining the authorization of additional provincial money, the CIC President said, “It’s a short-term solution until a long-term solution is found,” since the upgrader is “not generating sufficient revenues to pay its debts.” In describing the additional money, he said, “It’s a loan. If they don’t pay it back, its equity.”<sup>122</sup> By this time, government comment on the upgrader had been transferred from elected officials to staff. Proposals for interpretive centres and other promotional activities were shelved. The days of celebrating the benefits of Saskatchewan’s first heavy oil upgrader were over. However, the authorization of additional public money into the obviously troubled upgrader was not seized as an issue by the NDP legislative opposition. Not a single question about the upgrader’s finances was asked in question period during the 1989 or 1990/91 sittings, a total of 222 days of sessions.<sup>123</sup> Indeed, the NDP Energy Critic told the Legislature in 1990 that the party supported the upgrader and that “the Consumer’s Co-op Refinery which has been a real major undertaking by the people of Saskatchewan and a very successful undertaking for the people of Saskatchewan...[is] an example in our view of a co-operative that has been undertaken by local people, has been operated by local people, and has proven to be successful as a result of this local initiative.”<sup>124</sup> The position of NewGrade was contrasted with that of Bi-Provincial, which had “been given straight equity money from your government, from the Government of Alberta and from the Government of Canada. They’ve been given straight cash.” This meant, said the NDP critic, that “you’ve given this \$222 million cash to this bi-provincial upgrader in equity as opposed to guarantees, and you gave NewGrade the debt for them to carry and put them into a little more precarious situation economically than any company would like.”<sup>125</sup> In suggesting that the Saskatchewan government had given preferential treatment to Bi-Provincial and Husky as compared to NewGrade and CCRL/FCL, the NDP neglected the fact that, by this point, Saskatchewan had invested more equity into NewGrade than Bi-Provincial, both in total dollar terms and as a proportion of the cost of the project. The existence of debt at NewGrade arose from the unwillingness of other partners to invest equity rather than from any reduced level of support from Saskatchewan.

Following the authorization of the additional short-term funding injection by Saskatchewan, NewGrade performed slightly better than had been feared. The additional funds were not drawn against as the upgrader was able to meet operating costs and interest payments for the last quarter of 1990 through 1991. This averted the need for additional cash. However, operating losses continued as the upgrader lost another \$79,463,000 in 1991.<sup>126</sup> The book value of Saskatchewan’s equity investment in NewGrade was written down annually to reflect the operating losses incurred in accordance with Generally Accepted Accounting Principles. By the end of October 1991, the net carrying value of the

province's \$232 million equity investment was down to \$2 million.<sup>127</sup> CIC and its auditors, Ernst and Young, grappled with the question of whether ongoing losses needed to be recorded as a "negative balance in the investment account (e.g. the investment would be recorded as a liability rather than as an asset)."<sup>128</sup> According to accounting standards, there were three conditions, "any one of which" would require the recording of additional losses as a balance sheet liability:

1. "The investor has guaranteed obligations of the investee.
2. The investor is otherwise committed to provide further financial support for the investee.
3. The investee seems assured of imminently returning to profitability."<sup>129</sup>

The accountants wrote "with respect to the third condition, there appears to be little likelihood of NewGrade returning to profitability in the near future. However, the first and second conditions appear to be met."<sup>130</sup> The implication was that ongoing operating losses, including depreciation, would have a corresponding negative impact on the financial statements of CIC and thus on the deficit position of the province itself.

### **3.2.3: A Partnership in Trouble**

The NewGrade partners were successful in managing the complex construction task to complete the upgrader on-time and on-budget. Despite this, by 1991 the partnership relationship was a troubled one. The start-up operational problems had undermined the public image of the upgrader while created discord around the NewGrade board table. Low oil prices and the resulting small differential between the price of heavy and light crude oil contributed to significant operating losses and cash shortfalls. Default on the guaranteed debt had only been averted by Saskatchewan making unilateral cash injections into the project. The financial projections suggested the project would be incapable of supporting its debt load. This objectively bleak situation would cause strain in any partnership. In the case of NewGrade, the governance structure made the relations between partners even worse. Attempts by government nominated board members and staff to monitor and influence the project were interpreted by CCRL management as infringing upon their rights to operate and a questioning of both their honesty and competence. At the same time, CCRL management's assertions of its right to operate were interpreted by the governmental representatives as confirmation of CCRL malfeasance.

### **3.3: Building and operating the Bi-Provincial Upgrader**

While the negotiating process to reach the partnership agreements for Bi-Provincial, construction and the start operations proceeded according to schedule and with relatively little acrimony between the partners despite significant capital cost overruns. Since Bi-Provincial was a “stand-alone” facility, monitoring of costs allocations was much easier than with NewGrade. Oil prices remained low during construction. Prior to operations commencing, this did not directly affect the project, but it did make it impossible for Husky to finance its share of construction out of operating cash flow. This contributed to an ownership change for Husky. Low oil prices also contributed to financial pressures on the governmental partners.

#### **3.3.1: The Public and Political Response to Bi-Provincial**

The signing of the upgrader agreement between the three governments and Husky was greeted with joy and jubilation in the Lloydminster area. Premier Devine received praise from area local government officials<sup>131</sup> and business groups.<sup>132</sup> The Premier was told that “the announcement that was made here that Friday morning in September has made Lloydminster a very happy city”<sup>133</sup> and “since the upgrader concept was brought to public attention six years ago, it has been alternately a source of both frustration and optimism. Finally with the agreement we can have confidence in the future of the community.”<sup>134</sup>

The euphoria around Lloydminster did not last long. For government partners, the first concrete reading of the political benefits of the announcement came with the federal election held 49 days later. While the Conservative candidates were re-elected handily on both sides of the border, Bill McKnight’s total vote dropped by 5,437 (26%) and Don Mazankowski’s tally dropped by 7,919 (24%).<sup>135</sup> While there are many factors beyond the scope of this study that impact voting behavior, it can be said that the upgrader did not result in an increase in the vote for elected officials claiming credit.

The announcement that the Bi-Provincial upgrader was proceeding was made in the midst of a significant downturn in the local oil patch as a result of low prices. Two months after the agreement to fund the construction of the upgrader, Husky was forced to curtail exploration and development in the Lloydminster area. Work on all Enhanced Oil Recovery (EOR) projects was curtailed, and some existing

EOR facilities were mothballed. The company began work on capping 920 of their 2,300 wells in the area, shutting down entire fields rather than just low producing individual wells. Layoff notices were issued and contract staff phased out.<sup>136</sup> Even though work remained on schedule, Husky and its governmental partners were forced to issue regular statements confirming that the upgrader project was still proceeding.<sup>137</sup>

Within five months of the signing ceremony, local governments had redefined the upgrader into a problem. The City of Lloydminster and surrounding rural municipalities and towns presented the Saskatchewan government with a brief demanding assistance in “mitigating the impact” of the upgrader.<sup>138</sup> In order to deal with the burdens caused by the upgrader construction, the local governments said they needed the provincial government to give them \$20,193,850 for road construction, \$16,500,000 to deal with the “extra loading placed on them with the influx of additional people” by building new parks, senior citizens centres, a performing arts centre and two new arenas. \$10,182,000 was demanded for water and sewer upgrades, \$20,000 for an economic development study, and unspecified demands for the upgrading of schools, expansion of home care and nursing home services, and more police. Construction of a trade and convention centre was also deemed necessary as a result of the beginning of upgrader construction.<sup>139</sup>

### **3.3. Contracting and Sub-contracting Issues**

As construction began, governmental partners were approached by individuals and companies attempting to by-pass Husky’s procurement policies via political intervention and demanding change to everything from quality assurance processes to the size of supply contracts.<sup>140</sup> A decision by Husky and the upgrader’s Board to sign a project agreement with building trade unions provoked a flurry of protest from contractors, employers’ associations, and business groups.<sup>141</sup> The Premier replied that “while the Saskatchewan government prefers open competition on projects such as this and is helping to finance the project, our government does not determine the course of action for the Saskatchewan representatives on the board for this, or any other, management issue. As a government, we trust that what is best for the project as a whole will ultimately benefit Saskatchewan.”<sup>142</sup> Close attention was paid, however, to the geographical distribution of construction jobs. In early 1991, at the peak of construction activity, Husky reported that 32.4% of person-hours of construction work came from those defined as “local” (within 80 km of the upgrader on either side of the border); 34% from Saskatchewan, 22% from Alberta, 9.3% as “native” and 1.7% from the rest of Canada.<sup>143</sup> In accounting for the macro-

patronage effects of the upgrader, both local residents and First Nations and Metis people were excluded from the tally of provincial residence.

### **3.3.3: Issues Related to Board Composition and Competence**

Construction proceeded on schedule,<sup>144</sup> and disputes on the project's board or amongst shareholders are not detectable. The most significant issue related to the operation of the projects development was occurring in the Husky boardroom. Government nominees to the project's board possessed extensive business experience but no specific technical knowledge of upgrading or refining. Saskatchewan filled the one "employee" position in their roster of nominees with the President of SaskPower rather than with an official from either the Department of Energy and Mines or the Crown Investments Corporation. The other board representatives were the CEO of a major farm implements manufacturer and the President of a large investment firm specializing in commercial real-estate.<sup>145</sup> The project agreement did not provide for the appointment of any government staff monitors to assist its board nominees.

### **3.3.4: Issues Related to Cash Flows and Partnership Changes**

Because of the depressed prices for oil during the construction period, Husky's cash flow was insufficient to generate enough money to meet its equity obligations. As we have seen earlier, borrowing for the upgrader project in the absence of government guarantees was impossible. Husky's parent company, Nova Corporation, was overextended and overleveraged as a \$115 million write-off arising from the failed attempt to build the Foothills Natural Gas pipeline<sup>146</sup> and the purchase of Polysar Energy and Chemical Corporation,<sup>147</sup> a petrochemical company, from the federal government. Other Nova subsidiaries, ranging from a company converting trucks to run on natural gas to a pipeline equipment manufacturer, were losing money.<sup>148</sup> In 1987, the Hong Kong-based investor Li Ka-shing personally and one of the companies he controlled, Hutchison Whampoa, purchased a 52% interest in Husky from Nova for about \$600 million.<sup>149</sup> Five years later, with the upgrader construction underway and with both Nova and Husky unable to meet their equity commitments, Nova sold another 43% share of Husky to Hutchison Whampoa, giving the Hong Kong company firm control for \$325 million. With the sale, Hutchison Whampoa became Husky's dominant shareholder, with the remaining 5% of stock held by the Canadian Imperial Bank of Commerce (in which Hutchison Whampoa was a major shareholder). As part of the sales agreement, Hutchison Whampoa agreed to inject another \$300 million into Husky which was used to pay for its equity stake in the Bi-Provincial Upgrader and complete the development

of a natural gas project in north-western Alberta.<sup>150</sup> Li explained why the additional investment was made with “since we are already deeply involved in this investment, we had no choice.”<sup>151</sup> Husky delisted itself from stock exchanges and quickly developed a reputation in the oil industry for secretiveness.<sup>152</sup> Nova was forced to accept a \$265 million write down (after taxes) on its investment in Husky, but needed the sale funds for the restructuring of its own debt.<sup>153</sup> For Nova as Husky’s owner, the double-or-nothing gamble on the Lloydminster upgrader had crapped out.

Husky’s new ownership by Hutchison Whampoa meant ownership by a single individual, Li Ka-shing, whose business philosophy began to have a direct impact on Husky’s behavior. Li was a self-made billionaire who had constructed a financial, real estate, energy, media, and industrial empire starting in the early 1950s with a small company manufacturing plastic flowers using an injection system he designed based on articles in a plastics magazine.<sup>154</sup> When Li Ka-shing gained control of Hutchison Whampoa, one of the five dominant British-created Hong Kong business conglomerates, in 1979, he became the first ethnic Chinese person to gain control of one of these enterprises. By the late 1980s, he was considered the richest person in Hong Kong<sup>155</sup> and controlled five of the twenty largest firms listed on the Hong Kong stock exchange.<sup>156</sup> He operated his businesses using the traditional model of a Chinese family business with centralized personal control, reliance on a tight network of family members and close associates, and, in accordance with the principles of *guanxi*, the stressing the importance of connections and long-term relationships over short-term market transactions.<sup>157</sup> Observers of Li note that he used this traditional approach in his deal-making and relationships with partners but incorporated Western-style, bottom-line driven, technocratic management into operations.<sup>158</sup> Li is noted for stressing the importance of trust and trustworthiness in business relationships, and he once concluded a HK \$1.85 billion property purchase agreement after a five-minute discussion during a golf game and the informal drafting of a two-page summary of the transaction.<sup>159</sup>

Like Nova’s Bob Blair, Li was a very politically sensitive and sophisticated owner. However, while Blair operated the company in a way that pursued the particular ideological position of Canadian national control and Alberta province building, Li pursued harmonious relations with host governments pragmatically in order to facilitate business.<sup>160</sup>

In the 1980s, as the scheduled transfer of Hong Kong from Britain to China approached, Hong Kong businesses and individuals began to make contingency plans in case the result was a significant change in governance and respect for property rights. Hong Kong-based investment in Canada soared

along with immigration and what might be termed “quasi-immigration”, as children were sent to Canada to study, establish connections, and gain citizenship. This process intensified after the 1989 suppression of protests at Tiananmen Square raised concerns about the potential for authoritarian rule in Hong Kong.<sup>161</sup> Li was explicitly a purchaser of this kind of political risk insurance.<sup>162</sup> However, investments in the United States were limited because of Li’s dislike for the litigious nature of the country,<sup>163</sup> while Australia was rejected because of the residue of that country’s “white only” immigration policies.<sup>164</sup> Li’s two sons worked in Canada for a time and obtained Canadian citizenship. In addition to the purchase of Husky, Li and his network of companies purchased a 10% interest in the Canadian Imperial Bank of Commerce (the maximum allowed under federal legislation), undertook a massive condominium development on the site of Expo 86 in Vancouver, and bought a number of pieces of prime commercial property at distress prices from the troubled developer Olympia and York.<sup>165</sup> Initially, the management structure of Husky was left unchanged. As a result of the ownership change, Husky was owned by a flexible owner who had a streamlined decision making process, financial resources, and a reputation for attention to the bottom line but who operated on the basis of long-term relationships, trust, and accommodation with host governments.

On November 1, 1991, the change of a second partner occurred as a result of a regime change in the Saskatchewan provincial government. An NDP government led by Roy Romanow replaced Premier Devine’s conservatives in a campaign centred around the province’s fiscal record and an attack on both the government’s privatization of existing Crown corporations and investments in mega-projects.<sup>166</sup> Despite their attacks on the Devine government’s mega-projects, Bi-Provincial itself was largely exempt from criticism. From the signing of the agreements in the fall of 1988 until the change in administration (including a total of 222 sitting days), not a single question was directed at the project during the question periods in the provincial legislature. The only concerns raised about the project were whether there was sufficient feedstock for two upgraders and whether the Free Trade Agreement with the United States could affect their viability in the event of shortages.<sup>167</sup>

The surge in employment resulting from the construction of the upgrader did not translate into electoral survival for the Conservative MLA who had been representing Lloydminster. His 849-vote margin of victory in 1986 was transformed into a 944-vote defeat at the hands of the NDP. The changed result did not come primarily from an increase in the NDP vote, which increased by 166 votes (4.5%), but from a drop in the Conservative vote, which decreased by 1,627 votes (35.9%). The former Conservative

voters appear to have either voted Liberal or stayed home on election day, as the total number of votes cast dropped by 6.7%.<sup>168</sup>

### 3.3.5: Issues Related to Construction Costs

While construction of Bi-Provincial was proceeding according to schedule, the project was costing more to complete than anticipated. The delineation of the cost overruns book-ended the 1991 Saskatchewan election. One estimate for an additional \$175 million was provided late in 1990 and the second for a further \$190 million early in 1992. As was noted in the previous chapter, the 1988 agreement did not provide for capital cost overruns and Bi-Provincial was prohibited from borrowing. In these circumstances, the only solution was a cash injection by the owners. In 1990, they quickly agreed to fund the additional requirements proportionate to their existing equity share. Saskatchewan authorized its additional \$32 million expenditure in an Order-in-Council dated December 21, 1990.<sup>169</sup> The injection of additional money received little notice from either the media or legislative opposition.

The three governmental partners received the news of a second estimate of cost overruns with less good humour than they had the first. The federal Energy Minister said “at that time [when the first cost overruns were being discussed], the three of us very clearly spelled out: Is there – quote – any additional money that you’re projecting on overruns. The answer was ‘no’.”<sup>170</sup> Husky responded to the governmental reluctance to provide additional equity by indicating the partially completed facility would be mothballed in the absence of more capital. Alberta almost immediately became the first governmental partner to agree to provide additional funds.<sup>171</sup>

Saskatchewan refused to participate in another equity injection for the upgrader project. Ned Shillington, the Minister Responsible for CIC, described the province’s position as being similar to “a great aunt developing a bit of a sneer when the ne’er-do-well heirs come back for more money.”<sup>172</sup> At a meeting of the partners in Edmonton, Shillington and CIC President Don Ching offered to contribute a maximum of \$100,000 on the condition that the money be used to paint the upgrader white in recognition of its status as a “white elephant.”<sup>173</sup>

The strongest reaction to Saskatchewan’s refusal came from the other governmental partners, with Ottawa suggesting “conditions whereby there are penalties against Saskatchewan.”<sup>174</sup> Alberta shared the sentiment, but was more specific in suggesting both that Saskatchewan could lose feedstock access to the upgrader<sup>175</sup> and could be deprived of a share of future profits.<sup>176</sup> The Alberta Energy Minister told reporters, “we’re going to penalize Saskatchewan, it’s just a matter of how much.”<sup>177</sup>

Saskatchewan discounted the threat of a loss of future profits, saying, “we think it is unlikely we will get any return on the money.”<sup>178</sup> Threats having failed, Canada and Alberta then offered to lend Saskatchewan the money for its share of the equity injection. This too was rejected, with the Minister saying, “it’s not that Saskatchewan can’t borrow money...It is that Saskatchewan, given its financial position, does not believe it is wise to put any further money in.”<sup>179</sup> Husky did not intervene in this exchange between governments, instead simply holding to the position that without a further equity injection from partners, construction would not be completed and the project would be mothballed. Saskatchewan took the position that “we are not prepared to put any more money in, even if that were to put at risk what we initially put in.”<sup>180</sup>

These negotiations were conducted, by government, at the Ministerial level. It was a shareholder dispute, not an operational one and did not result in any differences at the level of the project’s board of directors.

The negotiations over the cost overrun were resolved with Husky and Canada funding Saskatchewan’s pro-rata share. In exchange, the province’s equity share was diluted, with a corresponding increase in the ownership share of Husky and Canada.<sup>181</sup> The Saskatchewan government hailed it as a victory since “the upgrader [will] go ahead despite no further injection of money from the Saskatchewan taxpayers and without any penalty to this province. This marks an important victory for Saskatchewan for two reasons. First, we have saved \$33 million of taxpayers’ money. Secondly and more important perhaps, we’ve established an important principle of the taxpayer not accepting cost overruns.”<sup>182</sup> The Conservative opposition attacked the outcome as being an example of a broken contract<sup>183</sup> and expressing concern that the dilution in equity would cost Saskatchewan a portion of future profits.<sup>184</sup> The Liberal opposition member was silent on the issue.

The Bi-Provincial Upgrader was officially opened in November of 1992. The Alberta Premier called it an exercise in nation building. Saskatchewan, represented by the Associate Finance Minister, was more restrained, describing it as an example of unprecedented cooperation.<sup>185</sup> All partners joined in stressing the benefits the upgrader would bring to the heavy oil industry around Lloydminster and Cold Lake.<sup>186</sup>

### **3.3.6: Issues Related to the commencement of operations**

Bi-Provincial did not achieve full capacity operations quickly or smoothly. These start-up difficulties lacked the highly visible flame, explosions and toxic emissions associated with the start-up of

NewGrade. Instead, in addition to production at less than full capacity for the first 18 months, the start-up problems manifested themselves in staffing levels, both direct and contractual. During the first year of operations, the workforce at the upgrader hovered around 500<sup>187</sup> compared to the 330 the enterprise was originally projected to employ.<sup>188</sup>

The larger problem was oil prices. The price of Saskatchewan crude was even lower in 1993 as production geared up than in 1989 when construction got underway.<sup>189</sup> The result was that the commencement of production meant the commencement of operating losses. All partners were immediately called upon to contribute to the \$50 million fund provided for in the project agreements, and all contributed without dispute.<sup>190</sup> However, Saskatchewan served notice on its partners that its position on future operating shortfalls would be the same as its position on the second capital cost overrun, with the Minister Responsible for CIC saying, “any shortfalls above that and we’re not legally obligated...someone is going to have to be awfully persuasive to convince us to put in dollars beyond our legal obligations.”<sup>191</sup>

Saskatchewan’s share of the Bi-Provincial Upgrader’s operating losses were \$7,237,000 in 1992<sup>192</sup> and another \$19,620,000 in 1993<sup>193</sup>, resulting in a corresponding write-down of the equity investment by the province. By mid-1993, the \$50 million available to cover cash shortfalls was close to being exhausted. Another \$30 million was provided on the same basis as the second capital cost overrun – that is, with Alberta paying its pro-rata share, Saskatchewan refusing to participate and Canada and Husky paying Saskatchewan’s share with a corresponding dilution in the province’s equity. As a result, Saskatchewan’s total ownership share had dropped from the original 17.5% to 15.2%, while Canada’s had increased from 31.666% to 32.4% and Husky’s from 26.666% to 27.8%.<sup>194</sup> The allocation of this injection was agreed upon by the partners without significant internal debate or any public controversy.

### **3.4 Similarities and differences in building and operating the upgraders**

Both CCRL/FCL and Husky succeeded in constructing large and complex projects on schedule. CCRL/FCL further achieved the goal of completing the construction project on budget as well as on time, while the construction supervised by Husky was some 28% over budget. Nevertheless, both experienced some start-up operational difficulties for about the first 18 months following completion. In the case of NewGrade, these difficulties were highly visible, since they were accompanied by the sounds of

explosions and emergency sirens, the visuals of fireballs and smoke above the complex, the smell of potentially lethal hydrogen sulphide gas, and the feel of oil droplets falling from the sky. The only sensory experience missed by residents of North Regina was taste, although the upgrader was beginning to leave a bad one in their mouths. The difficulties experienced by Bi-Provincial were much less visible and took the form of production bottlenecks and higher than anticipated staffing levels (primarily through contractors). CCRL/FCL was successful in resolving these problems. Despite these differences in completing the construction of the projects, in the next chapter we will discuss how Husky had similar success in roughly the same time frame after beginning operations.

The actual record of the operators did not correspond to the level of questioning of the decisions made by the operating partner by governmental partners. In the case of NewGrade, both the Saskatchewan and federal governments appointed board members with a high degree of technical expertise in refinery operations and supported them with a dedicated monitoring staff. As a result, CCRL/FCL had its decisions, and ultimately both its competence and integrity, questioned aggressively and in detail. While the actual dollar value of contested items was relatively small in proportion to the costs for constructing and operating the upgraders, these disputes became vitriolic. In part, this was because of CCRL/FCL's decision, after one experience, to block access to the arbitration process contained in the project and operating agreements. In part, it also arose from the complexity of the enterprise in relation to the CCRL refinery.

All partners involved agreed that there was the potential for hundreds, if not thousands, of decisions that contained the potential for the favouring of the position of the refinery over the upgrader. In retrospect, there is no evidence that CCRL/FCL management was abusing this position in any systematic or consistent way. However, the close scrutiny they were under inevitably resulted in a small number of decisions that were arguable. The NewGrade board members nominated by Saskatchewan along with Saskatchewan government officials came to view these as symptomatic rather than *sui generis*. In reaching this conclusion, they were assisted by lingering resentment at the results of the negotiating process; by CCRL/FCL's aggressive insistence on protecting the integrity of the refinery; and, ultimately, by the intensity and highly political nature of CCRL/FCL's defence of its positions.

Even in the context of significant capital cost overruns, Husky as operator was not subjected to anything approaching the same level of scrutiny by its partners. In part, this was because the expenditures were easier to monitor. Money was spent on the upgrader or it was not. There was no additional complexity of interpretation arising from a decision as to which corporate entity should

properly pay the invoice. Further, the governmental board members lacked the specific technical expertise to question in detail the operational decisions, and they received no staff assistance in monitoring. It is conceivable that, had Bi-Provincial been as closely scrutinized as NewGrade, some greater degree of conflict between Husky and its governmental partners would have arisen. This is speculative, but it is entirely possible that, on a project of this size and complexity, some decisions would have been made for which the underlying wisdom could be challenged by an informed observer. Nevertheless, the nature of the response by the Hutchison Whampoa would have likely been different than the one by CCRL/FCL because the owner of that company, Li Ka-Shing, placed a higher value on maintaining good relations with the governmental partners.

The existence of three government equity holders also served to divert conflict away from Husky as operator. When it presented the bill for the second round of construction cost overruns, the reaction from governments was to demand answers as to why this had occurred. However, this unity quickly dissolved as Saskatchewan essentially ignored the question of “why” to move to the question of who pays what. By refusing to contribute according to its equity share, Saskatchewan did Husky the service of diverting the attention and anger of Canada and Alberta from the operator to the recalcitrant governmental partner. Following the 1991 change in administration, Saskatchewan’s representatives were intentionally difficult to deal with on the project, but this was directed at the other governments as much as towards Husky. The objective was to contribute to a desire by the federal and Alberta governments to exit the partnership rather than to question Husky’s performance as an operator.<sup>195</sup>

All of this was occurring against the backdrop of financial losses that were primarily the result of the prolonged period of depressed oil prices and the resulting squeeze on the differential. Throughout the first years of the upgraders’ operation, the price of crude oil was 40% to 50% lower than when the upgraders were conceived and planned. Even at that stage and based on the prices of the early 1980’s, the economics had been borderline at best. With the sustained drop in prices, upgrader economics became catastrophic for both projects. Given lead times, construction was in part a gamble that prices would recover before completion. This did not happen. While both projects, after the start-up problems were overcome, would be able to pay for their day-to-day operating costs, they could not generate enough income to pay for the cost of capital invested. It was because of this that the mode of financing became so important. In the case of NewGrade, 80% of the initial cost of the initial capital was held within the enterprise. The interest charges contributed to (or, more accurately, caused) the cash flow deficiencies. In the case of Bi-Provincial, with its accidental equity financing, the cost of capital was not

held by the enterprise but within the partners. The interest costs for the upgrader disappeared into the general financial picture of government. For Saskatchewan, in particular, this led to very different results from the losses and cash deficiencies. In both cases, initial operating losses showed up on the province's books according to its equity share in the enterprise. Because Saskatchewan was the only partner to contribute equity, the upgrader's operating losses resulted, dollar-for-dollar, in a negative impact on the province's balance sheet while, only 17.5 % (initially, and then less after dilution) of Bi-Provincial's losses were written down by Saskatchewan. This led to the NewGrade equity investment being written down much more quickly than that in Bi-Provincial. The potential cash flow impact of NewGrade was worse. If the guaranteed debt reached the total threshold of \$635 million, a call on the guarantees was triggered. Thus, in the absence of partners willing to contribute, Saskatchewan had to unilaterally cover the shortfall or see the resulting call immediately trigger \$360 million expenditure as well as another few hundred million to honour its contractual commitments to both CCRL and the federal government. In the case of shortfalls at Bi-Provincial, even had it contributed to them, Saskatchewan would have been liable only for 17.5%. As it was, unlike the case of NewGrade, with Bi-Provincial Saskatchewan had partners who were not only willing to pay their share but willing also to pay Saskatchewan's share rather than risk project collapse. For the province, therefore, the difference in the method of financing affected both the amount and impact of shortfalls.

Despite these differences, the two projects shared one other feature in common. Upgraders had fallen out of favour. From being engines of economic growth and the mechanism to ensure the prosperity of Saskatchewan's oil industry, the upgraders were now being described as pollution belching, money guzzling failures. The reality was that the original public policy objectives were being achieved as much as was possible in an era of low crude prices. However, the emphasis had shifted to the performance of the upgraders as commercial investments. By this measure, they were seen as abject failures. In 1992, the federal Auditor General weighed in with a report on the federal government's involvement in these two upgraders, along with the Hibernia oil development off the east coast, the Vancouver Island (natural gas) Pipeline, and the proposed OSLO oil sands project.<sup>196</sup> The Auditor General concluded that the projects suffered from:

- lack of a comprehensive set of clear and measurable objectives,
- inadequate co-ordination of benefit monitoring,
- deficiencies in the follow-up of environmental assessment recommendations and commitments,
- continuing gaps in effectiveness measurement; and

- limited and poor reporting to Parliament and the public in Part III of the Main Estimates.<sup>197</sup>

The Auditor General did not indicate that the projects had failed to achieve worthy public policy objectives or had been ineffective. Instead, he argued that proper evaluation was difficult because these objectives were expressed as statements of intent rather than “clear objectives and specific intended results”<sup>198</sup> and further maintained that there were “a multiplicity of objectives, which is confusing to the observer.”<sup>199</sup> The Auditor’s report was silent on the question of the actual return from projects, either by commercial standards or those of public policy. The distinction between failure to properly measure and failure to achieve was too subtle for most media commentary, and the report was cited as proof of the failure of the upgraders.<sup>200</sup>

The initial operational problems and the seemingly incessant calls for additional cash had caused both upgrader projects to be cast as losers. This characterization was accurate in the short-term according to commercial, rather than public policy, criteria. However premature or partial the judgement might have been, it helped shape the climate in which the substantive negotiations of the upgrader deals occurred.

