Today's Resources, Tomorrow's Legacy:

NWT Heritage Fund Public Consultation

February 2010

Northwest Territories Finance

Northwest Territories

Kīspin ki nitawihtīn ā nīhīyawihk ōma ācimōwin, tipwēsinēn.

Cree

ʔerihtł'ís dëne sųłiné yati t'a huts'elkër xa beyéyati theʔą ʔat'e, nuwe ts'ën yółti.

Chipewyan

If you would like this information in another official language, call us.

English

Si vous voulez ces renseignements en français, contactez-nous.

Français

Jii gwandak izhii ginjìk vat'atr'ijąhch'uu zhìt yinohthan jì', diits'àt ginohknìi.

Gwich'in

Hapkua titiqqat pijumagupkit Inuinnaqtun, uvaptinnut hivajarlutit.

Inuinnaqtun

ᑕᒃᑯᐊ ᑎᑎᖅᑲᐃᑦ ᐱᔪᒪᒍᕕᒋᑦ ᐃᓄᒃᑎᑐᓕᖅᓯᒪᓗᑎᒃ, ᐅᕙᑦᑎᓐᓄᑦ ᐅᖃᓚ ᔪᓐᓇᖅᑐᑎᑦ.

Inuktitut

UVANITTUAQ ILITCHURISUKUPKU INUVIALUKTUN, QUQUAQLUTA.

Inuvialuktun

K'éhshó got'įne xədə k'é hederi ʔedįhtl'é yeriniwę nídé dúle.

North Slavey

Edi gondı dehgéh got'įe zhatié k'éé edatł'éh enahddhę nide.