### **3.5: Concluding Observations**

Despite the fact that both operators did a credible job of managing construction, the public image of heavy oil upgraders suffered during the period of construction and initial operation. Ongoing low oil prices and the resulting compression in the differential between light and heavy crude oil resulted in financial losses at both upgraders. This was compounded by start-up operational problems. Even though these were resolved within 18 months of the beginning of operations, the start-up problems undermined confidence in the viability of the projects, NewGrade especially. The stage was now set for the Saskatchewan government to launch its efforts to renegotiate the agreements governing these partnerships. This will be the subject of the next chapter.

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## **Chapter 4:**

### **The Partnerships Under Stress:**

### **Renegotiating the Agreements**

#### **4.1 Introduction**

The administration headed by Roy Romanow took office on November 1, 1991. During its first term, this administration renegotiated both upgrader partnerships in a fundamental way. Both upgraders were sustaining losses as a result of low oil prices and the resulting squeeze on differentials. In both cases, Saskatchewan injected additional funds into the projects in order to maintain their operational viability while limiting provincial financial exposure to levels consistent with the province's financial plan. In the case of NewGrade, the Saskatchewan government aggressively forced changes in the financial structure of the partnership agreement. In the case of Bi-Provincial, Saskatchewan responded to events and the actions of its partners in a more opportunistic fashion. In the case of NewGrade, the negotiations with the private sector partner were extremely acrimonious while at Bi-Provincial the partnership relationship remained civil and disputes were resolved in private. This chapter will examine these renegotiation processes in order to determine why they were so different despite similarities in the starting point.

#### **4.2: Saskatchewan's Fiscal Crisis and the Context for Renegotiation**

The efforts by the Romanow administration to renegotiate the terms of the two agreements governing the two upgrader projects can only be understood in the context of Saskatchewan's fiscal position when it assumed office. Very simply, the province's public finances were on the verge of effective bankruptcy. The province had a large deficit and accumulated debt. One of the NDP's 1991 campaign platform commitments was a promise to "Open the Books". In fulfilment of this commitment, the new administration appointed the Financial Management Review Commission (FMRC) headed by Saskatoon accountant Donald Gass.

The terms of reference for the FMRC included a mandate to review the status and viability of investments made for economic development purposes by the Devine administration. The commission's report, issued in March 1992, expressed generalized caution about the economic development joint ventures saying, "while many of these investments have created a long term potential to generate significant economic benefits to the province...these investments carry with them significant levels of risk that must be monitored on an ongoing basis."<sup>1</sup> Both heavy oil upgraders were cited as a cause for concern. In the case of Bi-Provincial, which was still under construction, the treatment was perfunctory and centred on the dangers arising from low commodity prices.<sup>2</sup> In the case of NewGrade, it was noted that \$232 million previously invested had already been written off and that decisions were needed on whether to make a loss provision for another \$334 million outstanding in provincial loan guarantees.<sup>3</sup> Gass noted that the integrated facility (with FCL's existing refinery) had not performed as expected, that the government's ability to monitor the project was "severely restricted under the agreement," and that "on the NewGrade Board, a strained relationship appears to have developed between the two partners."<sup>4</sup> The new government declared that "CIC has a significant class of assets that requires careful scrutiny and management."<sup>5</sup> In this case, scrutiny and management was a euphemism for an attempt to lower financial exposure.

The Devine administration had been consistently determined to utilize CIC as a vehicle to promote economic growth and diversification, particularly through the value-added processing of natural resources. The Romanow administration, particularly in its first term, was just as determined to reduce the province's exposure on these ventures. The basic policy objective of CIC thus underwent a profound transformation.

In many ways, the new administration had no real alternative to attempting to lower its financial exposure on investments such as the upgraders. The financial situation of Saskatchewan had shaken the confidence of the financial community in the province's ability to meet its financial obligations. The immediate result had been a series of downgrades to the province's credit rating, resulting in increased interest rates on the public debt. The very real and immediate possibility was that any further downgrade would result in a lack of ability to borrow at any interest rate and in a resulting default on debt issues as they came to maturity: in short, bankruptcy. A long-term financial plan was set out in the 1993 provincial budget, and was designed explicitly to meet the financial targets set by the credit-rating agencies as the minimum acceptable for the province to continue to borrow.<sup>6</sup> The budget was a draconian one, featuring the closure of 52 hospitals, significant tax increases, the lay-off of almost 10

percent of the province's civil servants, and cuts to third-party organizations including health districts, school boards, and municipal governments. Even with these actions, the government required behind-the-scenes assistance from the federal government in order to meet its targets.<sup>7</sup>

Following the presentation of the budget in the Legislature, Premier Romanow was dispatched to New York and Toronto. His essential task was to convince the rating agencies and investors that the targets established in the budget would be met. In a six-day period (including travel), he met with 14 rating agencies and groups of investors in New York and seven in Toronto and conducted numerous media interviews with reporters from financial publications.<sup>8</sup> The message, simple and direct, was repeated in every speech: "We have announced all major expenditure and revenue measures required to eliminate the deficit in four years. We were the only province to reduce government operating expenditures and take dramatic action on our deficit. In fact, our expenditures last year came in under budget."<sup>9</sup> In addition to promising to meet its fiscal targets, the Premier promised, "in order to minimize our financial exposure, we are continuing to negotiate many of the megaproject commitments made by the previous government."<sup>10</sup> Hard commitments were being made to powerful people who were paying attention to results. In this context, there was a phobic reaction to risk and exposure. For example, a write down on an investment would produce an impact on the bottom line of CIC, which in turn would flow through to the ability of the province to meet its deficit targets. Even if the write-down did not result in a new cash outlay, the need to meet the promised targets would necessitate further program cuts or tax increases. Calls on loan guarantees would have an even worse effect on the bottom line, with a contingent liability being turned into a cash outlay, a current expenditure, and a write-down. The perception of these problematical outcomes would be amplified through the prism of uncertainty and doubt in the province. During this period, every decision made by the Saskatchewan government had to be made with primary consideration being given to the impact the decision would have on the bottom line of the province.

It was in this context that the Romanow government considered not only its roles and responsibilities as well as its relationships with its partners in the two upgrader projects, but also how it should renegotiate the agreements with them.

### **4.3 Renegotiating the NewGrade Upgrader Agreements**

The inability of NewGrade's cash flow to service its debt meant that more money was required for the project. The alternatives were injecting money to reduce the debt load, injecting money to cover

cash deficiencies, or allowing the default to be triggered with the resulting call on the government loan guarantees. CCRL/FCL was contractually protected from the problems facing the project. As a result, the provincial and federal governments were facing the economic consequences of the project's failure. It was in the government's interest to force a sharing of the any financial restructuring or cash injection, while CCRL/FCL could avoid loss by maintaining the contractual status quo. In the short-term, at least, NewGrade was a zero-sum game.

#### **4.3.1: Saskatchewan Requests Changes and Prepares for a Fight**

Following the release of the Gass Commission Report, CIC requested that the agreements be opened to address the problems facing the upgrader. This was ignored by CCRL/FCL and followed up by a request from the Premier. Premier Romanow met with FCL President Vern Leland on July 28, 1992, and it was agreed that negotiations would begin. For the next two months, calls from government officials to ask for meetings to be scheduled were not returned. At the beginning of October, FCL CEO Wayne Thompson told the Minister Responsible for CIC that he "was not prepared to recommend changes to the arrangements or even a continuation of discussions related thereto. He further advised that any revision to the transaction would be up to the Board and the membership."<sup>11</sup>

The Saskatchewan government began the process of preparing for a renegotiation fight. On July 29, 1992 members of the government caucus received a briefing that began, "when a partnership is struck there is usually a relationship between the amount of risk each partner accepts and the amount of control they exercise. This is not the case with NewGrade. The Saskatchewan government takes all the risk, pays all the bills, but is unable to make any decisions about how the project is managed."<sup>12</sup> The financial arrangements, the implications of a call on the loan guarantees, the "questionable expenses" of the allocation of costs to NewGrade were outlined. The upgrader was described as "a black hole for taxpayers' money". The briefing document pointed to the \$17 million management fee and claimed "about half is profit." This, combined with CCRL/FCL's improved financial results, was deemed as suspicious, since "it is also interesting that in 1991 refineries owned by Petro Canada, Shell, Imperial and Husky all lost money. The petroleum division at FCL earned \$40 million." It was predicted that FCL would portray government action "as an unwarranted attack by one friend on another. If successful, this 'attack' will severely hamper Federated's ability to pay dividends to its members – the retail co-ops." As a result, MLAs were told that "our response must be that this is a bad deal for the Saskatchewan taxpayer. So bad in fact, that to not try to limit our liability would be to shirk our responsibilities as a government."<sup>13</sup>

#### 4.3.2: FCL Rejects Calls for Negotiated Changes

CCRL/FCL responded to the government's request for renegotiation by saying that the terms of its original participation had been established through a membership consultation process and that before any changes could be discussed, FCL management and Board needed to engage in a similar process to obtain a mandate for change. This consultation process was a call-to-arms. The FCL-nominated co-chair of the NewGrade board told delegates at regional meetings that "the government clearly stated that they are not happy with the deal. Even though it is a signed legal document – even though they are legally bound to accept all the terms – they have insisted that we must agree to the changes they are demanding. The Saskatchewan government wants you and your retail to sacrifice the refinery and its earnings."<sup>14</sup> Rather than seeking a mandate to negotiate, FCL management sought support for an entrenchment of its position in support of the status quo, saying, "we need to rally the troops – we have a cause that is worth fighting for – we have a lot to gain from joining together in a united front."<sup>15</sup> While FCL officials stalled on requests for negotiating meetings, the membership was mobilized to begin the fight. Through the fall of 1992, local co-op leaders who were members of the NDP began moving motions at riding association meetings demanding the dismissal of senior CIC officials on the grounds that they were alleged to be hostile to co-ops.<sup>16</sup>

At the beginning of 1993, despite the findings of the Gass Commission, CCRL/FCL had reason to be confident about its ability to maintain its protected position in NewGrade. Through hard work and determination, as operators they had overcome the start-up operational problems and the upgrader was operating smoothly. Blockage of the arbitration process had limited the ability of governments to intrude into their operational authority, and the contractual provisions of the project and operating agreements inoculated the refinery and the co-operative retailing system from any financial risk. FCL had demonstrated its ability to stare down the Devine administration, and it had some reason to believe that it could do the same with the new Romanow-led NDP administration. Part of this confidence came from the intrinsic nature of the retail cooperative system and its roots in almost every community in Western Canada. As the FCL Board Secretary Empey, told delegates at a conference on co-operative/government relations, "the very fact that you come from an organization like ours, broad-based and democratically controlled[,] is all you need to open doors that need opening."<sup>17</sup> The political clout of the co-operative movement in general was buttressed by its relationship with the NDP. In opposition, the NDP had supported the NewGrade arrangements, exempted the upgrader from its

critique of a megaproject investment strategy, and even supported CCRL management in disputes with the government on environmental questions.

Part of the reason that the CCRL/FCL leadership was confident of its ability to rebuff the provincial government's demand for renegotiating the agreement is that many elected and appointed senior officials of the provincial government had roots in the cooperative movement. For example, the Acting President of CIC was a former Board chair of the Saskatoon Co-op, as had been the Minister who would serve as the Minister Responsible for CIC in early stages of the dispute and who would go on to be Finance Minister. The father of CIC's senior in-house legal counsel was a director of FCL and in line to become its next president.

FCL as a whole was in better financial condition than it had been in the past. The tough operating decisions made by FCL management in the early 1980s<sup>18</sup> had paid off. FCL's annual profits increase from \$27,415,000 in 1983<sup>19</sup>, when the original NewGrade agreement was signed, to \$78,428,000 in 1988,<sup>20</sup> when the upgrader construction was completed to \$92,026,000 in 1992,<sup>21</sup> when the new Saskatchewan administration suggested renegotiating the terms of the agreement. The government was later to suggest that this improved financial performance was as a result of the NewGrade upgrader. In reality, over two-thirds of the improvements in profitability came from non-petroleum operating divisions. While NewGrade's financial performance meant it was exceptionally unlikely for the upgrader to contribute to FCL's bottom line over and above whatever the profit margin in the management agreement actually worked out to be, the upgrader had provided long-term security of supply for the CCRL refinery, and FCL seemed to be adequately protected against any financial risks. For FCL management and the co-operative retailing system they represented, the status quo for NewGrade was the best available option. Just as importantly, they believed they could maintain it.

FCL's mobilization efforts began to yield results. Premier Romanow began to receive letters from the boards of local retail co-operatives informing him that "[y]our attempts to change this agreement are in fact a threat to take money from every Co-op member in western Canada,"<sup>22</sup> and "we feel it is unfair to expect the Co-operative system to pick up the Government responsibilities in the event the project does not meet their expectations. The co-op system did not initiate the project. They in fact entered into the project with some misgivings."<sup>23</sup> As a harbinger of things to come, the majority of the letters opposing any restricting and the most vitriolic ones came from Manitoba. That province's NDP began to feel pressure arising from the actions of its Saskatchewan counterparts. In response to an invitation to a fund-raising banquet at which the Saskatchewan Premier had been invited to speak, a

long-time Manitoba New Democrat wrote, “I was brought up as a part of the Co-operative movement as well as the CCF and NDP and believed these two movements were basically one and the same. How could Sask have done this to their own people! I do not want to attend any function where Roy Romanow is present. It would turn my stomach!!”<sup>24</sup> Manitoba’s NDP agriculture critic told the Saskatchewan Premier that “[o]bviously we would want to ensure that the interests of Manitoba members is [sic] being given fair consideration.”<sup>25</sup> Retail co-operatives began distributing information sheets to all shoppers defending its position on the upgrader and attacking the Saskatchewan government for asking for changes.<sup>26</sup>

Complicating the relationship between CCRL/FCL even further were lingering environmental concerns. While the explosions, fires, and releases of toxic gas seemed to be a thing of the past, the combined upgrader/refinery complex was troubling the provincial environment department, which contended that the complex was not meeting solid waste and wastewater management regulatory standards. There were concerns about possible contamination of the Regina Aquifer, and hydrocarbon contamination had been detected in the Condie Aquifer, both of which helped supply Regina’s drinking water. These environmental problems were seen by the government as predating the construction of the upgrader,<sup>27</sup> arising instead from the establishment and operation of the refinery in an era of weak regulation and limited monitoring capacity. CCRL/FCL officials chose to interpret the raising of these issues at this time simply as an additional tactic by the province to apply pressure in support of financial restructuring.<sup>28</sup>

#### **4.3.3 The Provincial Government’s Appointment of the Estey Commission**

The position taken by FCL management and the resulting response from FCL’s membership consultation quickly made it clear to the government that its attempt at quiet, reasoned persuasion had failed. Copies of documents outlining the government’s case against CCRL/FCL, including the July 29, 1992, briefing to caucus members, began to appear mysteriously in the hands of the media.<sup>29</sup> The government’s official move was to appoint a Commission of Inquiry “into certain matters regarding a refinery operated by Consumer Co-operative Refineries Limited and a heavy oil upgrader owned by NewGrade Energy Inc. adjacent to such refinery.”<sup>30</sup> The Commission of Inquiry was a one-person affair, with retired Supreme Court Justice and Saskatchewan native, Willard Estey, receiving the appointment. This choice was supported by FCL. However, while FCL was dealing with the Estey Commission, member retail cooperatives were maintaining their attacks over the possibility of any changes in the upgrader agreements.

Estey's mandate was to examine the financial, governance and environmental issues facing the refinery/upgrader complex and to "mediate any differences arising between the parties."<sup>31</sup> While the primary mandate was forward-looking and directed towards solving problems, the Commission was also invited to delve into the political exercise of laying blame with "a review of the information available to the Government when the decision to enter into such financial involvement was undertaken, the advisability of entering into this commitment on the basis of this information, the criteria to be used to determine whether the objectives of the Government were or are being achieved, the effect of this commitment was to have on the Government's financial position and, where, appropriate, an assessment of the success in achieving the Government's objectives to date."<sup>32</sup> Estey ignored this invitation to provide a critique of the policy decisions of the previous administration and treated the venture as found at the time of his appointment. Estey also ignored a provision calling for a report on the upgrader/refineries record of complying with environmental regulations and standards.<sup>33</sup> His interpretation of his mandate was to serve as a mediator rather than as a blame-assigning investigator. As such, he conducted only two public hearings – one at the beginning and one at the end of the process.<sup>34</sup> He did not solicit testimony under oath. Indeed, his work was based primarily upon a 36 page statement of agreed-upon facts jointly submitted by CCRL and CIC,<sup>35</sup> a review of supporting documentation and private meetings and discussions with the partners. The difficulties in reaching a mutually acceptable solution of the problems facing NewGrade were based on differing interests rather than on differing perceptions. The central problem facing the upgrader was that it could not generate enough cash flow to pay operating costs, meet interest obligations, and retire the outstanding guaranteed debt. Further, there was no agreed-upon method of providing for the project's cash deficiencies. Shutting the upgrader down made no sense, since the project was now operating well. It was generating significant positive cash flow before the fixed costs of interest and debt retirement were included. In Estey's summation he said, "the project has, in a financial sense, run aground Operating at capacity, it cannot sustain the existing debt load."<sup>36</sup> Estey concluded that the conflicts over governance were the inevitable result of the project's structure of two ownership entities within one operational complex, saying, "what the engineers necessarily integrated, the lawyers artificially segregated...it is not at all surprising that differences have arisen from this cost allocation process."<sup>37</sup>

The consensus of the partners was that a \$6/barrel differential was the most likely scenario for the next several years. In a jointly submitted cash flow projection, the financial projections for NewGrade were presented, with the annual deficiency payment required to retire the balance of the debt by 2008. Six scenarios were provided, these being the results for differentials at \$5/barrel,

\$6/barrel and \$7/barrel with and without an upfront \$225 million capital injection. The figures in brackets represent a projected negative cash flow while the figures without brackets represent a projected positive cash flow. The results can be summarized as:

**Table 4.1**

**Financial Scenarios for the NewGrade Upgrader<sup>38</sup>**

	\$5 w/o Injection (000)	\$6 w/o Injection (000)	\$7 w/o Injection (000)	\$5 with \$225 million Injection (000)	\$6 with \$225 million Injection (000)	\$7 with \$225 million Injection (000)
1994	<40,583>	<25,964>	<11,345>	<14,780>	<161>	14,458
1995	<43,895>	<28,068>	<12,262>	<18,046>	<2,265>	15,541
1996	<43,480>	<27,104>	<10,676>	<17,677>	<1,301>	15,127
1997	<43,208>	<26,270>	<9,253>	<17,405>	<467>	16,550
1998	<42,830>	<25,257>	<7,549>	<17,027>	546	18,254
1999	<42,386>	<24,136>	<5,733>	<16,583>	1,667	20,070
2000	<41,912>	<22,962>	<3,838>	<16,109>	2,841	21,965
2001	<41,456>	<21,758>	<1,862>	<15,653>	4,045	23,941
2002	<41,110>	<20,495>	199	<15,307>	5,308	26,002
2003	<40,781>	<19,222>	2,298	<14,978>	6,581	28,101
2004	<40,443>	<18,013>	4,440	<14,640>	7,790	30,243
2004	<40,090>	<16,759>	6,574	<14,287>	9,044	32,377
2006	<39,726>	<15,444>	8,815	<13,923>	10,359	34,618
2007	<39,334>	<14,098>	11,137	<13,531>	11,705	36,940
2008	<38,944>	<12,682>	13,556	<13,141>	13,121	39,359
Total	<610,103>	<318,230>	15,497	<233,091>	68,809	371,546

The cash flow projections show the impact of the actual differential upon the economics of the upgrader. Even with a financial restructuring, the pessimistic \$5/barrel scenario would result in significant cash deficiencies for the each of the next 15 years. During the period when Estey was

completing his work, the differential was hovering in the range of \$4.50 per barrel. The Estey Commission process transformed, essentially, into an attempt to reach a mediated solution to the twin questions of which partner would pay how much towards immediate debt repayment and which partner would be responsible for how much of any ongoing cash deficiency. The discussions were centred on the avoidance of loss rather than on any attempt by any partner to secure a greater share of upside benefit that would occur in the event of a major increase in the differential.

The governance issues were treated as secondary. At an early meeting, Estey described the blocking of the arbitration process as “totally unacceptable.” Lawyers for CCRL and CIC were dispatched by Estey to develop a workable arbitration protocol. This was done with dispatch (and came to be known in discussions as the Wilson/Dierker Protocol, which was agreed to by the province. CCRL said it agreed in principle with the protocol but reserved final decision until the final report of the Commission had been issued.<sup>39</sup>

In his report, Estey hinted that the intensity of the governance disputes would dissipate once the financial pressures arising from the debt were reduced. With the removal of the barriers to arbitration, governance would remain unchanged in the short term. Once the guaranteed debt was reduced to \$75 million, he suggested, the monitoring provisions could be disregarded, since this amount of debt “is an arbitrary approximation of the level of debt which will, for practical purposes, bring the interests of Saskatchewan and FCL into parallel with reference to the operation of NG[NewGrade] and the debt retirement program.”<sup>40</sup> In the long-term, Estey said, the legal separation of the upgrader from the refinery was untenable and that “no-one before this Commission has advanced the proposition that it is in the interests of Saskatchewan to seek continued ownership.”<sup>41</sup> Logically, said Estey, “FCL, the current operator, who is developing a very sound record as an efficient manager is the logical owner.”<sup>42</sup> When the debt was retired and outstanding obligations to Saskatchewan met, FCL should receive full ownership for the price of \$1.00.

#### **4.3.4: Canada and FCL’s Positions to Estey**

In the negotiations over paying down the debt, Canada took the position that it was willing to consider a substantive contribution but only if both shareholders (CCRL/FCL and Saskatchewan) contributed in a fair and equitable manner. FCL again stalled. Its representatives cooperated with the commission and “responded to any and all inquiries.”<sup>43</sup> While making general statements about being willing to participate in a negotiated solution, FCL did not provide Estey with any concrete indication as

to what it was willing to consider until April 9, 1993,<sup>44</sup> despite the fact that the original deadline for the Commission to report was January 25 of that year.<sup>45</sup>

FCL originally suggested that it might be willing to consider purchasing three operational units from NewGrade (and allowing NewGrade to continue to use them for incremental operating costs in the same way that the CCRL refinery was then using these NewGrade assets), for a payment of \$18 million in 1993, \$10 million in 1996, and \$20 million in 1998. In his April 9 letter, FCL's CEO presented three options for a FCL contribution. The first would result in a \$50 million cash injection in the form of CCRL purchasing three operational units from NewGrade (and allowing NewGrade to continue to use them for incremental operating costs in the same way that the CCRL refinery was then using these NewGrade assets). The second option would be to purchase these assets for \$29 million in cash, a \$59 million forgivable loan, and a reduction in the management fee to \$15 million annually. The third option would be for CCRL to provide NewGrade with an annual contribution of \$4.2 million. With all three options, CCRL would write off the \$4.7 million in outstanding subordinated operating fees. The offer of CCRL participation was contingent upon Saskatchewan's writing off all but \$75 million of its equity investment in NewGrade; providing an upfront contribution of \$25 million, providing the upgrader with a monthly grant of \$1.25 million, withdrawing all outstanding issues for arbitration, and selling its shares in NewGrade to CCRL for \$1.00 once the guaranteed debt had been repaid. Canada was to contribute a grant of \$125 million or \$150 million. Thompson stressed that "our system would not accept the upfront cash being paid without ownership of the assets by CCRL. The ownership of assets is part of the heritage of the Co-op system and something they feel very strongly about." He also explained that he had presented the proposals to the elected FCL President and "our arguments for this proposal were not as persuasive as I would have liked and he was very nervous about trying to sell this to our system. He did agree, however[,] to discuss this alternative further with me if you favoured this option and he could see the total package."

The proposal was not yet an offer. Thompson told Estey that the appearance of a \$50 million CCRL contribution, however bounded and conditional, would mean that "Premier Romanow could better sell the package to some of his own people, the media and the public to justify the inquiry and to the debt rating agencies" and assist the federal government in justifying its contribution.<sup>46</sup> While CCRL/FCL was indicating, for the first time, that it **might be** willing to contribute some cash to the project, it was still refusing to accept any of the ongoing risk arising from the project and was making its willingness to even consider a contribution conditional on a much greater contribution from the federal

government and an even larger one from Saskatchewan. It was designing its offer to create the public impression of FCL support to make it easier for the governments to justify making large contributions to the upgrader, which FCL would then own solely.

#### **4.3.5 The Estey Report on NewGrade**

Estey did not convey this FCL proposal to the governments. Instead, five days later he issued his report outlining his opinion as to who should pay what. In his recommendations, Estey accepted FCL's argument that it could not justify an up-front cash injection except in the form of an asset purchase from NewGrade. He proposed that FCL contribute \$50 million in this manner, continue to subordinate the portion of the operating fee as it had agreed to do a few years earlier, lend NewGrade \$30 million spread over 3 years, allow the outstanding issues to be arbitrated and make good on any resulting settlement in favour of NewGrade, and be responsible on an ongoing basis for half of any future cash deficiencies.<sup>47</sup> Canada was to contribute a grant of \$150 million towards debt retirement,<sup>48</sup> while Saskatchewan would write off its original \$155 million capital investment, contribute a grant of \$25 million to retire guaranteed debt in 1993 and lend the project another \$30 million spread over three years, continue to match CCRL's subordination of its operating fee with equivalent cash, and fund half of any ongoing cash deficiencies. The province would be repaid, as cash flow permitted, the \$76 million that it had already contributed to operating shortfalls (along with interest). When the outside debt and money owing to Saskatchewan had been paid, the province was to sell its ownership share in NewGrade to CCRL "free and clear of all encumbrances and subject only to the nominal price of \$1.00."<sup>49</sup>

The effect of the recommendation would be that three partners would immediately inject into NewGrade a total of \$225 million in kiss-goodbye money for debt repayment, with the federal government paying \$150 million, CCRL \$50 million, and Saskatchewan \$25 million. Saskatchewan and CCRL would also invest another \$30 million each in the form of interest-bearing debt, to be repaid from the project's cash flow as this became possible. The two owners would be jointly responsible for cash deficiencies, although these would only be required if the most pessimistic projections for the differential proved to be reality. NewGrade would also have its position improved by whatever the arbitration process yielded. Saskatchewan would renounce any claim to recover its original \$155 million equity investment and sell its ownership share for \$1.00 as soon as the project was clear of debt – both external and owed to the government. The cash injection would mean that the project would likely be

able to service its remaining debt. In exchange for their cash injections (and, in Saskatchewan's case, walking away from its original investment), the two governments would reduce both the size of their ongoing exposure and the likelihood that the guarantees would be called. CCRL/FCL, on the other hand, would receive all the potential economic upside from the project once the debt was paid down. Saskatchewan's write-off of its \$155 million original investment would mean that this happy day would come several years earlier. Governments were being offered the opportunity to purchase risk avoidance, CCRL/FCL the opportunity to purchase upside economic gain. Even with a relatively cautious projection of the differential, the CCRL/FCL would receive full ownership of an established, debt-free upgrader for \$50,000,001.

Estey proceeded from the observation that none of the partners were legally responsible to keep the upgrader complex viable. Just as CCRL/FCL had no legal obligation to assist with financial shortfalls, it was also true that "Saskatchewan has not covenanted, in any of the agreements, to make such deficiency payments to NG in perpetuity." The lack of a provision to meet shortfalls was one "fateful reality." The need for someone to do so was a second reality.<sup>50</sup> As a result, Estey laid out a series of interconnecting moral obligations. Saskatchewan's government were the "custodians of the Provincial Treasury. A threat to the fiscal integrity of the Province must be met by the office-holders of the day."<sup>51</sup> At the same time, the province had the obligation not to act in a way that threatened the viability of the cooperative retailing system. Similarly, FCL needed to protect its members' interests but to be attuned to the fact that "it is heavily involved in the Saskatchewan industrial/commercial community. Its future welfare is not unrelated to that of the Province and its people."<sup>52</sup> The retired judge reminded both FCL and the provincial government that "the long-term viability of FCL and their component organizations and membership, the overall economy of Saskatchewan and the financial integrity of the Province form a complex web, each part of which is sympathetic to tensions in the other parts."<sup>53</sup> As for the Government of Canada, "the national government cannot be blind to the risk of serious financial injury to a province should timely and relevant intervention by the federal level of government not be undertaken."<sup>54</sup>

#### **4.3.6 Reaction of Partners to the Estey Report**

Estey's report was greeted with caution by both governments and with a portrayal of vindication by CCRL/FCL. Federal officials said there was no immediate crisis to justify expending \$150 million, while the Energy Minister said that he was aware of the problems facing the upgrader and that he was

“prepared to look at solutions that are realistic.”<sup>55</sup> The provincial Minister Responsible for CIC said, “can we afford it [refinancing the project]? I don’t think we can. Can we afford not to? That’s also a very difficult question.”<sup>56</sup> The Saskatchewan government expressed no hesitation about officially abandoning \$155 million previously invested in the upgrader. This had already been written down on CIC’s balance sheet and would therefore not affect the province’s fiscal plan. However, new cash was a concern – but so was the possibility of a call on the loan guarantees. FCL immediately distributed a copy of the report to all member co-operatives along with a summary that highlighted all of the statements confirming FCL’s legal position, endorsing CCRL’s operating record, and highlighting the conclusion that CCRL was the logical operator and should become the sole owner. The summary acknowledged that the report recommended a reduction in the project’s debt but said that “[t]he suggestions are not in line with the direction we have received from the System and they are inconsistent with the statements made in the report...it is likely that the Estey report will be a topic of discussion during the meetings scheduled for some districts in June.”<sup>57</sup> FCL’s response blurred the distinction that Estey had made between what the company was **legally required** to do and what it **should do** in order to place the project on a sound financial footing. It also ignored his linkage between the long-term upside gain he proposed that CCRL/FCL receive and the short-term commitment required to make it possible.

As FCL’s leadership celebrated the narrative in the Commission’s report while rejecting its conclusions, the Saskatchewan government decided it could not “cherry-pick” recommendations. The report placed rights and obligations on each party, and it was decided that the only way to obtain the provincial benefit was to pay the provincial costs. On April 29, ten days after the public release of the report, the CIC Minister wrote both FCL and the federal government to indicate that the province would support any settlement on the basis of the recommendations made by Estey. He asked each of the partners what their position was.<sup>58</sup> The federal government replied that it was willing to discuss, subject to agreement from the shareholders.<sup>59</sup> FCL President Vern Leland replied by stressing his company’s lack of a legal obligation to contribute anything. He said, however, that “we are prepared, however, to consider CCRL participating in a refinancing package for NewGrade” and referred to the terms outlined in the April 9 letter to Estey,<sup>60</sup> apparently under the belief that the province had a copy of this. Once the resulting confusion was cleared up, CIC Minister Penner noted three proposals were presented but none committed to, which “would have the effect of worsening the taxpayer’s exposure, while likely reducing even further FCL’s obligations to NewGrade.” Particularly objectionable, said Penner, was the condition that Saskatchewan contribute \$1.25 million per month to the upgrader, the lack of provision for sharing any possible future deficiencies, the demand for a withdrawal request for arbitration items and the lack

of any changes in governance. The Estey Report had provided a fair and equitable blueprint, and action was needed on an urgent basis in order to avoid losing a potential federal contribution.<sup>61</sup>

As letters were being exchanged, both FCL and the province began ramping up their communications campaigns. Government MLA's were provided with draft pamphlets and letters to communicate with their constituents. Retail cooperatives were supplied with pamphlets to give to customers which attacked the government's demands to renegotiate the arrangement. Both sides clearly demonstrated an understanding of the importance of time in the dispute. A slow pace favoured defence and the status quo, while speed worked to the advantage of offence and change. As a result, FCL expressed a generalized willingness to negotiate (as opposed to contribute) while being tardy at answering correspondence and refusing to return phone calls or schedule meetings. The government, on the other hand, was constantly forcing the pace by demanding immediate responses and quick commitments. While gearing up for a major confrontation with the government, CCRL/FCL appeared confident in its ability to resist change. It had faith in its ability to mobilize the retail cooperatives and their members, and the Estey Report had confirmed the strength of the immunity of legal challenge to the project and operating agreements.

In this assessment of its position, CCRL/FCL made three misjudgements. The first was in its assessment of the government's determination. The government had just tabled a very controversial budget designed explicitly to meet the deficit targets being set by the credit rating agencies and bond holders. When the Estey Report was submitted, the Premier and Department of Finance officials were in New York to confirm their determination to meet those targets. When they returned to the province, the Premier told the Legislature that "Moody's, in issuing credit rating said 'Success in curtailing government exposure to private sector venture debt and loan guarantees will be important to maintaining the current credit rating.'"<sup>62</sup> In the circumstances of 1993, the Government of Saskatchewan was not in a position to deal with a call on the loan guarantees, and NewGrade's financial position made this possibility probable but unpredictable in timing. As Premier, Romanow said, he must heed the admonition from Estey that "provincial leaders...are the custodians of the Provincial Treasury. A threat to the fiscal integrity of the Province must be met by the office holders of the day."<sup>63</sup> The government's determination was driven by desperation, which is something that FCL leadership did not appear to understand.

The second miscalculation was the lack of recognition of the implications of the change in governing party. The overlap in membership between co-ops and the NDP cut two ways. Just as the co-

ops had been able to turn NDP constituency association meetings into forums to demand the dismissal of CIC staff, a dense network of personal connections allowed the NDP government to by-pass FCL leadership and speak directly to board members and other opinion leaders in local retail co-operatives in Saskatchewan.<sup>64</sup>

The final miscalculation made by FCL leadership was their comfort in the impregnability of their legal position. They took comfort in the legal wording of contracts, overlooking the observation made in 1651 by Thomas Hobbes that “there can happen no breach of Covenant on the part of the Sovereign; and consequently none of his Subjects, by any pretence of forfeiture, can be freed from his Subjection.”<sup>65</sup> The provincial government, as the sovereign power within its field of jurisdiction, had the power to unilaterally change the contractual arrangements. FCL was challenging a wounded Leviathan, which can be a dangerous business.

#### **4.3.7: The Saskatchewan Government Considers Legislation**

While the government had the legal authority to replace contract with legislation, it was not a decision it took lightly. In its analysis of the Estey Report, Department of Justice officials cited quotations that alternately implied support or rejection of an legislative solution and concluded that, “taken collectively, these general remarks appear to provide the inference that some legislative intervention may be required but that it should be moderately conceived, tailored to achieve specific necessary fixes and not be an over-reaction. In short, the Commissioner appears to believe that if government action is required it should be delivered by the rifle and not the shotgun.”<sup>66</sup> Expropriation was specifically ruled out as a legislative option. “It may readily be seen that the Report, read as a whole, sends strong warnings against expropriation or like heavy handed measures.”<sup>67</sup> In drafting possible legislation, the government needed to remember that, “taken as a whole, therefore, the Report supports the conclusion that the Province got what it bargained for, as did CCRL. Again, although the Report does not say it, it is a clear inference from the Report that FCL got by far the better part of the business bargain.”<sup>68</sup> In wrestling with the decision as to whether to attempt to use legislation a means to force a settlement, Premier Romanow reviewed briefing material outlining the economics of the NewGrade project, the implications of the Estey recommendations, the history of the potential arbitration issues, the process and impact of the project’s collapse, the legal arguments about legislation, and the Wilson/Dierker arbitration protocol that FCL had not yet endorsed.<sup>69</sup> In a manner reminiscent to that of Premier Devine’s in 1985 as the decision was being made over whether to proceed with construction in the face of deteriorating project economics and new FCL demands, Premier Romanow requested and

received a briefing note from the Department of Finance. In 1985, Premier Devine carefully studied Finance's analysis of the financial benefits to the province that would be created if the project proceeded.<sup>70</sup> Eight years later, Premier Romanow studied a similar briefing memorandum. This one outlined the impact on the province's credit rating and ability to borrow money in the event of the project's collapse.<sup>71</sup> A call on the loan guarantees would, in the best-case scenario, result in additional borrowing with a resulting \$28 million to \$30 million annually in interest expenses combined with a credit rating downgrade. Depending on "the surrounding circumstances" of a call on the guarantees, an end to "access to capital by the Province" was a real possibility.<sup>72</sup>

On May 19, 1993, CIC Minister Penner informed FCL President Leland that, "if a Memorandum of Understanding is not signed by May 25, 1993, I will have no alternative but to recommend to my colleagues that the Saskatchewan Legislature pass appropriate legislation to protect the overriding public interest."<sup>73</sup>

FCL responded to the deadline and the threat of legislation by playing for time. Citing the April 9 options presented to Estey, Leland said, "we continue to be open to discussions on the refinancing of NewGrade" and "we have district meetings planned with our member co-operatives across western Canada for June. These meetings will give FCL an opportunity to receive direction from our members, to whom we are accountable." As a result, Leland urged Penner "to consider the positive side of the NewGrade upgrader and to withdraw your threat to use legislation to unilaterally change the NewGrade contract."<sup>74</sup>

The attempt at delay was summarily rebuffed. Minister Penner responded by saying, "It is very disappointing to me that even at this late date Federated Co-operatives Limited, remains unwilling to enter into meaningful negotiations on the financial restructuring of the NewGrade Project as recommended by Mr. Justice Willard Estey in his report of April 14, 1993. I reaffirm our government's strong desire to meet with FCL to negotiate a restructuring package based on the principles recommended by the Estey Report."<sup>75</sup> Penner noted FCL's approval of Estey as the commissioner and reiterated his objections to FCL's proposals. He then said the government would not delay. "FCL has been asking: 'What's the hurry?' I believe that taxpayers have a right to ask FCL: 'What's the benefit in waiting?' Delaying action on this issue is not prudent. In fact, it is irresponsible." After indicating his willingness to meet and providing phone numbers where he could be reached, Penner concluded with "failing a negotiated settlement by Tuesday, May 25[,] I will be recommending the introduction of appropriate legislation on Wednesday, May 26."<sup>76</sup>

#### 4.3.8: The Legislative Opposition Becomes Involved

The threat to introduce legislation brought the dispute into the chamber of the Saskatchewan Legislature. Until then, the opposition had remained silent on the issue. The controversy was a critique of their record in government, and, up until legislation was posed as an option, they did not see fit to defend this aspect of it. Legislative changes to contracts, however, fit with a promising opposition theme that the Romanow government was both untrustworthy and dictatorial in using legislation to override contractual commitments. In its first legislative session after being elected, the new government had passed legislation to revoke the contractual severance provisions of departing senior civil servants. In the second session, it had used legislation to escape contractual commitments for farm support that were deemed to be prohibitively expensive to the provincial treasury. The first of these uses of legislative authority had been politically popular. The second was not. Regardless of its own frustrations with FCL while it had been in government, the Conservative opposition now had a promising political angle by demanding that the Premier rule out legislation.<sup>77</sup> In addition to opposing legislation on the principled grounds that contracts entered into by governments should be honoured, even in the event of a change in administration, the opposition quickly developed other themes of attack that would be repeated both by them and by FCL over the coming weeks. Acting Opposition Leader Rick Swenson argued:

- That the Romanow government was being hypocritical in attacking the upgrader deal and had some ownership responsibilities for it because it had known of the terms before the election and had not opposed or criticised it;<sup>78</sup>
- That the government's motivations were nefarious. Two sinister motives were attributed to the government. The first was that the government was seeking revenge on FCL for having done business with the Devine government by proceeding with the upgrader and thereby contributing to the Conservatives 1986 re-election. The second was that the issue was a personal vendetta being conducted by the CIC President, and to a lesser extent, by the Minister of Finance, arising from disagreements they had had with FCL while serving on the Board of the Saskatoon coop some years earlier;<sup>79</sup>
- That the upgrader was not as bad a deal as the government maintained, since it had contributed to economic growth and the generation of oil royalties. On this theme, haste was attacked as unnecessary since no cash deficiency payments had been required for the past few years;<sup>80</sup> and

- That legislation was unnecessary. While it was conceded that the upgrader's debt needed to be restructured, any failure in negotiations was the result of NDP incompetence rather than FCL intransigence.<sup>81</sup>

On the second point, Swenson was being silly and on the fourth, disingenuous. He had been the last Minister of Energy and Mines during the Devine administration and had participated in discussions that centred around the financial problems faced by the upgrader and its implications for the province's finances. Like its successor, the Devine administration had been painfully aware of FCL's determination to avoid assuming liabilities or risk associated with the upgrader and the resulting issues arising from this, including the inability to get federal assistance without FCL participation.<sup>82</sup> However, these four points became the basis for opposition within the Legislature before legislation was introduced. After introduction, these lines of attack remained, and added to them was the argument that legislation overturning contracts damaged investor confidence in the province.

The Premier himself could be disingenuous on the question of the NDP's behavior in opposition. Pointing to the Devine government's refusal to table the final complete project and operating agreements in 1987, he developed the argument that NDP members had been unaware of the true nature of the agreements and their implications until assuming office.<sup>83</sup> His initial, more straightforward response had been "this is irrelevant."<sup>84</sup> The detour on the issue of prior knowledge was a rare example of the government departing from its core message that the NewGrade upgrader, as then structured, was an unconscionable deal granted by the previous administration and that the resulting exposure for the province threatened the integrity of Saskatchewan's finances. It was the duty of the currently elected officials to fix the problem fairly and in a timely way, even in the face of FCL resistance. The blueprint for such a resolution had been provided by the Estey Report, and, while the government much preferred a negotiated solution, it was willing to use legislation if necessary. The government aggressively rebutted allegations that its intention was to use the pretext of upgrader problems to expropriate CCRL's refinery. It was, said government spokespeople led by the Premier, the opposite. The government's goal was disengagement. The Premier told the Legislature that he would sell all of the government's equity in the upgrader – some \$253 million – to CCRL/FCL for \$1, adding "I will even advance them the \$1 – they can take the upgrader, lock, stock and barrel for \$1. Whole thing. Won't take a thing from them. I'll sign the deal right now. We'll drop the legislation right now. Why don't you advance that? They'll take on the liabilities and the operations. This is such a good deal, I'll turn all of it over to FCL right now. That's the promise."<sup>85</sup> The reaction to this rhetorical, but very real, offer from the

Premier graphically demonstrates the way NewGrade was regarded. CCRL/FCL refused to comment on the proposals, the Opposition Leader called it “a pile of garbage”<sup>86</sup> and the Saskatchewan Taxpayers Association endorsed the offer with congratulations to the Premier for “taking taxpayers into account.”<sup>87</sup>

#### **4.3.9: The Provincial Government Introduces Legislation**

On May 26, the government attempted to introduce its NewGrade legislation. The opposition used procedural tactics to delay first reading, so the CIC Minister released the text of the bill outside the house. First reading occurred on May 31,<sup>88</sup> with a recorded division which is unusual at this stage of the legislative process. The legislation, Bill 90, *An Act to Protect the Financial Viability of NewGrade Energy Inc.*, began with 4 “whereas” clauses setting out the history of the issue and justifying the legislation.<sup>89</sup> This is suggestive of the government’s nervousness about the legislation. A total of 352 pieces of legislation were introduced during the 22<sup>nd</sup> Legislature. Exempting a handful of Bills for interim supply, only three others contained “whereas” clauses. One of these established a process to amend contracts between commercial lenders and farmers,<sup>90</sup> one changed the contractual terms of farm insurance,<sup>91</sup> and one established balanced budget legislation.<sup>92</sup> By taking the unusual step of justifying legislation within its text, the government demonstrated that it viewed legislative amendments to contracts as extraordinary.<sup>93</sup>

Bill 90 authorized CIC to instigate arbitration of disputes in the name of NewGrade and to act on behalf of the joint venture in arguing these cases<sup>94</sup> and force CCRL to share equally in any NewGrade cash deficiencies.<sup>95</sup> The legislation did not provide for expropriation, and forcing CCRL/FCL to contribute to a financial restructuring had been deemed to be outside the authority of the legislature to mandate.<sup>96</sup> Then came the real hammer. Section 9(1) stated:

*The Lieutenant Governor in Council may, by order in council, amend, modify or supplement any NewGrade agreement if the minister considers that the amendment, modification or supplement is necessary to protect the financial viability of NewGrade or to improve NewGrade's corporate governance.*<sup>97</sup>

The government acknowledged this provision was “extremely serious” but was necessary to protect against the possibility of FCL using its “almost total operational control” to “force NewGrade into default.”<sup>98</sup> In setting out the case for the provision, Saskatchewan’s Justice Minister said, “I stress again that in the event of default, under the current agreements, FCL is protected from all risks while the

taxpayers would pay all costs. I am not suggesting that FCL intends consciously to attempt to force this project into default; however, the potential is there. It could be argued that FCL could, in the end, financially gain from a NewGrade default.” Further, said the Justice Minister, “based on the actions and comments which I have just outlined, they tell us – and this is the lawyers [who] tell us – that there is clearly some reason to apprehend that CCRL intends to try to make an argument under the agreements that it has these rights. Our lawyer went on to advise us that such an action could lead to a call on the guarantees.”<sup>99</sup>

Bill 90 went on to protect the government’s ability to act under the terms of the legislation. Orders-in-Council and regulations made under this Act were granted supremacy over any other conflicting measures.<sup>100</sup> Recourse to the courts for any action or decision made under the authority of this Act was denied.<sup>101</sup> A year earlier, the government had established its right to re-interpret the calendar by legislating that one date “is deemed” to be another.<sup>102</sup> In Bill 90, the government gave itself authority to pass regulations “defining, restricting or enlarging the meaning of any word or phrase used in this Act but not defined in this Act.”<sup>103</sup> A wounded Leviathan is a determined Leviathan, and if it was forced to legislatively amend contracts, the government was determined to do what was necessary for the legislation to be effective. With eight pages of text, the government had bypassed the detailed contractual provisions that had allowed FCL to believe that its position was legally impregnable. However, to demonstrate that its preference was a negotiated settlement, the Act concluded with the provision that:

*If the Lieutenant Governor in Council is satisfied that the Government of Saskatchewan and CCRL have entered into an agreement that settles all outstanding issues between the Government of Saskatchewan and CCRL respecting NewGrade, the Lieutenant Governor in Council may, by regulation, repeal all or any provision of this Act.*<sup>104</sup>

If the loan guarantees had hung the sword of Damocles above the government’s head, Bill 90 did the same for CCRL/FCL.

#### **4.3.10 The Protest Campaign Launched by FCL Against the Legislation**

FCL used the advance warning of impending legislation and the time bought for it by the opposition to prepare for a serious fight. Before the legislation had received first readings, full page ads attacking the government’s actions appeared in newspapers across the province. Bearing the banner headline “Your rights, your property, your business AT RISK” FCL said that the “threat of legislation to unilaterally

amend the upgrader agreement is a totalitarian act unworthy of a democratically elected government.”<sup>105</sup> The ad contained a mail-in coupon addressed to FCL President Leland asking people to sign their support for the statement “I strongly object to the Saskatchewan government’s use of legislation to unilaterally amend the agreements for the NewGrade heavy oil upgrader. I demand that the Saskatchewan government abandon this unfair and undemocratic course of action. Please forward my objection to the Government of Saskatchewan.”<sup>106</sup> Information packages were sent to every retail coop in Western Canada. Pamphlets, petitions and protest coupons were presented to shoppers. FCL approached its suppliers asking them to protest the government’s actions. FCL leaders worked tirelessly to obtain media coverage, and a speaking program was launched to present their case to organizations ranging from service clubs to Chambers of Commerce. Leaders of local coops, both elected and appointed, conducted parallel campaigns in their own communities and with their local media outlets.

Although FCL had launched an impressive organizational protest campaign, signs emerged early on that the FCL campaign was disappointing to the organization. The media began to report significant opposition from coop shoppers to the protest material being distributed in stores, something that was reflected in the correspondence to the Premier. Some of this opposition was coming from long-time, dedicated coop members and was emphatic. One example came from a member of the Battlefords coop, who told that organization’s board chair “I have been a co-op member since 1967 and have been an avid co-op supporter from birth. I strongly protest this propaganda being pushed in my Co-op. I am, as I said, a strong Co-op supporter. I am also a taxpayer of this province. I believe that Co-ops have no more right than anyone else, to bleed the taxpayers dry.”<sup>107</sup> In a statement that would be a cause for concern to any retailer, the writer added, “I recently went to the Territorial Place Mall to make a few purchases. I found Federated Co-op propoaganda at every cash register. I left without making my required purchases.”<sup>108</sup> A group of “concerned cooperators” quickly emerged to protest the stand being taken by their leaders. As petitions began to be presented in the Legislature by opposition members on behalf of FCL, the organization’s difficulties became more apparent. Three weeks into FCL’s campaign, a total of 6,590 names had been presented to the Legislature in protest of the government’s actions.<sup>109</sup> This compared unfavourably with the NDP’s own performance in signature-gathering only 5 years earlier, when it collected over 100,000 names protesting the proposed privatization of SaskEnergy in only two weeks,<sup>110</sup> even without the advantages possessed by the FCL and its member coops in terms of its presence in every community, those traffic through its stores, and the ability to use paid staff to collect signatures. In another implicit demonstration of disappointment, FCL CEO Leland did not, in fact, forward to the government the protest coupons addressed to him.

FCL's most compelling argument against the legislation was a principled argument in favour of the sanctity of contract. This argument convinced Liberal Leader Lynda Haverstock to oppose the legislation, regardless of the nature of the existing contractual arrangements. She argued that, "if we cannot afford the financial consequences of the current deal, we certainly cannot afford the potential consequences of this particular piece of legislation. Those consequences are the loss of this province's integrity, the loss of our capacity to attract new investment, and the loss of trust – further loss of trust in government, an institution which unfortunately suffers from a great deal of mistrust by too many in our society."<sup>111</sup> Better, she said, to suffer a financial loss than the moral one arising from a government breaking its word.

The government challenged this argument with the defence of necessity. The combination of an unconscionable contract combined with FCL's intransigence made extraordinary action acceptable. Further, the government suggested that the company had forced these terms on the previous administration under duress. It pointed to the recommendations made by officials against signing the agreement and the circumstances of the 1986 ultimatum from FCL. In speeches to coop members, FCL Board Secretary Empey had told the story of FCL's demand that the agreements be signed before the election, the government's delaying tactics, the FCL termination of talks, and the subsequent signing of the agreements.<sup>112</sup> It was a colourful story told to appreciative audiences. The story was intended to show how vigorously FCL management had defended its members' interests. In telling the story, however, Empey did not explain what the issues in dispute in 1986 were. While these issues were fairly technical questions of risk allocation in specific situations (none of which had any applicability to the project in the end), the governmental and media retelling of the story left the impression that the financial terms and conditions of the agreements had been extorted from a desperate Premier Devine in the midst of an election campaign. Although FCL could protest this impression, in the heat of the struggle it was too late. The moral authority of defending the sanctity of contract has been undermined – largely by FCL itself.

FCL's ability to defend the sanctity of its contracts had also been undermined by its handling of the disputed issues. The intrinsic potential for self-serving behavior in a situation containing an intrinsic conflict-of-interest was easy for people to grasp. While, as was argued in the last chapter, there is no evidence that CCRL management actually used their position with the intention of transferring economic benefits from NewGrade to CCRL, the intensity of their defence of any disputed decisions and their ongoing blockage of the contractual arbitration process made it easy for observers to conclude they had

been engaged in nefarious activity. On the eve of the tabling of Bill 90, FCL finally capitulated on this issue by having their legal counsel inform the government of their willingness to allow the arbitrations to proceed. The lawyer blandly suggested to CIC Minister Penner that his client had always been willing to have arbitration proceed.<sup>113</sup> This provoked the Minister to write to FCL President Leland reviewing in detail the history of FCL's refusals and saying, "I raise this history simply to explain my surprise at Mr. Dierker's statement that FCL 'has always [been] and continues' to be willing to allow the disputed issues to be arbitrated."<sup>114</sup> The Minister, somewhat sarcastically, said, "now that the issue has been clarified," the arbitration process could begin.<sup>115</sup> Thus, even in capitulating on this question, FCL reinforced the general impression that it had been up to no good.

FCL undermined its position in two other ways. One was the contradictory way it had been presenting its relationship with the upgrader project. It was both the operator and a 50% shareholder. For several years, it had tended to describe the upgrader as "the Co-op upgrader" and celebrate their ability to build and operate a facility of this size and importance. FCL had said for years that its contribution had been the refinery. This assertion of ownership, pride and contribution raised questions. If it was the "co-op upgrader" and a product of cooperative initiative, how was it possible that FCL had not invested any money and continued to refuse to do so? If it was a co-owner, how did this accord with its refusal to share in losses? If it had "put in" the refinery, how was it possible that the refinery was protected from every conceivable contingency? The normal expectations of partnership were in jarring contrast with the actual contractual provisions. In addition, FCL's defence of its operating record also contributed to the cognitive dissonance about its position. Pointing to its success in achieving full-capacity operations and the lack of requirement for any cash injections for the past two years, FCL insisted that "the outlook for the NewGrade heavy oil upgrader is much brighter than has been suggested by the Saskatchewan government."<sup>116</sup> This defence of its operational record invited the question of why, if the upgrader was doing well, FCL was so resistant to assuming any potential financial liability even with the incentive of eventual full ownership.

There was also the reality and perception of the different financial positions of the two partners. In 1983, when the upgrader was conceived, FCL was undergoing tough economic times while the Saskatchewan government was perceived as being prosperous. A decade later, their situations were reversed. FCL was annually reporting record earnings and dividends, while the Saskatchewan government was demonstrably in the midst of a fiscal crisis. Every time FCL or a member co-op protested that a change in the agreements would jeopardize the flow of dividends, it had the effect of

reminding people about the differential financial position of the two partners. The Saskatchewan government had been carrying the burden but was broke. FCL had been refusing to help, even though it had money.

FCL had been basing its strategy on the assumption that it could mobilize coop members to defend their local coops. For this to be successful, their members' primary allegiance would have had to be to their coop. For significant numbers of members, this did not happen. Years later, FCL President Leland said, "what I noticed out there was [that] a whole lot of members were more NDP than they were co-op."<sup>117</sup> Although he identified the issue of the primacy of divided loyalties, it is likely that he missed one aspect of the division. People's primary attachment was very likely not primarily to the NDP but to their status as citizens. Thus, for example, the government found allies amongst those usually critical of it such as the Saskatchewan Taxpayer's Federation.<sup>118</sup> The primacy of citizenship identification was expressed by a farmer from Carregana who wrote:

*I was raised on cooperative principles and for 25 years, I've driven out of my way to fill my tank at the Coop pumps. Not a single drop of fuel ever supplied to my farm has ever come anywhere but the Coop truck. Our groceries are purchased at the Coop, and so is a major portion of our building materials, hardware, cultivator shovels, tractor batteries and so on.*

*But of late, I am getting a rather bad feeling whenever I open my wallet at a coop. As everyone knows, these are rather hard times and just about everyone is feeling the "pinch" these days. ...so why should FCL be any different? Why is it that when Federated is being asked to renegotiate a deal that is obviously hurting Saskatchewan taxpayers, suddenly the well-paid top executives at FCL cry "foul" and claim a "grave threat to our democracy!"<sup>119</sup>*

The writer, who gave no hint or declaration of allegiance to the NDP, concluded it was time for "a dedicated effort to shop A.B.C. (Anywhere but Coop) for even just a week or two."<sup>120</sup>

While FCL was less than successful in winning the primary allegiance of co-op members in Saskatchewan, it had more luck in other provinces. An analysis of letters received by Premier Romanow that were written between the introduction of Bill 90 and the eventual negotiated settlement reveals three basic positions. One group of writers insisted that the status quo be maintained; another supported the government's efforts including the use of legislation, while the third supported the desire to restructure the upgrader's finances with a contribution from FCL but were hesitant about the use of

the legislative tool. In slightly over a month, the Saskatchewan premier received 208 letters on the issue, which is a significant volume of mail on any issue. This broke down as:

**Table 4.2**

**Categorization of letters regarding NewGrade received by Premier Romanow from the introduction of Bill 90 until the agreement on the Settlement Principles with FCL**

	Opposed to any change in Upgrader agreements	Wants negotiated changes, Opposed to legislation	Unconditional support for changes, including legislation
BC Public	5	0	1
BC Co-op Official	1	0	0
BC Supplier	2	1	0
BC Politician	1	0	1
AB Public	5	3	1
AB Co-op Official	5	0	0
AB Supplier	3	1	0
AB Politician	2	0	0
SK Public	12	11	12
SK Co-op Official	4	3	0
SK Supplier	2	1	0
SK Politician	0	2	0
MB Public	102	0	0
MB Co-op Official	3	0	0
MB Supplier	0	0	0
MB Politician	5	0	0

Other Public	0	0	0
*Other Co-op Official	3	0	0
*Other Supplier	14	2	0
Other Politician	0	0	0
Total SK	18 (38.3%)	17 (36.2%)	12 (25.5%)
Total non-SK	151 (93.8%)	7 (4.3%)	3 (1.9%)

\*Letters from “Other” were primarily from Ontario, with suppliers from Quebec, Iowa, and Kentucky as well.

Source: Tabulated from Premier’s Correspondence, Saskatchewan Archives Board, Roy Romanow Papers, Files 2802.05 and 2802.02 (vol. 1 to 3)

Coop members and officials from other provinces, particularly Manitoba, were far more likely to be supportive of FCL’s position and opposed to the Saskatchewan government’s policies than were people living in Saskatchewan. Co-operators from Manitoba, Alberta, and British Columbia did not have a great deal of concern about the province of Saskatchewan’s financial position. Conversely, the government of Saskatchewan did not trouble itself inordinately about the potential impact on voting intentions amongst citizens in other provinces nor was it particularly moved by the suggestion that Saskatchewan taxpayers should contribute to subsidizing dividends to co-operatives in other provinces. While NDP parties in the other provinces looked on nervously, Saskatchewan went about its business. Responses from the NDP in other provinces differed somewhat. In British Columbia, where the NDP was in government, the Premier told his Saskatchewan counterpart that “I trust the Government of Saskatchewan will continue to make every effort to balance fairly the interests of Saskatchewan taxpayers with the interests of co-op members across western Canada.”<sup>121</sup> From Manitoba, where the NDP was in opposition, Manitoba’s NDP agriculture critic told the Saskatchewan Premier that “Obviously we would want to ensure that the interests of Manitoba [co-op] members is being given fair consideration.”<sup>122</sup> From the NDP in that province, recognition of the need for balance with the interests of Saskatchewan taxpayers was absent. Letters to Premier Romanow from people living outside the

province tended to be far more vitriolic in tone than those from within. For example, an Alberta writer described the Saskatchewan government as “a pathetic lot of turds,”<sup>123</sup> while a Manitoba Liberal MP wrote that “the bill is a betrayal of trust. It breaks a legal contract. It tells all Canadians who have had or will have a contract with your Province that they could one day find themselves victim of such draconian measures such as the ones contained in Bill 90.”<sup>124</sup>

The reality was that these inter-provincial differences made the position of FCL leadership very difficult. While some Saskatchewan members were urging compromise and a negotiated settlement and most others would have accepted this, the member coops from outside Saskatchewan were steadfastly opposed to change from the status quo.<sup>125</sup> This intrinsic difficulty had been accentuated by FCL’s approach. FCL’s leadership had played to win. In so doing, it had portrayed any change from the status quo in cataclysmic terms by defining the issue in terms of “the future of CCRL” and “the future of retail Co-ops in western Canada.”<sup>126</sup> From the time that the government first requested a renegotiation of the NewGrade agreements, before any proposals had been presented, local coop leaders were being told that “the government is talking about taking away your refinery” and that “the bottom line is that the future of the refinery and its ability to generate savings for you the members is at stake.”<sup>127</sup> This absolutist positioning may have been useful for FCL’s leadership in mobilizing its membership, but it also had the effect of making any future compromise very difficult. When it crossed the Rubicon, FCL’s leadership burned the bridges behind itself.

#### **4.3.11 Negotiations and Other Initiatives After Introduction of Bill 90**

Following the introduction of Bill 90, there was one more effort to reach a negotiated settlement. In telephone discussions between the CIC Minister and the FCL President, FCL indicated its primary objection to the Estey report was the open-ended nature of potential liabilities arising from equal sharing of cash deficiencies.<sup>128</sup> The FCL Corporate Secretary told the media that “we can put up \$50 million,” but, when it came to the sharing of cash deficiencies, “we’re not prepared to put our name on the bottom line of something that we have no control over.”<sup>129</sup> The government moved to address this articulated concern and on June 3 sent CCRL/FCL a proposal that indicated a willingness “to negotiate an agreed upon ceiling provided that the parties would bear an equal responsibility until the ceiling is reached.”<sup>130</sup> The FCL President replied with a relatively conciliatory letter which began by saying, “We continue to support the conclusions and findings of Mr. Estey and we are committed to make a substantial contribution to help alleviate the potential call on the government” and concluded with a promise that FCL would provide a counter-offer within “the next day or two.”<sup>131</sup> This was received

with optimism by the government,<sup>132</sup> even in the face of a press release from FCL that described “the current Saskatchewan government proposal” as “totally unacceptable.”<sup>133</sup> On June 9, Leland told Minister Penner that FCL’s counterproposal would be delivered the following morning. “You can imagine my surprise when media reports on June 10 quoted you as saying that you were not sure whether or not you had received a proposal from the government,” the Minister wrote on June 11. “Contrary to your commitments, both written and over the telephone, I still have not received any substantive response to my proposal of June 3 or any counter-proposal from FCL.”<sup>134</sup>

Later in the day of June 11, FCL faxed the Minister a counter-proposal. This provided for the \$50 million asset purchase by CCRL but differed from the Estey recommendations by calling for CCRL to receive a 5% return from NewGrade on these assets in addition to the incremental operating costs. CCRL would provide NewGrade with a \$4-million-per-year, interest-free loan till 2001. The arbitration issues could go forward or be the basis for converting part of the annual loan to a grant. CCRL would have the option of purchasing Saskatchewan’s shares in NewGrade for \$1.00. The option would run until 2001, and CCRL would contribute (in the form of a loan to NewGrade) 50% of cash deficiencies only after the option had been recognized. In return, CCRL requested that the provincial government contribute \$1.25 million per month to the project until 2001, write off all investments to date in NewGrade, and advance the upgrader project a \$75 million interest-free loan that would be used to pay down guaranteed external debt. The offer was conditional upon both federal participation and membership approval.<sup>135</sup>

The CIC Minister telephoned the FCL President to request that negotiating meetings begin and was told that FCL officials would be unavailable for three weeks. The Minister responded by writing, “The province would like to negotiate a settlement of this matter if at all possible. We have repeatedly sought meetings with FCL to start negotiations. Each such request has been declined by FCL. Now you have suggested a meeting. When the government agreed, you opted for further delay. During the past few months, FCL has taken the position that the entire Co-op system is placed at risk by the government’s actions. I believe that these fears are greatly exaggerated. If the co-op network was indeed threatened in the manner that FCL has claimed, it is difficult to understand why you would allow weeks of delay before you are able to schedule a negotiating meeting.”<sup>136</sup>

In reality, the trial by combat had yet to run its course.

After the government defeated an opposition amendment that would have prevented the legislation from coming into effect for 9 months,<sup>137</sup> Bill 90 was passed on June 21.<sup>138</sup> The opposition had

insisted on recorded votes for the first and second readings, and, in Committee of the Whole, on both its proposed delaying amendment and on the Bill as a whole. However, the third reading vote was conducted by voice rather than by division.

#### **4.3.12: FCL Attacks – Gass, Threats and Legal Action**

Outside the Legislature, the political struggle between FCL and the government was just getting warmed up. The government had justified the launch of its efforts to renegotiate the NewGrade agreements on the basis of the findings of the Financial Management Review Commission released in 1992. The Chair of the Commission, Donald Gass, was a partner in the accounting firm Deloitte & Touche, which was FCL's external auditor. As a result, he found himself in the position, no doubt very awkward, of having his report being used to justify the government's efforts aimed at one of his firm's major clients.

FCL requested that he conduct another review of the NewGrade file, this time from the perspective of the impact on FCL rather than on the province.<sup>139</sup> From this perspective, Gass found that the restructuring proposed in the Estey report had "critical areas of concern" to the co-operative retailing system:

- The proposal is based on a \$150 million contribution by Canada which has not yet been agreed to. The financial forecasts would be much worse if the contribution is less than this amount.
- The proposal is requesting Federated to assume financial liabilities that are inconsistent with the original agreement.
- The proposal is asking Federated to assume responsibilities for additional liabilities that far outweigh the benefits of being able to acquire the Province's interests in NewGrade for \$1.00.
- The acquisition of the Province's interest in NewGrade for \$1.00 after all debt is repaid is questionable because the financial forecasts demonstrate the difficulties in generating sufficient funds.
- To limit your financial exposure and not risk the earnings generated from other areas of their operations, Federated would seriously have to look at the alternative of abandoning the refinery assets.<sup>140</sup>

While the opinion by Gass and Deloitte & Touche simply reflected the change in perspective arising from a change in client, it was cited as proof that “your own Don Gass... is recognizing that there are some inherent dangers with the approach that you’re taking, [and in] the demands that you are making on the Federated co-operatives, [with which]... he is not in agreement.”<sup>141</sup>

FCL also filed a Statement of Claim to challenge to Bill 90 on constitutional grounds. The Statement of Claim said that Bill 90 would “eliminate the corporate power of CCRL to control or direct the operation of its major asset, the refinery, and otherwise effectively strip CCRL of a corporate existence, save for name only.”<sup>142</sup> The government responded with a shrug, saying it had expected a legal challenge and was prepared for it.<sup>143</sup>

If obtaining the opinion from Gass had caused the government a moment of awkwardness and the launching of legal action caused indifference, in mid-July FCL parried with a thrust that caused the government considerable discomfort. Stating that it was responding to pressure from members in other provinces, FCL said that it was studying relocating its Saskatoon-based head office to another province.<sup>144</sup> Meetings were held with head-office employees to tell them to prepare for a move because of the government’s actions.<sup>145</sup> FCL issued a report suggesting that a move of the company’s head office would have a direct cost of \$30 million per year to Saskatoon as a result of \$18 million in salaries being paid to 405 employees; \$8 million in purchases from 60 local businesses; and other items including charitable donations by employees, RRSP purchases by employees, and employee visits to optometrists and dentists. The company then applied a multiplier to reach a front-page headline-worthy estimated impact of \$60 million per year.<sup>146</sup> The threatened move caused expressions of concern from Saskatoon’s business community, Saskatoon’s city council, the provincial Liberal leader, and members of the public.<sup>147</sup> In general, the reaction to the threatened head office move was to plead for reconciliation rather than the taking of a side in the dispute. The sentiment was perhaps most eloquently expressed by an FCL head office employee who lived in the Premier’s riding. After expressing personal concerns about the prospect of relocation, he observed, “the upgrader dispute has reached a point where irreparable damage may be caused in the province of Saskatchewan....Somehow, this upgrader dispute has been blown totally out of proportion. I hope that the fighting can end before both sides suffer irreparable damage...Positions on both sides seem to be hardening with each passing day. Surely there must be some other approach to resolving this issue other than the present one where we simply agree to disagree and all come out losers.” The writer concluded by saying “I feel very fortunate Roy that you are the MLA for our riding as I can communicate to someone I not only know but admire as well.”<sup>148</sup>

#### **4.3.13: Provincial Government's Attack on FCL within the Co-op Movement**

While FCL played out its multi-faceted campaign, the Saskatchewan government was not idle. Its strategy was based on attacking FCL's support at the level of individual retail co-operatives. After a request to speak to FCL's district meetings to explain the government's position was rebuffed,<sup>149</sup> Penner and CIC officials conducted meetings with local co-operative boards across Saskatchewan. When the Legislative session ended, the campaign of meeting with local co-op board members was expanded to Manitoba,<sup>150</sup> and CIC officials began working with the British Columbia government to organize a series of meetings in that province, beginning with co-operatives on Vancouver Island.<sup>151</sup> Meanwhile, a group of long-time co-operative members organized a "concerned committee" to challenge FCL leadership. Retired NDP MLAs played a major leadership role in this initiative.<sup>152</sup>

#### **4.3.14: Negotiations Resume and a Tentative Settlement**

Even at the most intense and bitter stages of the conflict, a line of communication was kept open between the government and FCL. In this, the close network of friendships and historical relationships between NDP and FCL officials played a role. While the official letters and position statements being exchanged by Penner and Leland were being composed with an eye to immediate media release and public positioning, quiet back channel communication was kept alive by Empey and CIC special advisor David Dombowski. In mid-August, these two emissaries agreed that there was a window open for a settlement before there was an irrevocable escalation in the form of either an actual FCL head-office move or a proclamation of Bill 90. Each side had given the other some good blows and was armed with a powerful weapon, but each one could only be used once, and doing so would cause considerable self-damage. With that, Leland and Romanow were brought together for secret face-to-face meetings at the Sheraton Cavalier hotel. The meetings lasted three days and were sometimes conducted one-on-one and sometimes with a small number of advisors present.<sup>153</sup> The key to movement was a matter of trust. A side-table group was charged with the task of establishing a transparent process for the pricing of NewGrade's sale of upgraded crude to CCRL. At 1:00 am on August 19, this group reached an agreement on a formula based on the use of an Alberta mixed blend intermediate crude as a benchmark. An hour later, Romanow and Leland reached an agreement to settle the dispute.<sup>154</sup> The essentials of the new agreement, compared with key previous proposals, are as follows:

**Table 4.3**

**Summary of Proposals for Restructuring of NewGrade**

	FCL April 9 <sup>155</sup>	Estey Commission <sup>156</sup>	Sask June 3 <sup>157</sup>	August 20 Settlement <sup>158</sup>
New capital injection Canada	\$125 or \$150 million	\$150 million	“Satisfactory” contribution	“At Least” \$100 million
New capital injection Saskatchewan	\$25 million grant plus \$15 million annually till guaranteed debt repaid	\$25 million grant In 1993, \$30 million loan @8% (spread over 1994-96), Ongoing matching subordination of operating fee (\$2.5 Million/year) as 8% loan	\$25 million grant in 1993, \$30 million loan @ 8% (spread over 1994-96), ongoing matching of subordination of operating fee (2.5 million /year) as 8% loan.	\$75 million Of which \$50 million was “equity” in 1994 and \$25 million a “grant spread over 1994-96.”
New capital injection FCL	\$50 million asset purchase	\$50 million asset purchase In 1993, \$30 million loan @ 8% (spread over 1994-96), ongoing subordination of operating fee	\$50 million asset purchase in 1993, \$30 million loan @ 8% (spread over 1994-96), ongoing subordination of operating fee (\$2.5 million/year) as 8% loan	\$75 million Of which \$50 million in the form of an asset purchase in 1993, Plus a \$5 million grant in 1994 & \$20 million in non-interest bearing loans spread over 1995-96.

		(\$2.5 million/year) as 8% loan		
Handling of future cash Shortfalls		Split between Sask and FCL	Split between Sask and FCL with unspecified cap on FCL share	Split up to \$8 million annually with FCL total capped at \$40 million
Handling of existing subordinated operating fee and Sask matching contribution	Both write off existing \$4.7 million + interest	Repayable with 8% interest	Repayable with 8% interest	Both FCL and Sask to write off \$4.7 million + interest
Treatment of past Sask cash investment	Write off \$154 million capital + interest, \$76 million operating advances to be repaid	Write off \$154 million capital + interest, \$76 million operating advances repayable with 8% interest	Write off \$154 million capital + interest (\$248 million total), \$76 million operating advances repayable with 8% interest	Write of entire existing \$234 million Sask investment + accrued interest
Outstanding issues and Arbitration	Withdraw issues from arbitration	3 Choices: roll into settlement, negotiate or arbitrate	Proceed to arbitration	Abandon past issues: go forward and arbitration process + pricing mechanism
Future ownership of Upgrader	Sask to sell shares to FCL for	When guaranteed debt paid, FCL to	When guaranteed debt paid, sell to FCL for \$1.00 plus royalty	50/50 ownership to continue

	\$1.00 when guaranteed debt drops to \$75 million	have purchase option for “nominal amount,” provision for “windfall profit”	mechanism in event of windfall profit	
Use of new Money	Retirement of guaranteed debt	\$50 million of new money be in fund to meet shortfalls – rest for debt repayment	Retirement of guaranteed debt	Retirement of guaranteed debt

The new agreement was based on the foundations established by the recommendations of the Estey Report. There were relatively minor changes in the amount and structure of the front-end capital injections designed to pay down the guaranteed debt. There were three significant changes from Estey: First, the final settlement was even more forward orientated than the Estey recommendations. Any claim on money invested in the past was renounced. This impacted Saskatchewan more than CCRL/FCL, although the latter wrote off the accumulated subordinated portion of its management fee. If there was to be any recovery of past investment, it would come from an equal sharing of the positive cash flow from the upgrader rather than from a claim on past investment. In addition, potential adjustments arising from past quarrels were dismissed in favour of a transparent pricing mechanism and a functioning arbitration protocol for the future. Second, while CCRL/FCL accepted responsibility for potential future cash deficiencies, its liabilities were limited both annually and in aggregate. Potential losses from the upgrader were quantified and capped at a level that did not threaten the viability of CCRL or FCL. Finally, the relationship was maintained into the future. Estey had recommended that the province give CCRL/FCL its ownership interest for \$1.00 when the guaranteed debt was repaid and Saskatchewan had agreed to this proposal. It speaks to the perception of the future prospects of NewGrade that the province was unsuccessful in selling its 50% ownership share for \$1.00.

#### 4.3.15: Securing Federal Support and Ending the Fight

The agreement between Saskatchewan and FCL was contingent upon federal participation. There was real cause for concern that the extended quarrel had damaged the two owners' chances of obtaining a cash injection from the federal government. As was noted earlier, when the Estey Report was released, the federal Energy and Mines Minister, Bill McKnight, had responded more favourably than federal government officialdom. Throughout the spring, McKnight and Penner had remained in contact.<sup>159</sup> The province was confident that McKnight understood the need for a reduction in the project's debt and would be able to deliver assistance once it had secured a commitment from FCL generally in accordance with the Estey Report recommendations. The federal Minister even expressed public support for Saskatchewan's introduction of legislation,<sup>160</sup> and a federal contribution was built into that government's financial plan.<sup>161</sup> However, the extended quarrel between Saskatchewan and FCL caused the restructuring of NewGrade to become a potential victim of the death agonies of the Mulroney Conservative administration. In the leadership race to succeed Mulroney as Conservative leader, McKnight was a supporter of Jean Charest. When the race was won by Kim Campbell, McKnight demonstrated a desire to leave politics by suggesting her selection by the Conservative Party as analogous to the mass suicide of cult members in Guyana who died drinking poisoned Kool-Aid.<sup>162</sup> He did not seek re-election and was not included in the new federal cabinet that was sworn in on June 24, 1993. Saskatchewan and FCL had lost a strong supporter of federal support for the financial restructuring.<sup>163</sup> After the agreement between Saskatchewan and FCL was reached, the federal government was again approached. Without McKnight as Minister, the response from the federal Department of Energy and Mines was unenthusiastic. A spokesperson said a request for assistance "begs a question, what would the federal government get for a contribution?"<sup>164</sup> Federal officials began questioning the nature of the restructuring, including the fact that FCL's \$50 million up-front contribution was in the form of an asset purchase. A provincial official responded by asking, "If they're turning around and saying we don't like asset purchases, why didn't they tell us four months ago?"<sup>165</sup> Members of the Retail, Wholesale and Department Store Union began lobbying the federal government's new Cabinet representative to block funding for NewGrade unless FCL reversed a decision to consolidate its warehouse operations.<sup>166</sup> After a meeting with the new federal Minister, representatives from Saskatchewan and FCL were told that the issue would have to wait until after the impending election.<sup>167</sup> There was a very real danger that the length of the negotiations between Saskatchewan and FCL had cost them a window of opportunity to receive federal assistance.

The NewGrade file appeared to be part of the new federal Minister's priority list, since Anne McClellan met with Penner, Leland, and Empey relatively quickly on January 13, 1994. Following the meeting, she told reporters "Mr. Penner and his colleagues made it very plain to me that financial restructuring is urgently required and I understand that urgency. I will act on that urgency and I will be meeting with Mr. Martin at the earliest possible date."<sup>168</sup> Negotiations continued through the spring in a non-confrontational manner,<sup>169</sup> even as Prime Minister Chrétien questioned the cost of protecting upgrader jobs during a visit to Regina.<sup>170</sup> Ottawa had discovered an answer to the "what's in it for us?" question. In exchange for a cash injection, it wanted to be free and clear from NewGrade.<sup>171</sup> The lenders holding the guaranteed debt were not willing to surrender the security of the federal loan guarantees, so the Saskatchewan government agreed to indemnify its federal counterpart for any expenses associated with a call on the remaining loan guarantees in exchange for a federal cash injection of \$125 million.<sup>172</sup> With that, the substance of the NewGrade restructuring was finished. A Memorandum of Understanding was signed on June 15, 1994, and, after uncontroversial implementation negotiations, the agreements were legally closed on October 21, 1994.<sup>173</sup> Section 17(2) of *The NewGrade Energy Protection Act* was proclaimed so that the rest of the bill could be rescinded by order-in-council in accordance with the terms of this provision.<sup>174</sup>

The last remaining business was the legislative repeal of *The NewGrade Energy Inc. Protection Act*. While the legislation had been legally repealed without being proclaimed in October of 1994, FCL also insisted upon the symbolism of legislative repeal, and "as a show of goodwill, the province agreed to the inclusion of a penalty clause in the final agreement that bound the province to pay a \$25 million penalty to Federated Co-operatives if legislation was not passed before July 1995, formally repealing Bill 90."<sup>175</sup> Once trust had been destroyed, rebuilding it was a slow and painstaking process. In any event, Bill 8, An Act to Repeal The NewGrade Energy Inc. Protection Act, was introduced on February 13, 1995,<sup>176</sup> and passed on March 29 without recorded division at any stage of the legislative process.<sup>177</sup> With that quiet end, the financial restructuring of the NewGrade upgrader project was completed.

#### **4.4 Renegotiating The Bi-Provincial Upgrader**

In contrast to NewGrade, Saskatchewan did not drive the process of renegotiation of the Bi-Provincial upgrader agreements. Instead, it responded to decisions and actions of its partners in order to improve the province's position.

#### **4.4.1: Setting the Stage for Restructuring Bi-Provincial**

Two developments set the stage for the restructuring of the ownership of the Bi-Provincial Upgrader. The first was the change in governments in Alberta and in Ottawa. A month after the beginning of operations at the upgrader, Ralph Klein was sworn in as Premier of Alberta. Not quite 11 months later, Jean Chrétien became Prime Minister of Canada. Amongst the governmental partners, there was no longer a single administration that had a political stake in defending the initial arrangements surrounding the upgrader. While Klein belonged to the same party as his predecessor and had served in the Getty cabinet, his election as leader was widely seen as both a break from and repudiation of the Getty record.<sup>178</sup> In the case of Chrétien, while the original upgrader proposal had been signed during his term as Energy Minister, the actual final agreement and construction had occurred during the Mulroney term in office. At this point, all three governmental partners were free, politically, to effectively disown the upgrader and blame any resulting financial losses on the decision to get in rather than on their decision to get out. The longer the governments waited to act, the more any problems at the upgrader would be seen as their own, as would any changes negotiated during their term.

The second development was the assertion of more direct control of Husky by Li Ka-Shing. Even after he assumed full control, the management team installed by Nova remained in place. Disappointing performance by the corporation in general and ongoing losses at the upgrader caused this passive approach to change. In July 1993, Price was replaced as president by John Lau, a long-term associate of Li with a reputation as a fixer, who had restored profitability to another Li acquisition, Green Island Cement.<sup>179</sup> Lau was joined in the head office by another Li associate from Hong Kong, P.C. Koh, as Vice President of Strategic Planning. In the spring of 1994, the General Manager of the Upgrader was replaced.

#### **4.4.2: Bi-Provincial Exhausts its Cash**

The process leading to the financial and ownership restructuring of Bi-Provincial began with meetings of the joint-venture board on December 21, 1993; January 25, 1994; and February 22, 1994. As the Board members reviewed the project's 1994 operating budget, it was determined that the upgrader would be expected to suffer cash flow deficiencies averaging \$3 million per month throughout the year. The additional \$30 million in funding provided by Husky, Canada, and Alberta was projected to be exhausted sometime in May or June.<sup>180</sup> Husky, as operator, noted that the project agreement precluded

the upgrader from borrowing money or making expending funds that were not authorized. As a result, “the Operator will therefore not be in a position to enter into further commitments in respect to the Project’s operation by or prior to Mid-April, 1994.”<sup>181</sup>

Husky then launched two related actions. After installing a new management team at the upgrader itself, Husky indicated that it was “actively considering the implementation of significant streamlining operations.”<sup>182</sup> Plans were developed both to remove identified production bottlenecks in the upgrader’s hydrocracking units and sulphur plant during the plant’s annual scheduled maintenance and to reduce staffing levels to those originally envisioned. A delegation of senior Husky managers, representatives of Hutchison Whampoa, accompanied by former federal Energy Minister Marc Lalonde in his capacity as a lawyer for Husky visited Regina, Edmonton, and Ottawa to brief its partners on plans to reduce the operating costs for the upgrader. It began implementing the plan with layoffs of 12 company staff and elimination of another 96 people working for contractors.<sup>183</sup> Saskatchewan’s Penner told the media, “if this is what it takes to put it on a positive cash flow, then we support it.” He suggested that Saskatchewan might consider participating in future cash-flow deficiency payments “if it can be demonstrated that this is a short-term phenomenon.”<sup>184</sup>

This was followed by the presentation of a clear choice to all three governmental partners. The governments were told, “Husky believes that it is not in the interests of any of the Joint Venturers to mothball the Project.”<sup>185</sup> Husky estimated that the immediate costs of mothballing the plant would be approximately \$34 million, with \$10 million per year in maintenance costs. Start-up after an extended shutdown would cost between \$110 million and \$150 million, depending on the length of the shutdown.<sup>186</sup> Husky suggested that total outside-the-fence revenues for the three governments from the upgrader’s operation was in the range of \$60 million per year, which would be lost in the event of a shutdown. It added that “some ‘outside the fence’ benefits accrue to Husky from the BPU. However, in the present climate, the value of these is significantly reduced by Husky’s share of the projected shortfalls of the BPU. As a result, ‘outside the fence’ benefits to Husky are not alone sufficient justification for Husky to continue funding shortfalls above its proportionate share.”<sup>187</sup>

Husky stated that its preferred mode of operation going forward was a continuation of the partnership and that it was willing to fund its pro-rata share of any ongoing shortfalls. However, this commitment was conditional and could be applied “only if all the other Joint Venturers are prepared to continue making their proportionate contributions.”<sup>188</sup> Saskatchewan’s refusal to participate in the earlier cash calls had violated Li Ka-Sheng’s sense of appropriate behavior amongst partners. Husky also

proposed an alternative. “If any Joint Venturer is not prepared to so commit, Husky is prepared to explore the possibility that it would accept sole responsibility for future funding of the BPU on terms and conditions commensurate with the substantially higher risk to Husky attached to any further Husky contributions.”<sup>189</sup> Having demonstrated its commitment, Husky was putting the onus on the governments to either agree to commit to the long-term as partners or to leave. Husky said “to allow this [governmental decisions] time to be completed,” it would fund operating shortfalls for three to four months. If the partnership continued, each partner would pay according to its ownership share.<sup>190</sup> Failure of governments to choose either option, said Husky, would result in the plant being mothballed.<sup>191</sup>

In the Lloydminster area, the priority was for ongoing operations. The President of the local Chamber of Commerce told Premier Romanow that they needed “some positive long term solution” and noted that “in many ways, the Bi-Provincial Upgrader is a victim of its own success. It is our understanding that one of the contributing factors to the current financial difficulties is the narrowing of the price differential between heavy crude oil and light crude oil which resulted from the increased demand for heavy crude oil when the Upgrader came on stream. This has also resulted in increased drilling activities in the region which, if continued, should help to rectify this problem.”<sup>192</sup> The city’s mayor said, “We realize the taxpayer can’t continue to fund an on-going liability. We do, however, want to see the Upgrader continue to operate.”<sup>193</sup> The community’s economic development officer drew attention to members of the Saskatchewan government questioning the “reason for having an upgrader” and urged the Premier to take a long-term view.<sup>194</sup>

#### **4.4.3: Saskatchewan and Husky Buy; Alberta and Canada Sell**

The three governments differed in their position on funding shortfalls. After the cautious, conditional support expressed from Saskatchewan, it was Canada’s turn to refuse to participate in funding shortfalls. “We have carried more than our share of costs in ensuring the ongoing viability of the project,” said the federal Natural Resources Minister.<sup>195</sup> Alberta opted for the exit alternative, with Premier Ralph Klein telling the media that “we won’t spend another cent. We would like to get out of it.” He described the project as a bad investment that should not have occurred, saying “I guess the one saving grace is that we were probably all stupid together.”<sup>196</sup> Saskatchewan Finance Minister Janice MacKinnon was more explicit, saying, “The last (two) times we said ‘no more money,’ essentially it was just a call from the operator saying ‘we need more cash.’ It was sort of like a phone call from your kid from camp saying ‘I need more money.’ This time it’s different...What we’re looking at is some sort of

long-term solution – same as the other upgrader.”<sup>197</sup> However, along with its partners, Saskatchewan remained silent on the question of whether it was prepared to change its past practice of refusing to contribute its pro-rata share.

At a meeting in Calgary, Husky presented its governmental partners with a buy-out offer at a price amounting to approximately 7.5 cents for every dollar that had been invested in the upgrader by governments.<sup>198</sup> Saskatchewan believed that the price had been separately negotiated between the corporation and Alberta on the assumption that Saskatchewan’s past record and Ottawa’s stated unwillingness to contribute further would cause the other two governments to agree.<sup>199</sup> Whether or not Saskatchewan’s analysis was correct, Alberta and Canada immediately agreed to accept Husky’s offer. Saskatchewan surprised its partners who had, apparently, not been paying attention to the ministerial ruminations in the Regina media. “CIC took the position that, at the prices being discussed, it would be interested in buying rather than selling.”<sup>200</sup> Further, the project agreements gave each partner the right of first refusal on any sale.<sup>201</sup> Not only could Saskatchewan want to buy, it could insist upon buying shares at the same price Husky was paying.

Saskatchewan’s position caused a great deal of consternation amongst the other partners. From Husky’s perspective, it was not adverse to partners who were willing to assist with covering losses. However, since the election of the Romanow government, Saskatchewan had been a recalcitrant and uncooperative partner, the only government unwilling to pay “its share” of the second capital cost overrun and additional operating losses. This raised the question of whether the province would be a good partner in the future. An emissary from Li was dispatched to Regina to evaluate the province’s trustworthiness as an ongoing partner. CIC President Ching explained that Saskatchewan believed in the viability of the upgrader after the exit of Canada and Alberta. Ching invited the emissary to talk to officials at Cargill and Millar Western to get references as to how the province normally behaved in joint-venture partnerships. A few days later, Husky indicated that its concerns about the reliability of Saskatchewan as an ongoing partner were resolved.<sup>202</sup>

From the perspective of Canada and Alberta, the political ability to absorb the economic losses crystallized by selling was premised on governmental unity. In Premier Klein’s formulation, “we [i.e. previous administrations] were all stupid together” in investing, then “we” [i.e. current administrations] would be smart together in divesting and ending any further payments. If Saskatchewan stayed in and increased its share, this simple and compelling political logic disappeared. Despite the consternation of the other governments, the contractual provisions of the partnership agreement meant that a

determined Saskatchewan could impose its will. If Alberta and Canada were to be allowed to leave, Saskatchewan had to be allowed to stay at an expanded ownership level.

The agreement reached was that Canada and Alberta would sell their interests for \$41.96 million and \$32.02 million respectively. This amounted to \$1.325 million per ownership share. Both Saskatchewan and Husky purchased the additional equity required to reach 50/50 ownership. This meant Saskatchewan purchased 32.5 percentage shares for a price of \$43.063 million and Husky purchased 23.333 percentage shares for a price of \$30.917 million.<sup>203</sup> Under a strict reading of the provisions regarding the “right of first refusal” provisions, Saskatchewan and Husky would have purchased equal amounts of stock, leaving Husky with a higher ownership share. However, the two remaining partners opted for equality in the longer-term outcome rather than equal treatment at the moment. One result of that was that each of the remaining partners had paid different amounts for their 50% ownership share. Husky paid a total of \$508,597,000 for its half interest, while Saskatchewan paid \$304,163,000 for an equivalent share. As another indication of Husky’s willingness to accommodate to a new, equal partnership, the preferential treatment the company had been accorded for the distribution of earnings (until rate of return targets had been met) was abandoned in favour of treating each shareholder equally.<sup>204</sup>

Husky’s residual concerns about Saskatchewan’s willingness to be a cooperative partner were resolved with an agreement to share cash deficiencies equally and with a confirmation of Husky’s operational role under the supervision of a board composed of representatives of both shareholders.<sup>205</sup> Husky continued to fund shortfalls until the final closing of the agreement, at which time Saskatchewan reimbursed it for its 50% share.<sup>206</sup> The concerns of Alberta and Canada about potentially appearing to have been taken advantage of by Saskatchewan were addressed with a provision that, if Saskatchewan sold its increased share for a gain within two years, the gain would revert to the original owners,<sup>207</sup> and with an “upside interest” provision wherein Alberta and Saskatchewan would receive an ongoing small share of positive cash flow from the upgrader.<sup>208</sup> The first provision was designed to prevent Saskatchewan from quickly flipping its shares to Husky for a higher price, with a resulting political embarrassment to Canada and Alberta. The second was largely a cosmetic provision designed to alleviate potential criticism of the decision to exit the project at a loss. For example, CIC calculated that with a \$6.00 per barrel differential, the upgrader would generate \$15,700,000 in positive cash flow with no payout on the upside interest. At a \$7.00 per barrel differential, the upgrader was projected to generate positive cash flow of \$36,300,000, with Alberta and Canada sharing \$711,960 in the form of

the upside interest payment.<sup>209</sup> Further, the upside interest payment did not apply to the revenue streams for the upgrader from the sale of re-cycled diluent and by-products such as coke and sulphur.<sup>210</sup> The equal allocation of feedstock from Alberta and Saskatchewan remained in place.

The Saskatchewan decision to buy was based on the belief that, once the start-up problems were resolved and Husky fully implemented the new, leaner operational plan, the upgrader would stop consuming cash. The government also argued that “according to the projections signed by the representatives of all 4 partners, the BPU is expected to generate positive cash flow over the next twenty-five years. However, this cash flow is not projected to be enough to repay the \$1.720 billion invested in it. All partners would lose money. However, with the lowering of the capital structure in the project to \$812.76 million (as a result of the losses being absorbed by Alberta and Canada), the two remaining partners can earn a modest profit over the life of the project. Any increases in the price differentials will improve the project’s economics.”<sup>211</sup> This explanation was expressed by a CIC official to the media as a situation in which “someone had to eat crow and Alberta and Canada volunteered.”<sup>212</sup>

There was another compelling reason for Saskatchewan to refuse to join Alberta and Canada in selling. While selling would have ended any demands for cash to meet project shortfalls and provided the province with \$23.2 million in cash for its ownership share, it would also have meant an immediate write-down on the province’s equity investment. Up to that time, write-downs had been occurring in accordance with the province’s ownership share of total operating losses (including depreciation). Projections for continued write-downs on this basis had been built into the province’s financial plan. However, selling would require an immediate write-off of the entire remaining book value of the investment (minus sales receipts). Sale of Saskatchewan’s share in Bi-Provincial in 1994 on the same terms as Alberta’ and Canada’s would have meant a \$150 million increase in the province’s deficit,<sup>213</sup> with the resulting need for expenditure cuts or revenue increases on this scale in order to meet the deficit target it had committed to achieve. The bond rating agencies said they were indifferent to the debate about whether the upgrader was a good project or not. What concerned them, said a representative of the Canadian Bond Rating Service, was how the government’s action fit into the province’s overall picture, explaining that “our philosophy is that at the end of the day, can you make your payments, so it really doesn’t matter whether you feel it was a brilliant idea or a stupid idea.”<sup>214</sup> As a result of selling, Canada took a write-off of \$516 million and Alberta one of \$392 million.<sup>215</sup> The reality was that Alberta and Canada could walk away from their investment in the upgrader. Saskatchewan lacked the financial flexibility to do this, even had it wanted to.

#### 4.4.4: The Politics of Buying and Selling

Following the announcement of Alberta and Canada's sale of their interests to Saskatchewan and Husky, the three governments engaged in a public political debate over who had made the right decision. Saskatchewan's unexpected position had destroyed the basis of Premier's Klein's "We were all stupid together [and now we are all being smart together]" communications plan and crystallized the issue into the wisdom of holding or folding. Husky stood silent while this debate raged. Ironically, had Saskatchewan followed the lead of the other two governments, it is likely that the company would have been the object of considerable attack, since "Husky Oil would have been the sole beneficiary of a huge giveaway. It would have received an upgrader that cost over \$1.6 billion to build for a total price of \$575 million (\$478 million in original investment plus \$97 million to buy out taxpayer's interests.)"<sup>216</sup> With Saskatchewan increasing its stake, the public debate and controversy ignored the potential "corporate giveaway" angle in favour of debating which government had been "stupid separately." Saskatchewan stressed the ability to recover its total investment, given the low purchase price of its new shares, while Alberta and Canada focussed on their escape from any further cash deficiency payments. Saskatchewan became the defender of the future of upgrading heavy oil, while Alberta and Canada dismissed the idea as a costly mistake made by their predecessors.<sup>217</sup> The debate featured comments such a federal official saying, "They were bad business decisions made by the previous government. They were losing money...It does not make sense to be funding these ongoing losses. Saskatchewan has an NDP government. They've got a different philosophical approach on these things, I guess."<sup>218</sup> Alberta attempted to moderate the right-or-wrong parameters of the debate by pointing to the upgrader's physical location in Saskatchewan as a significant difference in circumstance between the neighbouring governments.<sup>219</sup>

Saskatchewan's action was very controversial. Even within government an (unnamed) senior official questioned the wisdom of CIC's actions on behalf of the province, telling a reporter "this is the first thing I can think of that's inconsistent with what we have done in the past few years."<sup>220</sup> One long-time NDP supporter told Premier Romanow that the politics of the move were bad. "Congratulations! Your government has just 'bought into' one of Grant Devine's biggest follies (and that of Brian Mulroney and Donald Mazankowski too). The Lloydminster upgrader has now become your problem. This will be particularly true if history repeats itself and further bailouts are required."<sup>221</sup> The Conservative legislative opposition supported the decision to remain involved, citing the royalty, tax, and employment impact of a possible closure.<sup>222</sup> In the end, one of the most effective arguments the Saskatchewan

government offered was, literally and metaphorically, the company it was keeping. In arguing that the upgrader was viable in the long term, Ching told a newspaper columnist, “Klein and Chrétien may argue [that] it’s best to get out. But Li Ka-Shing is staying in.” The columnist conceded that “it’s enough to make you curious.”<sup>223</sup>In discussions and in public meetings, Romanow congealed Saskatchewan’s rationale to “Li do, we do.”<sup>224</sup>

#### **4.4.5: The Restructuring is Concluded**

Other than adjusting the board to accommodate the new reality of two owners rather than four and the management changes already implemented by Husky as operator, there were not significant governance or management changes as a result of the revision of the ownership structure. With the closing of the ownership change on February 7, 1995, the restructuring of the Bi-Provincial Upgrader was complete.

### **4.5 Comparison of the renegotiating processes**

The two common elements facing both upgrader projects that pushed the new Saskatchewan government towards seeking a change in the relationship were the inter-related imperatives of the province’s fiscal condition and low oil prices. The Romanow administration was forced to make many controversial and unpleasant decisions in order to meet the financial targets required by capital markets as a condition of continued solvency. Many of these decisions ran counter to the natural inclinations of the government members and directly inflicted pain on core members of the government’s political constituency. By necessity, the administration had to meet its financial targets. The real and potential losses, write-downs, and contingent liabilities threatened the very hard-won progress that had been made. Members of the government were in no mood to allow this to happen. There was a gritty determination bred from necessity that drove the government’s actions. At the same time, the government did not want to surrender the public policy gains that had been achieved by the upgraders. For the province to move forward, they had to survive and keep operating. Saskatchewan was willing to invest more to save the upgraders but only if overall risk was lowered and exposure quantified and regularized into predictable boundaries. With respect to oil prices, both upgraders had been conceived in times of sufficiency, built in times of dearth, and operated in times of desperation. The reality was that the Saskatchewan government and Husky had both bet that oil prices would recover during the

design and construction period. CCRL/FCL had the same assessment of the odds and found a way to play with other people's money. If the lean years in the oil industry, which started late in 1985, had been of biblical length, the pressure to renegotiate the agreements would have been much less. If markets and prices had recovered in seven years, NewGrade would have generated positive cash flow around the time of the change in administration, and Bi-Provincial would have achieved this upon start-up, operational issues notwithstanding. There would be, however, another seven lean years following the first. For both the Saskatchewan government and its partners, no end was in sight.

While the similarities between the two projects and in the contextual situation led the new Romanow government to renegotiate the two upgrader agreements, the differences created unique dynamics. When the Romanow administration was sworn in on November 1, 1991, few would have predicted a warm and harmonious relationship with Li Ka-Sheng and a nasty, bitter fight with its friends in the co-op movement.

The difference in dynamics was not the result of differences in the operational performance of the upgraders. When the Romanow administration was sworn in, NewGrade was completed, up-and-running, and had just been successfully in resolving its start-up difficulties. Bi-Provincial was near the end of the construction phase. After a start-up period during which operating problems occurred and were resolved, full production with an operating cost structure in line with the original business plan projections was achieved in roughly the same length of time it had taken CCRL to do the same at NewGrade. By the time both upgraders had reached the point of full production, both had cost more than originally anticipated. In this regard, NewGrade's performance was better than that of Bi-Provincial. The Regina upgrader was, effectively, about 10% over-budget while Bi-Provincial had cost its owners about 30% more than originally planned to reach this state. Once the start-up problems were resolved, the operators of both upgraders processed crude at a cost conforming to the original business plan projections and with the annual operating budgets set by the upgraders' Boards with the concurrence of the government-appointed members. In summary, the actual operating records of both CCRL and Husky were generally equivalent, with CCRL getting the decision because of the significant difference in the ability to deliver a fully-functional upgrader closer to the budgeted price. The different trajectories clearly did not stem from the operating record of the government's private sector partners.

#### 4.5.1 The Question of Trust

As was outlined in the first chapter of this study, trust between partners is an essential element in a functioning partnership. When the Romanow administration was sworn into office, the relationship between trust and mistrust were complex.

Trust in CCRL/FCL by the provincial government was divided. At the administrative level officials who had day-to-day responsibility for the upgrader, the trust relationship was very strained. At the governance level, there was a network of personal relationships between the NDP elected officials and the new government's key senior staff. While in opposition, FCL had kept the NDP informed of its perspective on the upgrader, and the NDP had both publicly supported the project and carefully exempted it from its overall critique of the Devine administration's economic development policies. This relationship very quickly unravelled. The new administration was immediately presented with the opinions of the staff and board members it inherited which outlined, in detail, the perceived perfidy of CCRL/FCL. The aggressive and intransigent response by FCL to concerns about the relationship being raised caused the policy-making level of government to very quickly accept the opinions of the legacy staff. From CCRL/FCL's point of view, they had operated the upgrader efficiently and honestly from the beginning, while being forced to continually fend off government efforts to renege on the spirit and intent of the negotiated agreements. When their friends in the new administration continued and then intensified these efforts, the emotional response by FCL was a sense of betrayal and an attrition of sinister motive and intent. From that point on, the struggle took on that special intensity that comes only in quarrels between siblings.

In the case of Bi-Provincial, the trust relationships were the opposite. At the level of the day-to-day officials, government relations with Husky were professional and harmonious. The corporation, for example, gave the government advance notice of business decisions that might have had an impact upon government. The governance process of the upgrader during construction had been non-controversial. At the level of the elected and policy-making elected officials, members of the new administration were more skeptical of Husky. This was not hostility. Bi-Provincial and Husky had been spared the more vigorous opposition attacks on business arrangements entered into by the Devine government, but the Saskatchewan New Democratic Party members had some residual suspicions about a large, foreign-owned oil company.

The different physical and operational design of the two upgraders also affected trust relationships. The Bi-Provincial project was relatively simple to monitor and account for. Expenditures were either inside-the-fence, or they were not. The price of feedstock purchased from Husky was based on observable market-set prices and sales of synthetic crude were to third parties. NewGrade was different. Since the synergistic benefits came from integration with the refinery, accounting and allocation decisions could be very complicated. The formula for pricing the sale of synthetic crude to CCRL was complicated and opaque. As was stressed by the government nominees to the NewGrade board and confirmed by Estey, CCRL management was on a daily basis in an intrinsic conflict-of-interest situation. This was inherently built into the project. Differences of opinion inevitably arose on some issues. Given the number of potential issues and their complexity, the noteworthy fact is actually how few of these differences there actually were, which suggests that CCRL management was genuinely endeavouring to fulfil its conflicting obligations to the refinery and upgrader in a fair and honest way. It thus interpreted questioning and debate as criticism and attack. By responding aggressively, they appeared to confirm the suspicions of first the government-nominated board members, then government officials, followed by elected Cabinet ministers; and ultimately a substantive element of public opinion. A self-reinforcing cycle of suspicion and recrimination was set in motion, the dynamic of which was ultimately broken with the agreement on a transparent pricing formula. In practice, the new formula did not have the effect of changing prices in any measurable way. It did, however, lower suspicion and distrust. The intrinsic conflict-of-interest situation at NewGrade also caused Saskatchewan to create a much higher level of monitoring capacity from the beginning. Government-nominated NewGrade Board members were technical experts in refining, while those at Bi-Provincial were not. At NewGrade, the government had full-time staff monitors scrutinizing every expense and operational decision made by CCRL management, while at Bi-Provincial this did not occur. As a result, CCRL/FCL management accurately felt that their decisions, made in good faith, were constantly being second-guessed, and they responded in a way that further undermined trust. It would be interesting to have seen what the effects this monitoring regime would have had on Husky's behavior had it been imposed at the Bi-Provincial upgrader.

The erosion of trust at NewGrade ultimately led to a situation where both sides were forming their positions based on an attribution of the very worst possible motives from the other side. When Saskatchewan wanted to change the terms of the agreement, FCL believed the government's intent was to expropriate their refinery. This belief was emphatically rejected by the government in both internal and external discussions, but no amount of government denials led FCL to stop basing its oppositional

campaign around this belief. As a result, any change from the status quo was seen in absolutist survival terms. Similarly, the government came to the conclusion that FCL might be deliberately trying to trigger a call on the loan guarantees in the hopes of eventually obtaining a debt-free upgrader for scrap value. While this scenario was likely possible under the terms of the project and operating agreements, there is absolutely no evidence to suggest that CCRL/FCL was operating the upgrader to achieve this goal. Nonetheless, fear of this scenario caused the government to resort to adopting the highly controversial and heavy-handed provisions in Bill 90. In the cycle of suspicion, these provisions reinforced FCL's expropriation fears. The dynamic was reflective of the 1969 Elvis Presley hit, wherein he sang, "We can't go on together, with suspicious minds. We can't build our dreams together, with suspicious minds."<sup>225</sup>

#### **4.5.2: The Different Nature of the Private Sector Partners**

The nature of the private sector partners in each upgrader was very different. As we have noted earlier, Husky was a willing partner and a proponent of the project. CCRL/FCL was a reluctant partner attached to protections against risk had contractually secured. We have seen how, in part, this was due to the differing impacts on the upgrader on each company's overall investment structure. During the renegotiation, these observations remained valid. In addition, other effects of the differing nature of the partners emerged.

In the case of Husky, the company was now owned and controlled by a new owner who could make quick decisions and act decisively and who had the financial capability to make further investments if required. Husky was freed from the constraints of being limited by immediate cash flow for access to capital. Further, the new owner had good reasons to avoid conflict with host governments and a very strong sense of the proper way partnerships should be conducted. Husky remained the project's proponent in terms of being the initiator of proposals and solutions, but these were guided by an ethic of valuing a relationship. Saskatchewan offended this sensibility when it refused to participate in the capital cost over-run and operating shortfall. When the need for more cash arose, Husky's proposal for continuing the four-party partnership arrangement was contingent upon every partner (namely including Saskatchewan) being a fully participating partner. It was not acceptable to Husky's owners that one partner was not being a true partner, even if other governments were willing to assume its share of the burden. Husky's proposal effectively told all three governments to be true partners or to allow it to proceed alone. When Saskatchewan surprised the other parties and insisted on staying in the relationship, Husky willingly surrendered the right for equality of purchase to exchange equality of ownership. It also surrendered some preferential treatment it had for the payment of

dividends at low profitability levels from the upgrader. For Husky, following its ownership change, partnership was partnership with an equal sharing of risk and reward.

CCRL/FCL was different. It viewed its mandate exclusively in terms of its responsibilities to its membership and ultimately its accountability to them. The persistence of its responses and offers being contingent upon a consultative and approval process from its member co-ops suggests that this imperative was real for FCL leadership. One result was slowness in the decision-making processes that the government did not understand and could not accept. The other result was a resistance to change. The member co-ops, particularly in Manitoba, Alberta, and British Columbia, had no stake in the financial integrity of the Saskatchewan government. Their attachment was to their own co-op, and anything that hurt its interests or threatened its viability needed to be resisted. This innate caution and resistance to changing the agreements within the member co-ops was accentuated by the decision to portray any request for any change in absolutist, survivalist terms. If, at any point, FCL's leadership wanted to reach some accommodation with the government, their own actions made this much more difficult to justify within their internal political structure. Finally, the difference in the ownership structure of FCL made its leadership believe that it could muster enough political support to defy a determined government. Its contractual agreements led FCL to believe it would be stronger than the government in a court of law. It believed its local ownership and democratic participation would make it stronger than the government in the court of public opinion as well. The Saskatchewan government showed that it could bypass the court of law and had mixed results in the court of public opinion. While no accessible polling exists, opinion as measured by letters, public commentary, and so on suggests that the FCL lost a fairly close decision in Saskatchewan and won overwhelmingly in the other three affected provinces. This split decision placed its leadership in a very awkward spot.

#### **4.5.3: The Implications of Different Financial Structures**

The differing nature in the financing of the two projects and the peculiarities in the rules for accounting treatment influenced the government actions. First and foremost was the effect of the highly leveraged nature of NewGrade and the loan guarantees. The debt internalized the cost of capital into NewGrade and created the possibility of cash deficiencies, even when the upgrader was generating enough to pay its operating costs. This made cash shortfalls both much more likely and potentially much higher. Accordingly, disputes about allocation became much more intense – indeed, it was viewed as a survival issue by CCRL. The guaranteed debt also created the possibility of a catastrophic situation for the Saskatchewan government. Unlike the prospect of a “once in a hundred years flood,” this

catastrophe was viewed, by all informed observers, as being both probable and imminent. If the potential of sharing in cash deficiencies was viewed as a survival issue by CCRL, the potential in having the loan guarantees called was a survival issue for the Saskatchewan government. The pressures arising from equity investments already made was much less intense. While the government was reluctant to give up claim to money already invested, it was willing to do so and, in the case of NewGrade, walked away from claims to a greater level than recommended in the Estey Report. Since this money had already been written-off on the province's balance sheet, abandoning a claim to \$254 million did not affect the province's future financial targets and therefore could be contemplated. In the case of Bi-Provincial, the situation with respect to write-offs was more nuanced. Because of the longer process of getting the project off the ground, it had not been operating long enough for Saskatchewan's share of operating losses (including non-cash items such as depreciation) to have been fully written down. The province had, year by year, written down a portion of its investment in accordance with its pro-rata ownership share. Continued write-downs at these levels were both non-cash and predictable. They could therefore be built into the province's fiscal plan and resulting targets. While a staged write-down was acceptable to Saskatchewan, a sudden one was not. This would congeal the predicted write-downs into a single year and disrupt the province's ability to meet its targets. As a result, even though it would have resulted in an immediate cash gain to sell in 1994, Saskatchewan could not afford to do so. In summary, however, the construction bills had already been paid in the case of the Bi-Provincial upgrader. Renouncing a claim on money spent and lost by a previous administration might be regrettable, but it would not be catastrophic, and potential future cash shortfalls were confined to operating costs. In the case of NewGrade, the construction bills were still outstanding and the potential cash deficiencies were higher because of the interest on the debt. This lent greater intensity to the concerns about NewGrade.

#### **4.5.4: The Role of Other Governments**

The negotiating dynamic was also affected by other governments. At NewGrade, even though the federal government had an interest in its loan guarantees and a member on the Board, it was passive. The board position was left vacant for long periods of time, and the federal government responded to all issues by telling the two owners to work out a solution before involving it in discussions. Bi-Provincial was different. Three governments were involved. All were shareholders and seen as having a political stake in the project. During the negotiation process, the conflict was primarily between governments in response to either circumstances or Husky's proposals. When Saskatchewan

refused to contribute to cost overruns or cash deficiencies, the angry reaction came from other governments, not from Husky. When Alberta and Canada decided to exit and Saskatchewan stayed, it was the other governments and not Husky that were the most concerned. In both cases, Saskatchewan's contrariness created the potential for a standard of comparison against which their decisions could be judged.

#### **4.6: Concluding Observations**

The factors identified above speak to the differences in the process of the renegotiation and on the relationship between the partners. The different financial structures of the two upgraders, the different nature of the private sector partners, and the presence/absence of other governmental partners all contributed to determining whether a restructuring could be achieved harmoniously or only with significant conflict. Further, the physical engineering of the two projects either contributed to maintaining or undermining trust between the partners. In the case of NewGrade, a self-reinforcing cycle of distrust and recrimination set in.

However, harmonious functioning is only one aspect of whether a partnership is successful. The other substantive measure is the extent to which the partnership achieves the objectives of its partners. The substantive results both of each partnership and each renegotiation process will be considered in the next chapter.

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## Chapter Five

### The Partnerships Assessed:

#### Costs and Benefits of the Upgrader Partnerships

##### 5.1: Introduction

One criterion for judging the success of a partnership arrangement is the ability of the partners to get along in a way allows the synergistic benefits of the partnership to exceed the cost of the partnership. From this perspective, relative harmony and cordiality of relationships is a measure of success. As we have seen in the narrative chapters, the process of negotiating both partnerships was long and created tensions between the partners. Once the project and operating agreements-in-principle were signed, the relationship aspect of each upgrader partnership took a different path. This crystallized when low oil prices and a compressed differential between heavy and light crude created a financial crisis at each upgrader which necessitated changes in the partnership relationship. At NewGrade, relations between Saskatchewan and CCRL/FCL deteriorated into a cycle of mistrust and acrimony that came very close to destroying the project and causing potentially cataclysmic damage to each of the partners. At Bi-Provincial, relations between Saskatchewan and Husky Oil remained relatively civil and professional. A change in the relationship was negotiated without public acrimony or project-threatening conflict.

However, the maintenance of harmonious relationships is only one measure of partnership success. The larger question is whether the partnership achieved the objectives of each partner involved, and at what cost. This chapter will explore costs and benefits of each of the upgrader partners. It will begin with an assessment of the extent to which the Saskatchewan government's objectives in the renegotiation process of the 1990s were achieved. Attention will then turn to the performance of the partnerships for each partner over the life of project from conception until the present day.

##### 5.2. The Results of the Romanow Administration Renegotiations

Heavy oil upgraders had consumed a great deal of time, energy and political capital during the Romanow administration's first term. In pursuing restructuring of the agreements governing the upgraders, the Romanow administration had three fundamental objectives. These were:

1. To ensure the survival of the upgrader projects on a reasonably sound financial footing in order to preserve the jobs, royalties, and economic activity in the heavy oil industry;
2. To reduce the province's financial liabilities and to ensure any losses became quantifiable, predictable, and of a magnitude that did not threaten in integrity of the financial targets established in the 1993 budget. This applied to both cash flow and the province's bottom-line balance sheet, which could be affected by non-cash impacts such as investment write-downs in accordance with Generally Accepted Accounting Principles.
3. To protect the Saskatchewan public investment in these projects and to recover as much of this investment as possible.

By any reasonable standard of judgement, the restructuring of the upgrader achieved these objectives.

Although oil prices staged a modest recovery in 1996, they began to fall again in 1997. By 1998, the average price received for a barrel of Saskatchewan crude was \$13.37 - the lowest price seen since the 1970s - recovering to the price levels of the first half of the 1980s.<sup>1</sup> Despite this pressure on oil prices and the resulting squeeze on differentials, the restructured upgraders survived without significant calls for cash or strain on the partnership relationships.

### **5.2.1: Results of NewGrade Restructuring for Saskatchewan**

In the case of NewGrade, the restructuring reduced the company's interest payments by about \$20 million per year.<sup>2</sup> Debt repayment proceeded on schedule. In 1995<sup>3</sup> and 1996<sup>4</sup> there were no cash deficiencies, and the province made no cash contributions to NewGrade other than those provided for under the terms of the restructuring. In 1997<sup>5</sup> and 1998<sup>6</sup> there were no cash deficiencies despite a drop in oil prices. In 1999, the schedule of debt repayment resulted in a \$22,400,000 cash deficiency which was divided between the owners without controversy in accordance with the terms of the agreement.<sup>7</sup> This required an \$18,400,000 contribution from CIC. In 2000, the cash deficiency was \$6,600,000 and was paid equally and without controversy by the two partners.<sup>8</sup> In 2001, the project's cash flow turned positive. Even with debt repayment continuing as scheduled, \$23,300,000 was returned to each partner.<sup>9</sup> As Estey had predicted, reduced financial pressure arising from an improved balance sheet contributed to more congenial relations between the partners. No externally recorded disputes or arbitration of issues emerged from the NewGrade Board following the restructuring. The government began to rebuild its relationship with the retail coop movement. It is noteworthy, however, that, when

Romanow subsequently gave speeches to cooperative organizations, NewGrade was tactfully ignored.<sup>10</sup> Despite the success of the restructuring and the general recovery in relations between the government and the cooperative movement, scars remained. A decade later, Leland described the fight over renegotiation as “a horrible thing to go through” and one of his worst experiences in decades of working in the cooperative movement.<sup>11</sup>

In August of 1994, after the federal support was secured, Estey wrote to Romanow to offer his perspective on the affair. The letter from the neutral, mutually-agreeable mediator gives a glimpse of ongoing strong feelings regarding the renegotiation of the NewGrade upgrader. The retired Supreme Court Judge told the Saskatchewan Premier that:

*It was, indeed, bitterly disappointing when the representatives of the Co-op were unable to persuade themselves of the opportunity which the Upgrader facility represented. This failure appeared all the more serious when the parties to these differences were prevented from settling the issue with Ottawa at a time when Saskatchewan had a fortuitous (and foreseeably fleeting) representation in the federal Cabinet.*

*None of these difficulties, at any time during the life of the Inquiry, were attributable directly or indirectly to any failure on the part of the Province of Saskatchewan or of its representatives.*

*Through it all, one could not fail to admire the solid and high-principled response on your part, as the head of the government of the Province, in the face of delay, intransigence, and worse, on the small but important group of the Co-op leaders...In the end common sense prevailed...<sup>12</sup>*

### **5.2.2: Results of Bi-Provincial Restructuring for Saskatchewan**

The restructuring of Bi-Provincial also had a positive result for Saskatchewan but without the residual bitterness between partners. Over the first several months of 1995, Saskatchewan contributed a total of \$12.5 million to cover its share of cash deficiencies. By the third quarter, the cash flow turned positive, with CIC receiving a \$3 million payment back from the upgrader.<sup>13</sup> The improved financial performance was attributed to the operational changes and a drop in the price of natural gas, assisted by a slight improvement in the differentials.<sup>14</sup> CIC reported in its 1995 annual report that “the technological and productivity improvements undertaken at the BPU over the past two years have met with success. The complex as a whole is running quite smoothly operationally and the relationship between the two joint venturers is very good.”<sup>15</sup> Economic performance continued to improve in 1996,

when the upgrader returned \$8 million to each partner,<sup>16</sup> and 1997, when each received \$20 million in positive cash flow.<sup>17</sup> The differential was gradually increasingly driven both by modest increases in oil prices and by significantly increased production of heavy oil. Production of heavy crude in the Saskatchewan-side Lloydminster increased from 5,272,328 cubic meters in 1993, when Bi-Provincial came on stream, to 9,380,524 cubic meters in 1997, or an increase of 77.9%.<sup>18</sup> As the upgrader achieved its public policy goals, it was rewarded by an increase in the supply of heavy crude, and therefore an increase in the differential. Following restructuring, no further write-downs of CIC's investment occurred.

The Bi-Provincial upgrader offers a very rare opportunity for accurate and quantifiable contra-factual history. The unfolding of operations and audited financial statements allow us to see what actually happened with the Bi-Provincial Upgrader. The concrete actions of the Alberta and federal governments, with measurable results and with results bounded in time, allow us to measure with precision what **would have** happened to Saskatchewan's investment had it followed the lead of Alberta and Canada compared to **what did** happen when it chose a different path.

The three decision points where Saskatchewan diverged from its governmental partners were its refusal to contribute to the second round of capital cost overruns, its refusal to contribute to the \$30 million call to meet cash deficiencies, and its decision to buy more shares rather than sell its interests in 1994, with the resulting loss of sales income, continuing and increased exposure to future cash deficiencies, and ability to share any financial returns. On a cash-in/cash-out basis,<sup>19</sup> if the Saskatchewan government had followed the lead of the Alberta and federal governments, it would have sustained a loss of \$277,579,000. With the alternative strategy actually followed by the Romanow administration, the Saskatchewan government enjoyed a net gain of \$6,000,000. These numbers, however, do not include the cost of the capital invested in the project. If compounded interest on the money invested is included, Saskatchewan's involvement with the Bi-provincial upgrader becomes much more expensive, both in reality and in the contra-factual scenario. At the average annual interest rate on Saskatchewan's public debt for the period from 1989 (when the province first put actual cash into the project) to 1999<sup>20</sup> (when Saskatchewan's investment terminated), the actual cost of Bi-Provincial to Saskatchewan was \$329,641,000. With the contra-factual scenario, it would have been \$662,660,000. Thus, on a dollar-in/dollar-out basis, the decisions of the Romanow administration improved the financial position of the province by \$283,570,000 compared to what it would have been had Saskatchewan followed the lead of Alberta and Canada. When the cost of capital is included, the result is a \$333,019,000 improvement.

Without a bounded comparison such as was provided by the alternative strategy implemented by other governments, it is impossible to establish an accurate statement of what would have happened under any contra-factual scenario for NewGrade. It is probable that the further downturn in oil prices would have resulting in either additional unilateral cash injections by Saskatchewan or a call on the loan guarantees by 1998 at the very latest. Indeed, in March of 1995 the differential was as low as \$3.50 per barrel. The cash flow break-even point at that time (post-restructuring) was 4.07 per barrel.<sup>21</sup> The debt-restructuring had already lowered the cash flow break-even point by slightly over \$1 per barrel, so it is likely that the loan guarantee ceilings would have been reached in 1995, thereby triggering either a call on the guarantees or a unilateral cash injection by Saskatchewan at that time.

While it is possible to conclude with a fair degree of certainty that the objectives of the Romanow administration in pursuing a restructuring were met, an analysis of the actual costs and benefits of the policy decision to support and invest in heavy oil upgraders, rather than pursuing other development initiatives in advancing either similar or different policy goals, is both more interesting and more challenging.

### **5.3: Assessment of the Upgraders against Saskatchewan Policy Objectives**

As was demonstrated in earlier pages, there was a high degree of policy consensus between the Conservatives and NDP on the desirability of promoting the creation of heavy oil upgraders in Saskatchewan. This consensus was long-lasting and survived transitions between government and opposition in both parties. This public policy consensus was premised on the belief that heavy oil upgraders in the province would:

1. Provide a secure, stable market for Saskatchewan heavy crude oil, thereby promoting the development of the province's oil industry with a resulting expansion in production;
2. Create jobs for Saskatchewan residents and opportunity for Saskatchewan companies;
3. Increase the royalties and other revenue the province would receive from both increased oil production and the increased economic activity;
4. Provide for import substitution by allowing Saskatchewan heavy crude oil to be used within the province; and
5. (In the case of NewGrade) Enhance the long-term future of the province's only remaining refinery capable of producing gasoline and diesel by ensuring security of feedstock supply in the face of declining supplies of Alberta light crudes.

In addition to the consensus on objectives, both the Conservative and the NDP governments agreed that the scale of capital investment required, the inherent risks, and the level of economic return on oil upgrading meant that public involvement was required if one or more upgraders were to be built. Left to commercial criteria and private investment alone, the policy objectives would not be achieved. In addition to agreeing on the need for public involvement, the political parties also agreed, in broad terms, on the form. Direct public ownership and operation through a Crown corporation was ruled out in favour of a partnership with a private sector company which would serve as operator.

### **5.3.1: Assessing the Saskatchewan Benefits from the Upgraders**

These policy objectives and choice of policy instruments are straightforward, easy to articulate, and coherent. Setting and measuring precise numerical targets is more difficult. The impacts are spread throughout the provincial economy. There can be intervening variables between the upgraders and the impact. The final performance on most of the objectives is affected by many other variables. It is difficult, for example, to know whether a trucker hauling heavy or intermediate crude oil in the Fosterton field near Swift Current would still be working without the incremental market demand created by the NewGrade upgrader. Over time, the impact on the province's royalties have been affected by world demand and price, the variable quality of crude produced, the variable productivity of individual oil wells, the nature of the recovery technology, and decisions on treatment of different crudes under regulatory pricing regimes in the first half of the 1980s. When the federal Auditor-General condemned the federal involvement in the upgrader projects as lacking clear and measurable performance criteria, he was ignoring the complexities facing government decision makers. In the end, perhaps the best that can be achieved is to examine the overall developments in the policy objective areas to see if the numbers are moving in a direction consistent with the stated policy objectives. Correlation, or lack of it, may or may not be primarily attributable to the impact of the policy direction, but the overall picture can give a general sense of whether some progress was made on policy objectives.

With this very substantive qualification, we'll now turn to evaluating the extent to which Saskatchewan's two heavy oil upgraders met the policy objectives assigned to them.

#### **5.3.1.1: Benefit: Saskatchewan Production of Heavy Crude Oil**

During the early years of the upgraders' operations, oil prices remained low. This suppressed the development of heavy oil fields and, during certain periods, actually led to a shut-in of production. The

impact of low prices was partially compensated by royalty adjustments by the provincial government as it attempted to stabilize the industry. Despite this, there was an upward trend in Saskatchewan heavy oil production.<sup>22</sup> Total production of heavy and intermediate crude suitable for upgrading went from 5,597,810 cubic meters (35,209,105 barrels) in 1987 – the last full year before NewGrade came on stream – to 5,913,611 cubic meters (37,195,430 barrels) or an increase of 5.64% during a period of sustained low prices in 1991, the first year of sustained full production at the upgrader. The majority of this increase came from the Swift Current area, which was the primary source of feedstock for the NewGrade upgrader. In 1994, the first full year of Bi-Provincial’s operations, total production of relevant crudes totalled 7,989,398 cubic meters (50,251,715 barrels). When crude prices began to improve in 1999, production accelerated. By 2005, total production of crudes suitable for use as upgrader feedstock increased to 15,023,109.50 cubic meters (94,492,351 barrels). The majority of the increased production had occurred in the Lloydminster area fields, which was the exclusive Saskatchewan source of feedstock for the Bi-Provincial upgrader.

#### **5.3.1.2: Benefit: Internal and Export Markets for Saskatchewan Crude**

Saskatchewan deliveries of crude oil produced in the province were 518,061 cubic meters (3,258,500 barrels) in 1987, primarily due to Husky’s asphalt refinery in Lloydminster.<sup>23</sup> In 1991 this reached 1,293,174 cubic meters (8,133,805 barrels) and 3,000,284 cubic meters (18,871,186 barrels) in 1994. By 2006, after upgrader expansions, this reached 4,315,278 cubic meters (27,142,235 barrels). With the exception of the relatively constant demand from Husky’s asphalt refinery, the two upgraders constituted the only demand for Saskatchewan crudes. Comparing 1987, before any upgrader capacity came on-stream, to 1994, when Bi-Provincial had its first full year of operations, increased deliveries to Saskatchewan accounted for 103.79% of the increase in production of heavy and intermediate crude oil. It is reasonable to conclude, therefore, that the upgraders achieved the public policy goals of providing stable markets for Saskatchewan heavy crude, spurring production, and increasing the Saskatchewan markets for Saskatchewan crude oil.

The construction of the heavy oil upgraders also contributed to the growth in the Saskatchewan export market for heavy oil. The projected shortages of Pentane as a diluent did emerge as the composition of natural gas being produced in Western Canada became “drier” with a resulting reduction in Pentane production. At the same time, demand for Pentane was increasing both as a result of increased heavy oil production and in situ oil sands development. By the middle of the first decade of the twenty-first century, Pentane shortages caused significant problems in using pipelines to export

heavy oil and resulted in restrictions in export market access, forcing the use of more expensive diluent options and contributing to the increase in export shipments by the more expensive rail option rather than through pipelines.<sup>24</sup> Both Saskatchewan upgraders permitted the recycling of Pentane within the province, thereby increasing the supply of this key commodity in promoting the growth of exports of heavy oil. In 2011, 23% of western Canadian diluent supply came from the recycling from the two Saskatchewan upgraders.<sup>25</sup>

### **5.3.1.3: Benefit: Provincial Government Revenues**

Crude produced as feedstock for NewGrade did not receive any preferential royalty treatment, while Husky received reduced royalty rates and a lower corporate capital tax rate for Saskatchewan assets used to produce feedstock. These amounted to savings through royalty reductions of about \$3 million per year and a reduction of the corporate capital tax of slightly over \$600,000 per year.<sup>26</sup> Since these provisions had been intended to neutralize the cost to Husky of meeting the equality of supply between Saskatchewan and Alberta, they were unaffected by the change in the upgrader partnership structure. These provisions were attacked by the Liberal opposition in 1996 as being a giveaway to “one of Canada’s largest corporations.”<sup>27</sup> The Finance Minister pointed the finger at the previous administration saying, “we have no choice but to provide it,”<sup>28</sup> while officials assured the media that the company’s commitments to increase Saskatchewan exploration and development were being monitored and that the government was “satisfied [that] Husky is complying.”<sup>29</sup> The preferential royalties did not apply to Saskatchewan-sourced feedstock purchased by the upgrader from other producers.

In aggregate, it is difficult to make a direct connection between royalty payments and the two heavy oil upgraders, since the number of complicating variables is much higher. Saskatchewan collected \$291,514,823 in oil royalties<sup>30</sup> and production taxes in 1987, \$240,657,567 in 1990, and \$252,763,029 in 1994. There was no apparent direct correlation between the upgraders coming on stream and the province’s capture of additional oil royalties. Receipts from royalties remained stagnant until crude prices began to increase significantly in 1999, when royalties yielded \$400,339,207, with \$761,922,816 being collected in 2000. It is impossible to calculate what the royalty yield would have been in the absence of the demand created by the upgrader, since this contra-factual scenario would require knowledge of the availability of alternative markets in the United States (which was still taking the majority of Saskatchewan’s heavy oil production) and of the impact on the price for heavy oil arising from the increased domestic demand. The best we can say is that it is intuitively logical that the increased demand for heavy crude oil had some positive impact on the province’s yield from production

royalties, but that this amount was likely fairly small in an era of low crude prices. As markets improved, these royalty yields would increase correspondingly. Saskatchewan's royalty system had been designed during the Blakeney NDP years to capture economic rents arising from high prices, and then modified by the Devine Conservative government to help producers deal with a time of low prices. The result was a price-sensitive royalty structure that captured economic rent when such rent was being created but yielded little when it was not. FCL's claim in 1993 that the province was receiving an incremental \$45 million per year in oil royalties as a result of NewGrade's operations is implausible. Husky's 1994 assertion that the Alberta, Saskatchewan, and Canadian governments were receiving a combined total of \$60 million per year in outside-the-fence' benefits including royalties, corporate and personal income taxes, sales taxes, and so on is probably more realistic but is likely still inflated somewhat. As crude prices improved, however, so, too, would the royalty returns created by the crude being used in the upgraders. Even at higher overall crude prices, without the upgraders, the existence (or not) of alternative markets is speculative since this would depend on factors such as refinery configuration in other locations, pipeline capacity, and the availability of pentanes.

#### **5.3.1.4: Benefit: Employment Impact**

The upgraders clearly delivered the promised construction and operational jobs. Employment at both the construction and operational stages are almost identical to planning projections. In fact, for its first 18 months of operation, the Bi-Provincial Upgrader over-delivered on its job creation promises with a corresponding reduction in economic performance. The impact on oil patch development and operations employment is more difficult to quantify, since it depends on how much increased production would have happened regardless of the upgraders (going to other potential markets) and the level of technology and capital investment in this production. For example, in oil field collection, pipeline collection will create more jobs than trucking during the construction phase but fewer during operations. Actual employment impact depends on a myriad of operational decisions by many producing companies and their contractors. In his analysis of Saskatchewan government economic development strategies, Phillips notes that the group of investments including the upgraders had a high "average cost per person-year of employment" resulting in the result that "even large amounts of money produced little new employment."<sup>31</sup> This focus on direct employment ignores the employment effects arising from feedstock and development. This is addressed by McAfee, who conducted a detailed study of the economic linkages and effects of the CCRL Refinery and NewGrade Upgrader.<sup>32</sup> In the two-year period of 1997 and 1998, the complex purchased \$950 million in inputs, with over 80% of

this being crude oil from the Swift Current and Lloydminster areas.<sup>33</sup> In addition, \$48 million of Saskatchewan-sourced natural gas was consumed,<sup>34</sup> and the complex locally purchased \$23 million in services and \$12 million in materials. The former were deemed to have a high local labour impact, the latter a low one.<sup>35</sup> Saskatchewan economic impacts were also created downstream from the upgrader, since 40% of the finished petroleum products were sold in Saskatchewan.<sup>36</sup> Without econometric modelling that is outside the scope of this study, it is impossible to determine precisely the employment impacts of the two upgrader projects. However, it is reasonable to assume that the stated employment objectives were achieved within a reasonable margin of error.

#### **5.3.1.5: Benefit: Security of Refinery Feedstock Supply**

Finally, NewGrade did achieve the objective of securing the feedstock supply of the CCRL refinery. This objective was based on the belief that the supply of Alberta light crudes would be diminishing. This, in fact, occurred. The production of Alberta non-heavy crudes declined steadily, with production dropping from 46,517,118 cubic meters in 1994 to 18,423,386 cubic meters in 2010, or a drop of 60%.<sup>37</sup> Although the Saskatchewan supply of light crude has recently been increasing from fields in the Estevan area, in contrast to heavy oil production, Saskatchewan's production of light crudes was relatively stagnant for a decade and a half.<sup>38</sup> If it were not for NewGrade, the CCRL refinery would have been in competition with other refiners for a shrinking resource.

In summary, it is fair to conclude that the public policy objectives that caused Saskatchewan to pursue the construction of heavy oil upgraders have been achieved, although the royalty impact was likely delayed because of the extended period of low prices.

#### **5.3.2: Assessment of the Public Cost of the Upgraders for Saskatchewan**

Achieving the public policy benefits of the heavy oil upgraders came with a financial cost to the provincial treasury. On a dollar-in/dollar-out basis, both upgraders eventually returned a profit to the Saskatchewan government. However, if the cost of capital is taken into account, the cost to the provincial treasury was significant.

In both instances, the upgraders were sold to the private sector partner. The events following the renegotiation of the partnership agreements during the first term of the Romanow administration are outside the scope of this study. As a result, the decision making process leading to the sale of the Saskatchewan government's shares and the dissolving of the partnerships is not considered. However,

to examine the cost of each upgrader, the impact on the province's treasury from the first investment until the final divestiture must be considered. Sale of Saskatchewan's interests crystallized the financial cost of the upgraders, although it should be noted that benefits arising from increased markets for heavy crude, royalties and employment continue even after the province ceased to be a partner.

Both sales occurred prior to dramatic increases in the differential. From 1995 to 1999, the differential fluctuated between \$5 and \$9 per barrel<sup>39</sup>, which was sufficient to generate positive cash flow and profits from both restructured upgraders. The underlying volatility in differentials was demonstrated with a brief drop in 1999 to \$2 per barrel.<sup>40</sup> Increasing oil prices in the new decade resulted in increased differentials. By the middle of the decade, the differentials had reached the \$20 to \$30 per barrel level. At one point in 2007, refinery problems in the mid-west United States resulted in a heavy oil surplus that caused the differential to reach \$45 per barrel.<sup>41</sup> At those differential levels, the heavy oil upgraders were capable of generating positive cash flow almost faster than it could be counted. As a result, it could be argued that the long-term costs to the treasury occurred as a result of the decisions to divest rather than invest. However, for the purposes of this analysis, both the ends of the province's involvement will be treated as a single policy decision – that is, to support the creation of the upgraders for public policy rather than commercial investment reasons. In this context, in both cases divestiture occurred in the context of the private sector partner wishing to pursue expansion plans independently.

In assessing the financial impact of the upgraders on the provincial treasury, the Generally Accepted Accounting Principles are an encumbrance, since their application resulted in a series of accounting adjustments on CIC's books such as investment write-downs to account for the province's pro-rata share of operating losses followed by gains over book value being posted upon sale. We shall present, instead, an outline of annual net cash flow into and out of each upgrader project by Saskatchewan, regardless of whether the money-in was in the form of a grant, equity investment, or loan or whether the money-out was in the form of a loan repayment (principle or interest), dividend, or sales proceeds. This provides for an assessment on a dollar-in/dollar-out basis. The next column shows the annual interest expense associated with the dollar-in investment plus the accumulated compounded interest from previous years. Interest is calculated at the average interest rate paid on Saskatchewan debt for each year. The final column shows, on an annual basis, the cumulative effect of the project's direct effect on the province's balance sheet. This estimation is not completely precise. It does not, for example, take into account the timing of cash flow in or out during a particular year or the impact the

additional borrowing may have had on the province's interest rates. These impacts, however, would be fairly minor. Timing issues should balance out, with cash flow occurring sometimes early in the year and sometimes later. The charts also highlight the money-in impact of decisions made and contracts signed by the Romanow administration by showing these expenditures in bold. The timing of these expenditures does not correspond directly with its term in office, since the Romanow administration issued some payments for each upgrader to meet the contractual commitments made by its predecessor. There is no such distinction made for money-out, since the revenue potential was the result of the combined decisions of both the Devine and Romanow administrations.

#### **5.3.2.1: The Financial Impact of the NewGrade Investment**

Thus, on a dollar-in/dollar-out accounting, Saskatchewan's involvement with the NewGrade Upgrader yielded a net positive return of \$360,500,000. However, if the cost to the province of the compounded interest charges is taken into consideration, the net direct impact of NewGrade on the province's balance sheet was a \$734,747,000 contribution to the provincial debt. The province's share of NewGrade was sold in 2007, so the possibility of any future income ended at this point, while the contribution to the debt and the resulting on-going interest charges remained.

Table 5.1

Financial flow between NewGrade Energy Inc. and Saskatchewan, 1987-2007<sup>42</sup>

Year	Cash invested or <returned” to/<from> NewGrade	Total Provincial investment or <gain> at year end	Annual interest on NewGrade investment plus accumulated interest	Cumulative Interest on NewGrade Investment	Cost of total provincial investment plus accumulated interest at year end.
1987	61,800	61,800	6,736	6,736	68,536
1988	60,913	122,713	13,204	19,940	142,653
1989	53,187	175,900	21,289	41,229	217,129
1990	53,800	229,700	27,906	69,135	298,835
1991	2,300	232,000	27,210	98,345	330,345
1992	2,500	234,500	32,619	130,964	365,464
1993	4,600	239,100	36,266	167,230	406,330
1994	<b>52,000</b>	291,100	41,564	208,764	499,894
1995	<b>17,800</b>	308,900	53,322	262,086	570,986
1996	<b>10,000</b>	318,900	55,775	317,861	636,761
1997	Nil	318,900	63,039	380,900	699,800
1998	Nil	318,900	66,481	447,381	766,281
1999	<b>18,400</b>	337,300	74,544	521,925	859,225
2000	<b>3,300</b>	340,600	77,627	599,552	940,152
2001	<23,300>	317,300	79,766	679,318	996,618
2002	<16,700>	300,600	73,493	752,811	1,053,411
2003	<7,600>	293,000	77,390	830,201	1,123,201
2004	<60,400>	232,600	75,458	905,659	1,138,259
2005	<105,000>	127,600	72,328	977,987	1,105,587
2006	<105,000>	22,600	69,040	1,047,027	1,069,627
2007	<383,100>*	<360,500>	48,220	1,095,247	734,747

\*Of this, \$325 million represented the sale price received by Saskatchewan from FCL, with the balance representing the province’s share of pre-sale dividends.

### 5.3.2.2: The Financial Impact of the Bi-Provincial Investment

Bi-Provincial shows the same general pattern of a gain on the dollar-in/dollar-out accounting but a significant expense to the province when the cost of capital invested is accounted for. Two differences can be noted. First, in the case of Bi-Provincial, the project started returning cash to the province in 1996, compared with 2001 for NewGrade. This is directly and solely attributable to the differences in financing for the two upgraders. Both upgraders were generating positive cash flow after operating expenses during this period. At NewGrade this cash flow was required to service the remaining guaranteed third-party debt, while at Bi-Provincial it was available for distribution to the two owners. This accounting is also impacted by the differential time periods in which the province was financially involved with the upgraders. At Bi-Provincial this financial entanglement lasted one decade, at NewGrade, two. The earlier start time for NewGrade meant that interest started being charged and compounded earlier, while the earlier exit from Bi-Provincial resulted in an earlier closing off of the books. Interest was still being charged and compounded on Bi-Provincial's contribution to the total provincial debt after 1997; however, it simply does not show up on this chart. If the compounding calculations were to continue through to 2007 to be consistent with NewGrade, Bi-Provincial's comparable contribution to the provincial debt would be \$599,647,000 compared with the corresponding figure of \$734,747,000 for NewGrade. It must be stressed that these figures represent only one side of the ledger, and are offset by the public benefits, including royalty revenues and other tax revenue discussed earlier. With this in mind, it should be noted that, for Saskatchewan, these benefits would be higher for NewGrade since all of this upgrader's feedstock was sourced from within the province compared to only half of Bi-Provincial's. In addition, NewGrade's geographical location means that Saskatchewan reaps all the direct upgrader employment benefits and resulting tax revenue, whereas Bi-Provincial's location means that a significant number of employees live in Alberta. Finally, just as the differences in timing meant that the financial costs of NewGrade began to be incurred and compounded sooner than those of Bi-Provincial, so, too, did the benefits. It is intuitively plausible that the overall cost/benefit outcomes would tilt in favour of NewGrade, but this is impossible to quantify accurately. If this were so, it would be a reflection of the synergistic benefits of building an upgrader integrated with a refinery.

Table 5.2

Financial flow between Bi-Provincial and Saskatchewan, 1989 to 1999<sup>43</sup>

Year	Cash invested or <returned> to/<from> Bi-Provincial	Total Provincial investment or <gain> at year end	Annual interest on Bi-Provincial investment plus accumulated interest	Cumulative Interest on Bi-Provincial Investment	Cost of total provincial investment plus accumulated interest at year end.
1989	13,991	13,991	1,483	1,483	15,474
1990	57,232	71,223	7,488	8,971	80,194
1991	126,277	197,500	20,028	28,999	226,499
1992	58,700	256,200	28,829	57,828	314,028
1993	4,900	261,100	31,255	89,083	350,183
1994	<b>5,700</b>	266,800	32,858	121,941	388,741
1995	<b>65,200</b>	332,000	46,756	168,705	500,705
1996	<8,000>	324,000	47,299	216,004	540,004
1997	<20,000>	304,000	51,480	267,484	571,484
1998	<155,000>**	149,000	39,566	307,050	456,050
1999	<155,000>**	<6,000>	28,599	335,649	329,649

\*\* Represents the proceeds received by Saskatchewan for the sale of its shares in BPU.

**5.3.2.3: Other Costs to Saskatchewan from the Upgrader Partnerships**

In addition to financial costs to the Saskatchewan government, involvement with the upgraders incurred other costs. The negotiating process necessary to establish the upgraders, to monitor their operations, and to renegotiate the terms and conditions of these projects consumed a significant amount of governmental time, focus, and resources. The mere quantity of briefing notes and documentation cited in this study (a mere fraction of what was actually produced) demonstrates the commitment of staff and Ministerial time to the negotiations associated with these projects. For over a decade, CIC had two or three professional staff people dedicated exclusively to monitoring NewGrade. Not counting the staff salaries, the renegotiation of the NewGrade agreements cost the Saskatchewan government \$85,000 in payments to Estey for his work as commissioner, \$270,874 in legal bills, and \$184,033 to other consultants.<sup>44</sup>

Finally, there is the reputational impact of the upgraders. NewGrade, in particular, was launched with great celebration as an indicator of the progress Saskatchewan was making in building and diversifying its economy. This positive impact dissipated as start-up operational difficulties, financial losses, and acrimony tainted the upgraders' reputations. Plans for ongoing promotional and celebration activities such as an interpretive centre were quietly shelved. Even more serious was the potential negative impact of upgraders on the perception of the province in the investment community and on the effect of the renegotiations on investor confidence. After the introduction of Bill 90, the CEO of the province's largest farm implement manufacturer told Romanow that concerns about the use of legislation to change the terms of contractual arrangements with government were contributing to consideration of constructing a required new plant outside of the province.<sup>45</sup> FCL's mobilization of suppliers on its behalf resulted in the leadership of many significant companies expressing concern about the reliability of the Saskatchewan provincial government, and the negotiated settlement did not completely quiet these concerns.<sup>46</sup>

#### **5.4: Assessment of the impact of upgraders on private sector partners**

Whereas the long-term impact of the two upgraders on Saskatchewan must be assessed as the achievement of the desired public policy benefits balanced against a cost to the public, the long-term impact on the private sector partners was more straightforwardly positive. Both CCRL/FCL and Husky gained both their corporate policy objectives and gained, in commercial terms, from their ownership share in the upgraders. This happy outcome took time to achieve and did not fully materialize until oil prices began to rise following the dawn of the twenty-first century.

##### **5.4.1: Security of Supply and Pipeline Capacity**

For CCRL/FCL, the primary corporate policy benefit was security of supply. As was discussed above, the anticipated decline in the supplies of Alberta light crude did occur. NewGrade prevented CCRL/FCL from having to join into the competition for a share of the supply of this dwindling resource which other refiners faced. For Husky, the corporate benefit was achieving stable markets for its heavy oil production and maintaining the ability to ship its product. These were achieved by the Bi-Provincial upgrader and became more important as the Pentane Plus shortages intensified and pipeline capacity from Western Canada became scarcer. In April 2013, Husky celebrated the processing of 500 million barrels of heavy crude in the Bi-Provincial upgrader, stating that "The Upgrader adds value to the basic commodities that Husky produces by converting them to premium products."<sup>47</sup>

#### 5.4.2 Upgrader Expansions Without Public Participation

The most telling indication of the long-term commercial success of both upgraders is the decision by both private sector operators to expand. In preparation for doing so, both bought out the Saskatchewan provincial government's ownership share and financed the expansion without any public assistance or participation.

Because Bi-Provincial was not encumbered by government-guaranteed third-party debt, improvements in commercial operating results led first to the sharing of dividends between the two owners, followed by the sale of Saskatchewan's interests in the upgrader in February of 1998. As part of the terms of sale, it was agreed that "Husky will continue with the current feasibility studies to determine if it is commercially viable to expand the facility."<sup>48</sup> Four months later, Husky announced a \$500 million expansion project.

The provincial government celebrated the resulting creation of 1,450 person-years of design and construction employment, 75 additional on-site operating jobs and 200 additional oil-patch jobs for feedstock supply. CIC Minister Lingenfelter said that the expansion would result in "drilling new wells, transporting more materials and all the other activities will create a lot of employment and help keep the economy moving ahead."<sup>49</sup> Since Husky could now justify the expansion according to normal commercial risk/reward criteria, the Saskatchewan government could reap all of the public policy benefits of expansion without assuming financial risk or providing subsidies. While the Romanow administration was widely praised for its handling of the Bi-Provincial upgrader<sup>50</sup> and the planned expansion of the upgrader was celebrated by the government in the lead-up to the 1999 provincial election,<sup>51</sup> the ability of any government to deliver upgrader jobs – even at no cost to the taxpayers – continued to be dubious. The voters of Lloydminster turned a 266-vote NDP victory in 1995 into a 793-vote loss in the midst of the expansion construction.<sup>52</sup>

In 2007, FCL exercised its right-of-first refusal to purchase CIC's 50% ownership share for \$325,000,000.<sup>53</sup> FCL was now willingly paying this amount for an ownership share it had refused to accept for \$1.00 thirteen years earlier. FCL's purchase was soon followed by an announcement that it was launching a \$1.9 billion expansion of the integrated upgrader/refinery complex to increase capacity to an official design capacity of 130,000 barrels per day with an expectation that the plant would eventually process between 140,000 and 145,000 barrels per day.<sup>54</sup>

#### **5.4.3: Long-term Impact of Bi-Provincial on Husky**

The Bi-Provincial upgrader was transformative for Husky. In 2012, with an average differential of \$21.46 per barrel, the upgrader had earnings of \$306 million or \$226 million after taxes.<sup>55</sup> The company was producing 76.4 thousand barrels per day of heavy crude in Western Canada<sup>56</sup> compared to 31.5 thousand barrels per day when it started down the path of pursuing an upgrader.<sup>57</sup> The upgrader's profits were higher than those of the entire corporation prior to construction. For Husky, the Bi-Provincial Upgrader yielded both inside-the-fence and outside-the-fence benefits. It should be noted, however, that this was of no benefit to the company's owner when the upgrader venture was launched, since Nova Corporation was forced to relinquish ownership of Husky in large part because it was unable to meet the financial commitments arising from the upgrader's construction.

#### **5.4.4: Long-term Impact of NewGrade on CCRL/FCL**

The impact of the upgrader on CCRL/FCL was, in the long-term, very positive commercially as well as for its corporate policy benefits. As noted above, NewGrade began to pay dividends to its owners in 2001. These dividends increased rapidly as differentials rose and the third party debt was retired. By 2005, the return to CCRL/FCL was \$105 million annually, or more than the entire capital amount it had been required to contribute to the upgrader.

In 2012, FCL's energy division generated net income of \$694 million on sales of \$6,240 million<sup>58</sup>, compared with a net income of \$48 million on sales of \$489 million in 1988<sup>59</sup>, the year NewGrade began its first troubled production. The upgrader was not the only reason for this growth, but it contributed to it significantly in commercial terms and ensured the security of feedstock that made the continued prosperity of the entire division possible. With the completion of the expansion, the integrated upgrader/refinery had a capacity of 145,000 barrels per day and was the fourth-largest refinery complex in Canada.<sup>60</sup> As Bi-Provincial was for Husky, so, too, was NewGrade transformative for CCRL/FCL.

## 5.5: Concluding Observations

The Saskatchewan government administration led by Premier Romanow achieved its objectives in renegotiating the agreements governing the partnership agreements. The projects were put on a sound financial footing and losses incurred while oil prices remained low were sustainable for the partners. Both upgraders were positioned to survive until higher oil prices created the potential for prosperity.

For the Saskatchewan government, the upgrader projects generally met the public policy objectives that had led to their creation, albeit at a significant financial cost. For both private sector partners, the long term effects of their participation in these projects was extremely favourable both from the perspective of corporate policy and profitability. Partnership with the government of Saskatchewan was sometimes difficult and, particularly in the case of NewGrade, at times unpleasant. However, it was profitable.

The concluding chapter will evaluate these two partnerships from the perspective of what they reveal about public-private partnerships for economic development projects.

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### Endnotes

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## **Chapter 6**

### **The Partnerships Interpreted:**

### **Synergy and Discord in the Public-Private Dynamic:**

#### **6.1 INTRODUCTION**

The narrative describing the evolution and results of these two public-private partnerships has taken us on a long and complex path. Partnerships are dynamic processes consisting of a series of decisions made by each partner. The partners' actions will be guided by their own objectives, and structured by the options available to them as a result of both general environmental conditions and the implications of decisions and actions taken at various points in time by each of them and other actors within the system. Partnership is akin to dynamic interpretive dance, where each partner's moves are influenced by their own desires, the background music and the movements of their partner. Just as all the dancers on the floor will tend to speed up if the music increases its tempo, changes in external conditions will impose pressures on the partners to respond. However, the exact nature of that response will vary amongst couples on the floor. Explanation of the results must therefore consider both the externally imposed conditions and the decisions made by the partners in response.

In Chapter 5, the results of these two particular partnerships were evaluated against the objectives and needs of each partner. It was demonstrated that Saskatchewan's public policy objectives were met, albeit at a significant cost to the province. Further, these objectives continue to be met with the dissolving of the partnerships and the operation of the upgraders solely by the private sector partner. The evidence suggests that the private sector partners also achieved their objectives from the partnership venture and continue to reap considerable benefit from their involvement with the

upgraders. Chapter 5 thus represents an answer to the study's fourth research question dealing with costs and benefits to the governmental and non-governmental partners.

In this chapter, the first three research questions noted in Chapter 1 will be addressed. That is:

1. What were the imperatives on both public and private sector partners as the project agreement were being negotiated, and how were the resulting agreements both similar and different?
2. How did both external pressures and the structure of the agreements influence the partnership during the construction and operation phases? What contributed to partnership success or failure?
3. What provoked the Saskatchewan government to seek to change the terms and conditions of both project agreements, and why did the renegotiation process take different trajectories?

It will be argued that the basis of the partnerships' synergistic advantages led to differences in the negotiated operating agreements, which in turn had a major impact on the functioning of the partnership and the course of renegotiation. The government's key contribution to synergistic effects was the ability to access capital in a non-commercial manner and to expend it in pursuit of policy goals. The different form of the government's contribution created differences in the financial structure of the agreements that had specific effects both during construction/operation and the renegotiation of the agreements. Further, the particularistic synergistic attributes of each of the different private sector partners resulted in differences in the governance and monitoring regime, thereby contributing to a different trust dynamic during construction/operations and renegotiation.

It will also be argued that the different nature of the private sector partners and the different levels of involvement from other governments impacted the partnerships at all three stages.

In the narrative, these questions were explored in each of the three phases of the projects: negotiating the agreements, constructing/operating the upgraders, and renegotiating the terms of the agreements. In this chapter, this chronological approach will be replaced with a thematic one with common explanatory variables impacting on each of the stages of the partnerships. In the issues arising from the nature of the synergies, differences at the agreement negotiation stage led to differences in the project agreements that had ongoing effects. On the other hand, the different nature of the private sector partners and the difference in the number of partners contributed to different dynamics that were present while the partnerships were being negotiated, the manner in which the partnerships functioned while the upgraders were constructed/operated, and during the course of the renegotiation.

The specific way these variables functioned could vary from stage to stage, but the effects were present throughout.

Finally, the chapter provides an assessment of whether the two partnership projects could be considered as successes or failures. It will be argued that the environment in which the partnerships were formed and operated was determined by market conditions in the oil industry. The price of oil served a function comparable to the music in the dance analogy discussed above. The reality of market conditions caused the partners to dance, and was the most important factor in influencing opinion as to whether the partnerships were a success or failure, and whether the upgraders were “good projects” or “bad projects”. Within the context imposed by the oil markets, the evolution of the partnerships was the result of decisions that were influenced by the differences in the agreements arising from the synergistic benefits of partnership, the nature of the private sector partners, and the number of dancers.

## **6.2 The Basis of Synergy**

In the 1980s, heavy oil upgraders were seen as one of the keys to Saskatchewan’s future economic growth and prosperity. This view was articulated by MLAs of the Conservative<sup>1</sup> and NDP<sup>2</sup> parties; the lone Liberal sitting between 1986 and 1988 was silent on the issue. This political consensus was reflected in the views expressed in various media<sup>3</sup> and also in the pronouncements of local governments and business groups<sup>4</sup>. Further, there was a political consensus both that the construction of upgraders required provincial government support and that the projects should be undertaken through a public-private partnership between government and an industry operator.

As was outlined in Chapter 1, the potential benefits of a partnership between the public and private sector entities arise from their differences. The literature dealing with public-private partnerships focuses on how the private sector is different from the public sector and whether the exploitation of these differences in a partnership will result in a net benefit or loss to the public.<sup>5</sup> An assumption in most of the literature is that P3s operate in delivering infrastructure, goods or services that have normally been provided by the public sector. As a result, the analysis questions whether the importation of the private sector capital, practices, values and motivators into the provision of public services provides a net gain.<sup>6</sup>

In the case of the two Saskatchewan heavy oil upgraders, the field of activity was in a realm that normally, in North America, lies within the realm of the private sector. Using Savas' descriptive criteria<sup>7</sup>, the upgrading of heavy crude oil is characteristic of private sector endeavour. If the government wishes to achieve public policy benefits from activity in this realm, it has a wide range of policy instruments available to it, including taxation, regulation, and direct ownership.<sup>8</sup> In the case of the upgraders, the Saskatchewan government chose the policy instrument of public-private partnership. From the perspective of the public, it is easy to identify the benefits arising from difference that this brought to an upgrader pursued by government. In both cases, partnership brought experienced, competent operators to the enterprise. There were also particularistic synergistic benefits. In the case of NewGrade, partnership with CCRL/FCL resulted in a significant reduction in capital costs and integration of the upgrader into a refining/wholesaling/retailing value chain. In the case of Bi-Provincial, partnership with Husky resulted in integration with feedstock production and oil-patch transportation systems.

From the governmental perspective, the only real attribute demanded of the upgraders was that they exist and operate. All of the employment, economic stimulation, industry development, and royalty benefits desired by government came from normal commercial operation. To achieve these public policy benefits, the government did not have to seek to change the normal operating behavior or decisions of its private sector partner. In the case of the two upgraders, governmental use of partnerships was not intended to change the way the projects would be built or operated. Conflicts that did arise over procurement policies in the case of Bi-Provincial did not occur between Husky and the government but between the provincial governments of Alberta and Saskatchewan, as each sought to maximize the economic benefits within their own geo-political realm.<sup>9</sup> Even the royalty reductions given to Husky by Saskatchewan arose not from the upgrader project itself but from the need to equalize royalty treatment between the two provinces, which were necessary if Husky was to meet the politically-imposed requirement for equality in accessing feedstock.<sup>10</sup> These issues arose as a result of the Bi-Provincial upgrader's location and the partnership arrangement involving two provincial governments rather than from the project's nature as a public-private partnership. In the case of NewGrade, with a location more distant from provincial borders and only a single provincial government involved, economic impact concerns resolved themselves through the normal course of construction and operation. In a public-private partnership, where the P3s are inherently instruments of public action, democratically-established goals and modes of accountability have an uneasy relationship with commercial imperatives and private managerial discretion.<sup>11</sup> With the two upgrader projects the public policy goals could be achieved through normal operation designed to achieve commercial goals.

In most analyses of public-private partnerships in which infrastructure or services normally provided by the public sector are being delivered, the normal perspective starts initially from the question of what private sector characteristics can be beneficial to the public.<sup>12</sup> In the case of the public-private partnership in a field of activity normally within the realm of the private, particularly when no change in operating behavior is being demanded, the starting point can be flipped: What public sector characteristics can be useful or detrimental to the private sector partner? To the extent that one can generalize from two case studies, it would seem that the partnership with government has many downsides for a private sector partner. Governments are under pressure to make decisions for non-commercial reasons. Illustrative of this is the set of demands on procurement and employment, as citizens and corporations demanded favourable treatment as a matter of right. It is difficult, for example, to imagine the President of IPSCO demanding of a wholly-private construction project that engineering decisions on pipe specifications be made based on his company's product line.<sup>13</sup> Even where government resists these demands, costs and distractions can be imposed on the private sector partner. Government personnel and policies can change rapidly and, from the point of view of the partnership, capriciously.<sup>14</sup> Being a partner with government brings a much higher level of public scrutiny and embroils the private sector partner in political disputes and controversies that are not of its making.<sup>15</sup> Such involvement brings with it an official opposition motivated by the desire to demonstrate that its decisions and policies would be superior to those of the current administration, thereby exposing the government's partner to a group motivated to attack. Even questions of environmental and safety regulation can become complicated by the dual governmental role as both regulator and shareholder.<sup>16</sup>

Against this list of real and potential negative impacts for the private partner, the participation of the public partner is the cause of few of the synergistic benefits often cited in considerations of public-private partnerships. For example, because the partnership is operating within the normal sphere of activity of the private partner, it is unlikely that the public partner will be able to contribute any additional or specialized expertise. Indeed, in the case of NewGrade, when the government attempted to do so by nominating industry experts as their representatives to the Board, CCRL/FCL vigorously rejected the suggested changes to their operating procedures and personnel policies. This was seen by the private sector partner as an unwarranted intrusion into its realm and second-guessing of management decisions.

### **6.2.1: The Public Contribution to Synergy: Capital Provision for Non-Commercial Criteria**

In the case of the two upgraders, the public partner brought only two attributes that were capable of providing a synergistic effect when combined in a partnership with its private sector partner. These were the ability to assemble large amounts of capital using non-commercial means and the willingness to make expenditure and investment decisions in pursuit of public policy rather than only commercial goals. Without a public partner, neither Husky nor CCRL/FCL could have built their respective upgraders. The projects were too big for them without significant outside capital, and the risk/reward projections were such that outside capital was unavailable under normal commercial criteria. NewGrade was financed largely by debt covered by government guarantees<sup>17</sup>, and borrowed money was unavailable to Husky in the absence of such guarantees<sup>18</sup>. Husky was unable to attract private equity investors to the project even with government support and with the tying of feedstock market access to equity participation. Some form of partnership with the government was a pre-condition of the projects being built at that time.<sup>19</sup> In entering these partnerships, the Saskatchewan government based its decision on the public policy benefits of the upgraders.<sup>20</sup> When the upgrader partnerships were first being discussed, it was believed that they barely met normal commercial profitability thresholds. By the time agreements were finalized and construction began, it was very clear that, at that time and place, neither upgrader met normal commercial standards of viability. In the case of Bi-Provincial, partnership with government made it possible for Husky to build an upgrader that it strongly desired. In the case of NewGrade, partnership made the upgrader possible and served to convince a reluctant CCRL/FCL to proceed. In both instances, the government's ability to mobilize capital and deploy it to achieve non-commercial goals was the key component of its contribution to the partnership.

#### **6.2.1.1: Types of Public Participation in the Partnership**

Conceptually, there are two ways governments can use its financial capacity to change the risk/reward profile of a project. The first is to assume downside risk in the event that the project is not technologically or commercially viable. The second is to subsidize the project by assuming some portion of the capital or operating costs and funding them through revenue streams generated outside of the operations of the project. These two can be intertwined and connected. However, the conceptual difference is important in looking at the various ways government can choose to have the public support a project such as a heavy oil upgrader.

The purest way to assume risk is through a loan guarantee. With this, the cost of capital is borne by the project unless the project is incapable of supporting the debt. While the loan guarantee can serve to have a subsidizing effect by lowering the cost of borrowing, the primary purpose of the guarantee is to assume lender risk and thereby make capital available when it would not otherwise meet the risk/reward profile demanded by commercial lenders.<sup>21</sup> Indeed, the subsidizing effect of the loan guarantee can be eliminated entirely with the payment of a fee equivalent to interest savings in exchange for the guarantee.<sup>22</sup> With this, the government involvement would have no subsidizing effect, but the public assumption of risk would make it possible for capital to be raised. In the event of the guarantees being called, there would be a sudden and dramatic subsidizing effect. The loan guarantees therefore represent the potential of a subsidy but a potential that has, intrinsically, a high probability of coming to fruition. If the risk profile of the loans were low, guarantees would not be required.

The purest form of subsidizing a project is a direct grant, paid out either up-front to lower the capital requirements of the project or on an ongoing basis in order to change the economics of operation. Subsidy can also take many other forms.<sup>23</sup> In the case of NewGrade, subsidies took the form of equity investments that had little prospect of generating a commercial return, lower interest rates on the project's debt as a result of the government guarantees, and the elimination of royalties on natural gas inputs. In the case of Bi-Provincial, the 1984 agreement called for a direct grant from the federal government, with the balance of government support coming in the form of loan guarantees that would have had a minor subsidizing effect in the form of lower interest rates on borrowed funds. As oil prices deteriorated, other subsidizing mechanisms were considered, including direct government loans at below-market interest rates and price guarantees for the upgraded synthetic crude. In the end, the subsidizing mechanism took the form of equity investments that were not expected to achieve a commercial rate of return. For governments that were operating with deficits of their own, the result was increased borrowing and interest payments in order to advance the equity required.

For government, entering a partnership with the sole objective of causing a private sector project to be built when it would not otherwise have been is rife with both political and economic hazard. As the Mulroney administration was considering whether to honour the commitments made by its predecessor in providing loan guarantees, the economic analysis conducted by the TD Bank indicated that the project did not meet normal commercial risk/reward criteria and that financing would be unavailable without government guarantees. As a result, it recommended that loan guarantees be denied.<sup>24</sup> In reality, this conclusion was perverse. If the project met normal commercial criteria, then

Husky could have, and likely would have, proceeded on its own without government participation. In the absence of any changes in the project required for public policy reasons, it would be a pointless expenditure – real or potential – for the government to assume risk or subsidize a project when this support is not required. The finding that the project was not commercially viable should have been the starting point for further consideration as to whether the real or potential cost of government support was properly balanced by the non-commercial benefits such as increased employment and royalty revenue. In approaching a public-private partnership, government is in the position of Goldilocks tasting porridge. If it is too cold, public support is not required. If it is too hot, the required public support will exceed the public benefit. Finding a project or a bowl of porridge that is just right can be a tricky piece of business.

When the two Saskatchewan upgraders were being proposed in the early 1980s, oil prices had only recently risen to a level that made the projects just barely commercially viable. The significant capital investment required and risk profile was still such that public support was required if the projects were to proceed. Public support was seen largely in terms of assuming potential risk rather than subsidizing the projects. This changed with the drop in oil prices in the middle of the decade. With this, it became very clear to all partners, both public and private, that some level of public subsidy would be required, if the public policy benefits were to be achieved. The Saskatchewan and other governments would thus have to buy any benefits they received. Achieving them through the normal workings of the market was not going to occur in the foreseeable future.

#### **6.2.1.2: Transparency and Obfuscation in Forms of Public Participation**

In both cases, the Saskatchewan government made the explicit decision that the potential benefits, taken together, exceeded the costs.<sup>25</sup> Whether or not the decision was correct, it was informed and shaped by information and analysis that was accurate. For example, in 1985, officials at the Crown Investments Corporation predicted very accurately the amount of additional money that would need to be put forward by the partners in order to put the remaining debt on a self-sustaining basis.<sup>26</sup> On the basis of a balancing of the overall costs and benefits, the decisions to proceed and subsidise were defensible in that the government was choosing, with the partnership, to purchase specific public benefits. From this decision that was difficult, although conceptually simple, things got murky. The dynamic leading to problems in and restructuring of the projects was created.

The projects' future problems resulted from the tools used by the government to both assume risk and provide subsidy. A grant, either up-front or to subsidize operations as needed, would have made the government's fundamental policy decision straightforward and easy to analyse. The financial losses of the two upgraders – predicted as inevitable by government officials, private sector partners, and commercial lenders – would have been accounted for and balanced against the public benefits. If the predicted financial losses had been provided for by way of a straightforward grant, both upgraders would have performed more or less as predicted and no renegotiation of the agreements would have been required.

This approach was not taken and was not even actively discussed. There are likely two reasons common to both upgraders that this approach was not considered, as well as an additional one specific to NewGrade. The first impediment to a straightforward granting mechanism was political optics. During this era, government was making some tough and controversial spending decisions.<sup>27</sup> It would have been difficult to explain why spending money to encourage economic development in the oil industry was a higher public policy priority than, for example, maintaining the children's dental program. A straightforward grant would have been perceived as a giveaway to FCL and Husky and challenged by every citizen or group that wanted some other fiscal allocation from the provincial government.<sup>28</sup> A grant would also have had a direct and immediate impact on the province's books. Transparency can sometimes prevent governments from making policy choices.

The second reason for avoiding straightforward grants was hope. The projects' economic performance was, in the end, predicated upon volatile oil prices. If market conditions changed, the upgraders would become profitable.<sup>29</sup> Subsidy might not be needed. In that event, any grant would be an expenditure not needed to achieve the public benefits and a waste of scarce resources. A grant would also make it impossible for the government to recover, on behalf of the public, any resulting upside gain. Prudence and a desire to protect the public interest would move government decision makers away from straightforward grants.

In the case of NewGrade, the situation was complicated by the reluctance of CCRL/FCL to participate. Since the private sector partner refused to contribute to capital costs or assume any risk, any grant to subsidize a portion of the capital or operating costs was effectively precluded since the grant would need to be for the full cost of construction.

Since the option of a straightforward grant was not discussed by the Saskatchewan government, the reasons for it not being chosen are speculative. However, what is tangible is the resulting structure of government participation: Financing and governance tools designed for commercial activity were used to pursue non-commercial objectives. In this lay the origins of the resulting need to renegotiate the financial structure of both upgraders.

In the case of NewGrade, the ultimate financial structuring of the upgraders was in the form of a combination of equity and third party loans, guaranteed by the Saskatchewan and federal governments and a royalty rebate on natural gas which was used by the upgrader.<sup>30</sup> In the case of Bi-Provincial, what eventually emerged from the negotiating process was a project financed exclusively by equity.<sup>31</sup> The royalty concessions to Husky were not tied to the construction of the upgrader but rather specifically to the provision for equality of feedstock supply from Alberta and Saskatchewan.<sup>32</sup> Each of these two financing tools had different results.

The equity investments in both upgraders were made on the expectation that they would not yield a commercial rate of return for the foreseeable future.<sup>33</sup> The cost of capital was removed from the project and externalized to the government. Any difference between the cost of this capital and a return on the investment was effectively a subsidy for the project. Under Generally Accepted Accounting Principles, describing the governmental contributions as equity had the effect of delaying the posting of the cost of the upgrader on the provincial balance sheet.<sup>34</sup> During the construction period, the money being advanced was balanced against a new asset being created. As a result, while the injection of money had an effect on the Saskatchewan government's cash flow and borrowing requirements, it did not affect the provincial government's bottom line deficit.<sup>35</sup> The reporting of the fiscal cost of the decision to support the upgrader was, in the short term, neutral. This changed when the upgraders began operation.<sup>36</sup> At this point, CIC and ultimately the government as a whole were required to write down their pro-rata shares of upgrader losses.<sup>37</sup> This had the effect of reducing the book value of the province's contribution to the upgrader, with a corresponding dollar-for-dollar increase in the government's annual deficit. These reported losses included depreciation, so the impact on the province's bottom line was much greater than any cash deficiency or cash injection. In financial terms, describing the provincial contribution to construction as an equity investment thus had the effect of both delaying and spreading out the impact on the government's bottom line. In political terms, it had the effect of transforming the policy-driven expenditure into losses on an ill-considered investment. For the Devine administration, a controversial but defensible policy decision became, after its defeat, an

incompetent investment decision. This message was hammered home annually as operating losses and the write-downs inevitably continued. The upgraders were described in terms of these accounting losses<sup>38</sup> and as “money guzzling” even if the upgraders were meeting cash flow commitments.<sup>39</sup>

The effects of financing 80 percent of the capital cost of NewGrade through third party debt guaranteed by government was more problematic to the Saskatchewan government in the long term. With this debt financing, the cost of capital was internalized to the project. If NewGrade had been capable of covering the cost of this capital, conceptually, the loan guarantees would not have been necessary. As we have seen, however, the financial projections were such that commercial lenders had some reluctance to be involved, even with the protection of government guarantees. The consensus amongst those working on the project was that about \$300 million of the debt was unsupportable by the project,<sup>40</sup> and these estimates were very accurate. As with the equity financing, financing the project with third-party debt initially obscured the cost of the province’s participation. However, the potential for a sudden, immediate payment was created. Given the state of oil prices and the differential, this had a very high chance of occurring. When combined with CCRL/FCL’s contractual protections, the Saskatchewan government was in the position of having either to absorb an immediate and complete payment of its exposure or to provide additional incremental cash to stave off the catastrophic event.<sup>41</sup> Thus, one effect of the loan guarantees was to escalate the province’s commitments to the project regardless of the overall cost/benefit analysis that formed the basis of the original decision. When the Saskatchewan government made the decision to proceed, it was balancing the public benefits against the cost of a \$154 million equity investment that was not expected to generate a commercial rate of return. Within a few years of the beginning of operations, this had increased by another \$79 million of provincial government cash. The motivation for this additional commitment was not based on a cost/benefit analysis, but upon survival. Subsequent to the change in administration, the same dynamic caused the provincial government to put in another \$75 million and the federal government to contribute \$125 million. The trap of the loan guarantees thus caused an escalation of total public contributions to the project of \$279 million, with the incremental commitments being motivated by a fear of the consequences of a call on the loan guarantees rather than any assessment of the benefits arising from the upgrader’s operations.

Whether in the form of equity or loan guarantees, using these commercial instruments to achieve the public policy benefits of the partnerships had the effect of causing both upgraders to be seen simply as bad investments.<sup>42</sup> This was compounded by the government’s decisions on its own

internal management of the projects. When the basic terms and conditions of the upgrader agreements were being negotiated, the lead governmental agency was the Department of Energy and Mines, which had the broad mandate of promoting the development of the oil industry. As a result, the agreements were negotiated from the perspective of a balancing of the public costs and benefits of the upgraders overall. Non-commercial criteria such as impacts upon employment, economic development, and provincial royalties were intrinsic to the government's decision-making as to the level and terms of provincial participation. In both cases, once the framework agreements were established, detailed negotiations and ongoing management of the partnership relationship was turned over to CIC, as the manager of the province's investments. CIC's primary mandate was to secure a commercial rate of return on its investment portfolio. The agreements that CIC inherited, particularly in the case of NewGrade, bore little relationship to a commercially-driven joint-venture partnership for the simple reason that they were negotiated and signed for reasons other than achieving a commercial rate of return. One result was a flurry of cautionary memos and letters, as CIC staff, lawyers, and nominees to the upgrader boards argued that the allocation of risk and reward did not conform to normal commercial arrangements.<sup>43</sup> The providers of this advice were correct, but, like the TD Bank in its advice to the federal government, they missed the point that the upgrader agreements did not look like normal commercial partnership agreements because that is not what they were. The other was friction in the partnership relationship as CIC attempted to manage the partnership as if it were a normal commercial investment with an equitable allocation of risk and reward. To the private sector partners, this appeared to be an attempt by the government to renege on agreed upon principles.

### **6.2.1.3: Impact on Government of Different Forms of Project Financing**

Quite simply, when Bi-Provincial began operations, it was paid for by the partners. NewGrade was not. With a debt-to-equity ratio of 80:20, it was highly leveraged. With Bi-Provincial, the cost of capital for the governmental partners was already absorbed within their overall finances. With NewGrade, this cost of capital was largely internalized to the project. This difference arose not from a differential in the up-front commitments from Saskatchewan but from the province's inability to secure other partners willing to make equity investments. FCL saw no upside to investing; the federal government confined itself to assuming risk rather than providing subsidy; and FCL's desire for autonomy and its suspicion of potential competitors precluded whatever chance the partnership had in securing a third, equity-contributing partner as the original memorandum-of-understanding envisioned.

As a result of the different financial structures of the partnerships, initial losses had very different effects on the province's balance sheet. Bi-Provincial had cash deficiencies that were unpleasant but manageable for the partners. Most of the operating losses arose from non-cash charges such as depreciation. For Saskatchewan, these losses required a write-down that had an impact on the province's balance sheet and deficit targets.<sup>44</sup> However, these losses were predictable and, because Saskatchewan had a relatively low ownership share, sustainable. Following start-up, the province could live with the status quo, particularly if other partners could be convinced to assume the province's pro-rata share of cost overruns and cash deficiencies. For Saskatchewan in the early 1990s, a change in the structure of the partnership was desirable but was not a survival issue.

Because it was not fully funded, NewGrade was different in how the provincial government dealt with losses. The internalization of capital costs to the project in the form of debt meant that potential future cash deficiencies could be much larger. Once the province's equity was fully written off to account in accordance with the province's official 50% ownership share, the combined yoke of equity ownership and the loan guarantees meant the province would have to write off all future operating losses, including depreciation, creating a negative valuation for the investment. Thus, the guaranteed debt increased both the cash drain and the balance sheet implications of NewGrade on an ongoing basis, even in the absence of a call on the guarantees.<sup>45</sup> The structure of the guarantees and the trigger for a call upon the project's reaching its guarantee ceiling resulted in a financial Sword of Damocles hanging over its head. In the context of the province's overall financial position and its commitment to achieving specified deficit targets, the NewGrade guarantees created the prospect of a catastrophic financial event, unpredictable in timing but likely in probability. By the time of the administration change in the Saskatchewan government in 1991, NewGrade was being viewed by the governmental partner from the realm of loss and risk. The government acted with the same aversion to potential loss as its private sector partner.

The impact of fear on the part of government's behavior was reinforced by both the psychological and political reality that it was easier to justify the loss of money expended in the past rather than expend additional funds in the future. Thaler suggests that people are more willing to accept the loss of a sunk cost rather than to engage in new expenditures.<sup>46</sup> We see evidence of this, for example, in the reaction of the CIC Minister to the release of the Estey report, when he expressed concern about the affordability of the recommendation for an additional cash injection from the province while accepting without demur the recommendation for a much larger abandonment of any

claim on money already invested.<sup>47</sup> This psychological tendency was reinforced by both accounting and political realities. The existing investment's being renounced was already written-down on the province's books, so the action had no new impact on the government's fiscal plan, and the write-off could be (and was) blamed on decisions of the previous administration. This willingness to abandon sunk costs is also evident in the decision by Alberta and Canada to sell their interests in Bi-Provincial at a significant discount. It is telling that, when Saskatchewan justified its decision to stay on as a partner in the project, it cited the \$150 million impact on the province's deficit rather than the \$234 million cash loss that would have actually occurred had it joined its governmental partners.<sup>48</sup>

#### **6.2.1.4: Evaluation by Policy or Commercial Criteria**

The tension between the government's policy objectives of entering the upgrader partnerships and its structuring of its participation as if they were normal commercial investments was never really resolved by the Saskatchewan government. Indeed, it was rarely even articulated. Perhaps the clearest expression of this came in the spring of 1995, during the debate on legislation to repeal *The NewGrade Energy Inc. Protection Act*. During second reading, former Premier Devine conducted his last significant contribution to debate in the Saskatchewan Legislature.<sup>49</sup> He started with fretting about the future of the NewGrade upgrader. In a manner remarkably similar in both tone and content to Blakeney's a decade earlier<sup>50</sup>, when the original legislation to authorize the government's participation in the venture was being debated, Devine asked a series of questions about projections for the differential, interest payments, and operating results. Both former Premiers, when in opposition, clearly understood the hazards and vagaries facing their successors and worried about the future of both the project and the province. Then came the substantive delineation of the commercial versus the non-commercial aspects of the upgrader partnerships. Devine demanded that the government articulate the public benefits created by the upgrader. Saying that "the public deserves to know the whole picture," the former Premier noted that NewGrade "generates substantial amounts of jobs in the oil patch, royalties coming into the province of Saskatchewan ... and you don't want to acknowledge that."<sup>51</sup>

Speaking on behalf of commercial imperatives, CIC Minister and Deputy Premier Ed Tchorzewski replied that "my position is that the NewGrade upgrader, as it was, would not have made any money until the year 2025 as a commercial entity. And I say to you, on that basis, it is a bad investment. It had to be repaired."<sup>52</sup>

Devine continued arguing for a holistic view, saying, “you have access to the royalty on the oil because you set that level. And you have equity in the upgrader. You can make money in [sic] the upgrader and you can make money in [sic] the royalty. You could make money in [sic] both as an equity participant.” It was, he said, much like a farmer selling himself grain to feed his cattle. “[A]s a farmer, he’d make that decision because it’s an integrated decision.”<sup>53</sup> Devine argued that his successor was refusing to look at the entire picture. “He owns the oil royalty and he’s got equity in the upgrader and [I’ll] be darned if we can get him to admit he has both. He just won’t do it.”<sup>54</sup>

Tchorzewski defended the evaluation of the projects on a commercial basis just as vigorously, saying “NewGrade doesn’t pay royalties. The producers who produce the oil pay the royalties to the province of Saskatchewan...now just because producers pay royalties doesn’t that mean we shouldn’t try to make the New Grade upgrader as a self-standing entity ... become commercially viable”.<sup>55</sup> Tchorzewski’s analogy was one of a person owning two shoe stores, one profitable and one losing money. Accepting losses in one on the grounds that the second was profitable was a poor business decision.

The two analogies crystallize the different points of view. Devine saw activity in the oil patch being with the result of the upgrader and dependent upon it. Without the upgrader (feed grain) the oil patch (cows) would starve. Tchorzewski saw them as two separate and independent entities. As a result, losses in the upgrader or the unprofitable shoe store were simply a drain on financial resources.

This debate was a rare moment of illumination on the contradictions inherent in the Saskatchewan government’s approach to its public-private partnerships for the upgrading of heavy crude oil into synthetic crude. It had proceeded with the upgrader projects to secure economic development, jobs, and oil production royalties even though the upgraders, in the market conditions of the time, were not themselves viable on a commercial basis. Indeed, the lack of commercial viability was the reason that justifying government participation was necessary, since the upgraders would not have been built without public assumption of risk and subsidy. However, the upgrader partnerships were structured as if they were commercial investments using commercial tools and instruments. Their performance then came to be evaluated based on commercial criteria and, almost inevitably, found wanting. This contradiction, combined with the fiscal crisis facing the Saskatchewan government in the early 1990s, propelled the Romanow government into setting out to renegotiate the terms and conditions of the upgrader partnerships. Its objective was essentially defensive – to limit and make predictable the impact that the upgraders would have on both the province’s cash flow and fiscal

balance targets. In both cases, therefore, the Romanow administration sought to keep the upgrader operating. It was willing to invest additional funds so long as these incremental investments increased the long-term prospects for a recovery of public funds and were consistent with the provincial government's meeting its financial targets.

### **6.2.2: Particularistic Synergy and the Erosion of Trust**

The existing literature on public-private partnerships suggests that the risk most difficult for the partners to manage is revenue risk and that trust, whether existing from the beginning or created through common action, is essential for a successful partnership.

Revenue risk is inherent in public-private partnerships that are operating the realm of the private sector. Goods or services are produced for the marketplace with all of the attendant uncertainties this brings. Revenues insufficient to ensure commercial viability create tensions amongst the partners, as the allocation of resulting losses must occur. This tension has a very high degree of certainty of occurring in these public-private partnerships that were created because the venture did not meet the normal criteria of commercial viability that would allow the private sector partner to go it alone. In a partnership where tension arising from insufficient commercial viability is likely, trust is built and maintained when partners refrain from acting in an opportunistic fashion in order to take undue advantage of their partners.<sup>56</sup> The ability to build trust is also predicated on the ability of each partner to see that the other is behaving in an honourable fashion.<sup>57</sup> As a result, transparency becomes important.

One of the ironies of the NewGrade partnership was that the feature that created powerful particularistic synergies was the same feature that undermined trust relations between the partners. One of the key synergies for the NewGrade upgrader was the integration of the upgrader with the existing CCRL refinery. It was believed that this integration would reduce the capital costs of the upgrader by about 50 per cent, and this expectation was met. However, this integration created an intrinsic conflict of interest situation for CCRL as operator, and made monitoring of its decisions about allocation of expenses to upgrader or refinery very difficult and complex. Physical integration was a source of huge synergistic benefit which reduced the capital costs of the project by almost 50%. However, when combined with financial and ownership separation, it was also a source of mutual antagonism. As Estey put it, "what the engineers necessarily integrated, the lawyers artificially segregated...it is not at all surprising that differences have arisen from this cost allocation process."<sup>58</sup>

The erosion of trust was compounded by a pricing formula for sale of synthetic crude from NewGrade to CCRL that was opaque. In the case of Bi-Provincial, allocation of expenses was easily defined by a transparent and clearly demarcated framework for pricing and sales. The pricing of the sale of heavy crude by Husky to the upgrader was easily verifiable by reference to current market prices being obtained by sales of equivalent crude to other purchasers. The sale of synthetic crude from the Bi-Provincial upgrader was on the open market to other refiners, with no potential for a conflict-of-interest for Husky.<sup>59</sup> By contrast, the transfer price of upgraded synthetic crude from NewGrade to the CCRL Refinery was formula-derived. Until the renegotiation of the operating agreement was concluded, there was no externally verifiable reference point that would allow the government nominated board members and staff to assure themselves that a fair price was being received.<sup>60</sup>

As a result of these differences, the Saskatchewan government was much more concerned with monitoring and controlling of NewGrade than Bi-Provincial. It placed industry experts on the NewGrade board and created staff capability to scrutinize every operational and allocation decision made by CCRL as operator. In retrospect, there is no evidence that CCRL management used their position to extract undue benefit from NewGrade. However, the existence of the additional monitoring and surveillance had the effect of creating a spiralling cycle of distrust and hostility between the partners. CCRL/FCL believed, quite rightly, that it was being treated with distrust and that its ability to operate both the refinery as well as the upgrader properly was being questioned.<sup>61</sup> The aggressiveness of their response seemed to the government to be confirmatory evidence of malfeasance.<sup>62</sup> This governmental suspicion of CCRL/FCL management was well established before the change in administration in 1991, and it carried over into the new administration. Because of the different structures of the two projects, Husky was never subjected to anything approaching this level of scrutiny as operator. An acceptable level of trust was much easier to maintain.

### **6.3 Impacts Arising from the Different Nature of the Private Sector Partners**

Differences in the views of the leaders of each partner, the organizational culture and decision making process of each partner produce different dynamics across partnerships. In addition, differences in the extent to which the partnership venture aligns with the overall corporate strategy will result in different levels of commitment to the success of the partnership by the private sector partner.

### **6.3.1: Impact of Different Corporate Cultures and Decision Making Processes**

In many ways, Husky and FCL were polar opposites. By the early 1990s, Husky was firmly under the ownership and control of a single individual. There was a clear, hierarchical decision-making process. FCL, on the other hand, was owned and controlled by several hundred independent co-operatives that were, in turn, owned by their membership. Decision-making with this partner was complex and consultative with FCL management being responsible to elected officers who were, in turn, accountable to the member co-operatives. This difference had a number of results, the most important of which was that Husky was far more able to respond quickly to changing circumstances and could be more flexible in its response. For fundamental change in the Husky relationship, only one individual had to be convinced, and this individual was very experienced in quickly reaching pragmatic solutions. In the case of FCL, decision-making was much slower, due to the number of individuals involved in the consultative and decision-making processes. These processes also built in a significant amount of inflexibility, since large numbers of people had to be convinced of the correctness of one course of action. If the leadership wanted to change this course, they were in a vulnerable political position until and unless they could go through a process of changing many minds. Broad-based, democratic processes locked FCL's leadership into an entrenched position, and pursuing one course could make it more difficult to change direction in the future. For example, we have seen how the absolutist position taken in order to more effectively mobilize the co-ops' membership to resist the government then served to make a negotiated settlement far more difficult.

Husky and FCL also differed on their respective leadership's assessment of their ability to challenge government. Li Ka-Sheng's acquisition of Husky was part of a strategy of political risk insurance in the event of unpleasant developments following Hong Kong's transfer from British to Chinese jurisdiction. He was also a stranger investing in a strange land. Both geography and circumstance would serve to move him to a position of accommodation rather than conflict. FCL, on the other hand, was organically connected into each and every community in Saskatchewan. Its members and activists were in leadership positions in the province. As a corporate entity, FCL was in an almost unique position to politically challenge the elected provincial government. If FCL was stronger politically than was Husky, the reverse was true economically. Even though FCL's financial position had improved by the time the Saskatchewan government demanded changes in the upgrader agreements, the ability of Husky's ownership to make large capital investments for long-term purposes was much greater than that of CCRL's owner. Husky's owner could tell all three government partners that he was prepared to

go it alone in assuming all future liabilities from Bi-Provincial. For CCRL's owner, the projected cash deficiencies for NewGrade represented about half of its annual net profits.

There were also different organizational cultural orientations. Husky's ownership was steeped in the traditions of Guanxi, with its emphasis on long-term relationships and partnerships. As Husky worked to overcome the start-up operational problems, its clear message to all three governments was that a choice was necessary – governments could choose to be partners and behave in a proper partner-like way, or Husky could go it alone. When it became clear that the Saskatchewan government would be a partner after the departure of the governments of Alberta and Canada, the response of Husky's ownership was to make concessions in its position that would contribute to the building of a harmonious and equal partnership. For Husky's owner, partnership was a relationship involving reciprocal rights and obligations.

The cultural orientation of FCL's leadership was very different. It was imbued with a sense of the mission of co-operative enterprise as a morally-superior form of economic organization. It repeatedly demonstrated its fundamental distrust of those outside the co-operative movement and refused to partner with those it deemed to be competitors. Instead of a pragmatic approach of compromise and developing a relationship, FCL attached great importance to the sanctity of a contract. This importance of adhering to contractual provisions went both ways. For example, there is no evidence that CCRL/FCL abused its contractual position to take advantage of the intrinsic conflict-of-interest position it was in as operator of the upgrader. However, it insisted upon full and complete recognition of the contractual rights it had negotiated. When FCL entered the upgrader negotiations, it did so on the basis that the corporation be the operator, assume no risk, and contribute no capital. Once the government accepted these conditions, the issue was settled permanently, as far as FCL was concerned, regardless of changing circumstances or the needs of its partner. Any request by its governmental partner to change these terms was interpreted as reneging on an agreement.

### **6.3.2: Impact of Occupying Different Positions on the Petroleum Value Chain**

Although these cultural and circumstantial differences between Husky and FCL contributed to the difference in the way negotiations went, the nature of the synergies created by the two partnerships was likely even more important. NewGrade fit into the bottom of CCRL/FCL's value chain. The synthetic crude was refined into finished petroleum products, wholesaled to member co-operatives, and retailed to customers. Notwithstanding limited acknowledgement about the long term security of supply, if the

synthetic crude was not available, the CCRL refinery would simply use its alternative, traditional feedstock. For CCRL/FCL, the only economic benefits arising from the upgrader were those directly generated by it. If NewGrade was not profitable, it contributed nothing to FCL's bottom line. This made CCRL/FCL a very reluctant partner. NewGrade was seen primarily in terms of risk to be avoided. In 1985, when it became clear that the upgrader was unlikely to generate any profits for the foreseeable future, this risk avoidance was combined with the demand for a guaranteed rate of return regardless of NewGrade's own performance. This was granted by the Saskatchewan government in the form of an increased management fee and the concessionary provisions for the supply of natural gas. The profits secured by CCRL/FCL as a result of this were modest in financial terms but, when combined with the detailed protections against risk, created a partnership structure that was profoundly one-sided. Throughout the debate on the upgraders, CCRL/FCL took the position that they would not have participated under any other terms, and they were very likely genuine in this protestation. Without the contractual terms they negotiated, the position of the upgrader within their value chain meant that, in the absence of upgrader profits, NewGrade brought nothing but risk.

The Bi-Provincial upgrader, however, was at the top of Husky's value chain rather than the bottom. Over several decades, it had invested in heavy oil production in Alberta and Saskatchewan. It had explored in the area, drilled wells, and laid collection pipelines. By providing stable and secure markets for its heavy oil production, the upgrader increased the value of all these existing assets. It also provided a market for the TOPS by-product for its new refinery in Lloydminster. As Husky President Art Price told the three governments in December 1987, Husky had compelling corporate reasons to build an upgrader even if, on a stand-alone basis, it did not achieve a commercial rate of return. There was a point at which the cost of the upgrader to Husky would exceed these benefits, but the position of the upgrader within the corporation created a commitment to the project.

As a result of the differential impact of the upgraders on each owner, Husky was an eager partner, while FCL was an extraordinarily reluctant one. Throughout the negotiating process for Bi-Provincial, Husky was always the project's proponent, while Saskatchewan was prepared to walk away at a number of points. With NewGrade, the Saskatchewan government was the ardent suitor, with FCL the reluctant and hesitant bride. The most concrete manifestation of this differential position was whose signature was on the cheques for engineering and design expenditures prior to the final agreements being reached. In both cases, these expenses were approximately \$100 million that would

be lost if the project did not proceed. With Bi-Provincial, Husky advanced the funds and was uncomfortably exposed. With NewGrade, the Saskatchewan government had paid the bills.

### **6.3.3: Impact of Different Perspectives on Loss and Gain**

When it came time to respond to dealing with the cash deficiencies, operating losses, and the Saskatchewan government's desire to change the structure of the agreements, this differential position still existed. Even with upgrader operating losses, Husky was still approaching the project from a position of gain. CCRL/FCL saw no potential gain in the foreseeable future and indeed gave up the opportunity to assume full ownership for \$1.00 when the guaranteed debt was paid off as had been recommended by Estey.<sup>63</sup> For this partner, the upgrader was defined strictly in terms of risk and potential loss. Kahneman and Tversky have documented how people and organizations attach greater significance to a potential loss than a potential gain.<sup>64</sup> As a motivating factor, fear trumps greed.

The cultural and governance differences between the owners of CCRL and Husky thus likely orientated one of the Saskatchewan government's upgrader partners towards fight and one towards accommodation. However, their differential behavior was also rooted in the differential impact the upgraders had on their overall corporate operations. For Husky, negotiations were about gain. For FCL, they were about the avoidance of loss. In addition to leading to differential negotiating positions, the differential motivators of greed and fear helped make FCL much more aggressive in support of its original position.

### **6.4: Impacts Arising from the Different Number of Partners**

A final significant difference between the two projects was difference in the number of partners. The NewGrade partnership was, in essence, a dyad relationship while at Bi-Provincial the relationship dynamic involved four partners.

There were two shareholders in NewGrade- Saskatchewan and CCRL/FCL. Although the federal government was involved as a guarantor, its role in this upgrader was very passive. The federal government insisted that Saskatchewan and CCRL/FCL come to an agreement on both the original agreements and on changes to the agreement following Estey. The essential terms of these agreements were then subsequently endorsed – sometimes with reluctance – by the national government. In

questions of the day-to-day governance and monitoring of the partnership, the federal government tended to simply endorse the position of the provincial government. Indeed, although it had the right to nominate one board member, this position was left vacant for long periods of time and was only filled in response to pressure from the Saskatchewan government. Publicly, the federal government neither sought nor received any significant amount of credit during happy times and largely avoided blame during unhappy ones.

The situation was very different with Bi-Provincial. There were three governmental partners, with the federal government being the largest investor. The federal government was much more actively involved in negotiations and, because of the close congruence between agreements and announcements with the federal electoral cycle, the federal government was the primary recipient of both favourable and unfavourable commentary.<sup>65</sup>

The impact of numbers in dynamics within a group has been a subject of much sociological analysis. Simmel argued that the most important distinction was between groups of two and groups of a greater number. While the bulk of his analysis was on differences between dyad and triad groups, he suggested that the dynamics of groups of larger numbers were not qualitatively different than the dynamics of triadic groups. For Simmel, the key feature of a dyad relationship is that it ends with withdrawal of one party. This increases both the bargaining power of each side of the relationship and intensifies feelings of both affection and hostility. The addition of members to the group allows for the group itself to continue after the withdrawal of one member, which has the effect of both lowering the intensity of feelings of the partners to each other and introducing the possibility of alliances and inter-group jealousies.<sup>66</sup> Simmel's theoretical insights have been confirmed in other sociological work<sup>67</sup> and by experiments based on game theory.<sup>68</sup>

The unfolding of events in the two upgraders is consistent with the findings of this body of literature. In the case of NewGrade, the dyad relationship had the seeds for an intensification of disputes and acrimony and an escalating pattern of distrust. The multi-partner structure of the Bi-Provincial consortium diffused potential acrimony between Husky and the governments. Husky consistently served as the proponent for the project, while the relationships amongst the three governments varied with circumstances. At various points, the three governments came together to present a united position to Husky, but these moments of governmental unity were fleeting. Prior to the signing of the 1984 memorandum, Alberta and Saskatchewan were willing to walk away from the project and worried that the federal government would yield too many concessions for its own political

reasons. After the agreement was signed, and subsequent to the 1984 change of government at the federal, the Alberta and Saskatchewan governments then made common cause with Husky in an attempt to force a reluctant federal government to move forward. By 1988, all three governments were articulating different positions. Saskatchewan's position began to converge with Husky's, and Saskatchewan then devoted its efforts to convincing the other two governments to move in this direction. Following the 1988 agreement, unity prevailed until the second bill for capital cost overruns arrived. At that point, Saskatchewan separated from the other three partners. This situation held until Alberta and Canada decided to exit, at which time Saskatchewan once again joined with Husky. Throughout this entire process, the most intense conflict was between the three governmental partners rather than between any or all of them and Husky. Even when two of the three governments were aligned on general terms, conflict remained. For example, as Alberta and Saskatchewan joined to urge the federal government to honour its commitments to the project, they were vigorously disagreeing about the division of economic benefits from the upgrader's construction. In these disputes, Husky, as operator and contractor, was a passive observer. It mattered not to Husky where a contractor paid its provincial income tax, but both provincial governments were very determined not to be seen as allowing the other province to receive more than its appropriate share of benefits.

The effect of the difference in the number partners involved was varied over time. During the stage of negotiating the original agreements-in-principle, the dyad relationship of NewGrade resulted in much quicker resolution than was the case for the larger, more cumbersome partnership that created Bi-Provincial. Indeed, even though the two projects were conceived at about the same time, NewGrade was constructed by the time an agreement-in-principle was reached for Bi-Provincial. However, when the upgraders were built, the dyad partnership at NewGrade contributed to the escalation of distrust and conflict while the prospect of coalition building amongst the more numerous partners at Bi-Provincial contributed to the maintenance of relatively harmonious relations between Saskatchewan and Husky.

## **6.5: Partnership Success and the Operating Environment**

The purpose of this section is to examine the effect of the operating environment on the success or failure of the partnership. The key question addressed is whether the upgraders were "good projects" or "bad projects" The key factors are market conditions in the oil industry and the price of crude oil.

By the early 1990s, the political consensus supporting the development of heavy oil upgraders in Saskatchewan had evaporated. Premier Romanow was describing the terms and conditions of upgrader agreements with descriptors such as “unconscionable and immoral.”<sup>69</sup> The Saskatchewan Taxpayers’ Association congratulated the Premier for “for taking taxpayers into account” when he offered to sell the province’s \$253 million ownership share in NewGrade for \$1.00.<sup>70</sup> Clearly, the consensus view about the desirability of public-private partnerships to build heavy oil upgraders had eroded. Conservative members of the legislature joined FCL management in pointing to the job creation and the oil royalty impact of the upgraders. However, the ability of these groups to present a positive portrayal of heavy oil upgraders was undermined by FCL’s management refusal to assume any risk arising from NewGrade, even when Estey recommended CCRL/FCL should be given complete ownership as soon as the guaranteed debt was paid off. In the early- to mid-1990s, Saskatchewan upgraders were generally considered bad projects created out of bad partnerships.

Flyvbjerg has examined the decision-making processes leading to major infrastructure projects that suffered from significant cost overruns and/or did not achieve the public policy benefits expected of them. He argues that there is a tendency to over-estimate benefits while under-estimating costs and risk. The result is that “misinformation about costs, benefits and risks is the norm throughout project development and decision making, including the business case.”<sup>71</sup> He also argues that the tendency to produce misinformation about risk, costs, and benefits is particularly true when the project can be seen to have a significant effect on regional economic development.<sup>72</sup> In their study of investments by government purported to be failures, Borins and Brown conclude that “the projects ran into difficulty primarily because of management errors, bad political decisions and poor monitoring systems rather than adverse environmental changes.”<sup>73</sup>

The structural tendency of organizations to produce misinformation supportive of proceeding with a project considered bad or the attribution investment failures to incompetence does not seem to apply in the case of Saskatchewan’s two heavy oil upgraders. The upgraders were always acknowledged to be inherently risky and, after the decline in oil prices in the mid-1980s, fundamentally uneconomic according to normal commercial criteria for risk and reward. Decision-makers were presented with information about projected economic performance that, in retrospect, was remarkably accurate for the first decade of the upgraders’ operations.<sup>74</sup> The financial problems facing the upgraders were predicted in advance, quantified, and deemed acceptable when compared to the resulting potential public policy benefits. While there are some inherent difficulties in the precise measurement of these benefits, it

would appear that they were described reasonably accurately. Further, both upgraders were built and operated in a competent manner. Both projects were completed according to schedule. NewGrade was completed on-budget, and the Bi-Provincial's cost over-runs were lower than average for major projects.<sup>75</sup> After overcoming initial start-up problems that lasted, in each case, about 18 months, both upgrader operators achieved throughput levels that met or exceeded design capacity at costs consistent with business plan projections. In the words of Estey, each upgrader was an "operating success."<sup>76</sup> The problems facing the two upgraders in the early- to mid-1990s were not the result of irrational decisions, misinformation, or incompetence.

There is also the question as to whether the public perception in the mid-1990s that the upgraders were failures was accurate. There is no doubt that they were in financial trouble. This, however, was largely due to the prolonged slump in oil prices with the resulting squeeze on the differential between light and heavy crude. If world crude prices had been in the range of \$25 to \$35 per barrel for the decade following NewGrade's coming on stream rather than stuck in the \$13 to \$23 range, financial losses would not have propelled a drive to restructure. When oil prices eventually improved, both upgraders became profitable. When oil prices improved a lot, they became very profitable.

As the Saskatchewan government was working to renegotiate the terms of each upgrader agreement, maintaining operation was one objective. Indeed, Bill 90 was titled "An Act to protect the financial viability of NewGrade Energy Inc." Further evidence of the two upgraders' fundamental strength as projects is underscored by both partners' subsequent decisions to expand the upgraders. In expanding, both Husky and CCRL/FCL wanted to go it alone, without the Saskatchewan government's participation. Unlike initial construction, the capital costs of expansion were covered by the private sector owners using normal commercial financing measures. Government support was neither provided nor requested. Indeed, in both cases, the sale of Saskatchewan's equity interest was seen as a pre-condition for expansion.

The NewGrade and Bi-Provincial upgraders provide the opportunities for insight into the dynamics of public-private partnerships. The projects were both successful in the long term but underwent significant stresses in their early years. The common features of their experience allow us to make some observations about the nature of public-private partnerships, while their very different paths to restructuring provide the opportunity to examine what specific features in such partnerships contribute to the creation and maintenance of trust between the partners.

## 6.6 Concluding Observations

The public-private partnership model was successful in causing the two heavy oil upgraders to be built in Saskatchewan. The combination of public assumption of risk subsidy with the private sector expertise and position within their corporate value chain resulted in the creation of enterprises that were successful in the long term both commercially and in achieving the public policy benefits. The strengths and weaknesses of this partnership model can be seen from the twin facts that:

- Both of these upgraders have undergone significant expansion. However, in both cases, the private sector partner preferred to proceed alone on expanding rather than maintaining the partnership, and
- No other upgrader has been built in Saskatchewan, even though market conditions for oil have been favourable for the past decade.

The public-private partnership yielded synergistic benefits powerful enough to cause the projects' creation, but where difficulties arising from differences in the positions of public and private sector partners were sufficiently profound and the partnership was no longer necessary for construction and survival, it was dissolved. Even after exiting the partnership, however, Saskatchewan still continued to receive the public policy benefits of employment, industry sector development, and the revenues arising from incremental oil production. The provincial government did not need to use the partnership to change what the private sector partner would have done on its own – it simply needed to make it possible for its partner to go forward with the project.

For the private sector partner, dealing with government in the relationship could be tremendously frustrating. It could also be very lucrative. Not only did the partnership with governments make it possible for Husky and CCRL/FCL to proceed with projects that transformed their business, the very lurches and reversals of governmental direction made windfall gains possible. With Bi-Provincial, Alberta and Canada essentially walked away from hundreds of millions of dollars in investments following changes of the governing party. With NewGrade, FCL received its first 50 per cent ownership share for \$75 million, while Saskatchewan paid over \$300 million for the publicly-owned half, and the federal government gave \$125 million in kiss-goodbye money simply in order to be allowed to leave. A decade later, FCL paid \$320 million for the other half of the upgrader – something it could have had for \$1.00

had it so chosen. In any event, by this time, the risk was largely gone from the project, the debt was retired, and the enterprise was spinning out cash. FCL's purchase price for the Saskatchewan government's equity share was based on an earnings-to-value ratio of 1:3, which is a deal that would be difficult to obtain in the open market.

For governments, public-private partnerships are fraught with both economic and political risk. On the surface, such projects "were great politics. If a project could not generate at least three or four ribbon cuttings with smiling politicians, there was something wrong with the government's communications staff. The photo opportunities were great and the speeches even better."<sup>77</sup> Appearances can be deceiving. Upgrader launches or expansions provided no assurance of re-election for local government representatives.

The most problematic issues with the public-private partnerships for the public interest are establishing a clear outline of public benefit and costs and having appropriate means to finance and govern the partnership. As was noted above, all that the government can really bring to such a partnership is the ability to access capital and spend it in pursuit of non-commercial goals. In doing so, governments on behalf of the public can assume risk, subsidize, or both. This forms the basis of the public-private partnership, and makes it possible for projects – worthy or not – to proceed when it would be impossible for the private sector actor to proceed alone.

In the case of the two upgraders, commercial tools and instruments were used to have the public assume the risk and effectively to provide subsidy during the start-up years. One effect was to undermine, in the longer term, any potential political benefit from the ventures. The predicted lack of immediate commercial viability was transformed into results that were deemed losses and bad investments, as the upgraders were judged by different criteria than those that had led to their creation. The second effect was a loss of transparency of the cost of the public support for the projects. The economic costs only appeared on the government's balance sheet years after the policy decision had been made. In the case of the loan guarantees, the cost was a potential (and probable) one that would have had catastrophic consequences to the province. Finally, the form of these investments contributed to conflicts with the private sector partners. If the government fooled the public about the nature of its partnership, it also fooled itself. Officials charged with dealing with the projects proceeded "as if" they were commercial investments, when they were not. This contributed to the private sector partners, particularly FCL, feeling as if government was constantly attempting to renege on negotiated terms and conditions.

Making matters much worse at NewGrade was the effect of the financial structure. The internalization of the cost of capital, the nature of the loan guarantees, and the long depression in oil prices and the differential all combined to cause both the Saskatchewan government and FCL to view the upgrader simply from the perspective of loss and risk. Given the time of the early 1990s and the conditions that then prevailed in the location of the partnership, both partners viewed the potential losses and liabilities as a survival issue – a desperate, escalating, unrelenting struggle for survival. The remarkable thing in this case is not actually the nature of the fight but rather the ability of both sides to co-operate after it was over. Significantly, this occurred when the debt restructuring reduced cash deficiencies to a sustainable level and reduced the likelihood of a call on the loan guarantees. When the allocation of risk was no longer seen as a survival issue, getting along became possible. With the elimination of desperation, the introduction of a transparent transfer pricing mechanism and the opening of the arbitration process could then slowly rebuild some trust between partners. It is worth noting that the arbitration process was never actually used after 1994.

In the end, Saskatchewan has been left with two heavy oil upgraders that have provided markets for heavy oil producers, contributed to the development of the province's oil industry, generated royalties for the province's treasury and created jobs for the Saskatchewan workers. These benefits were made possible by the synergistic effects of public-private partnerships. At the same time, it should be noted that these benefits came with significant financial cost to Saskatchewan. It is also worth noting that when changes in market conditions caused each of the private sector partners to expand the upgraders, they wanted to do so without their governmental partner.

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## Endnotes

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<sup>3</sup> Best, Dunny. "Friends may not be enough" *Financial Post*, December 14, 1985.

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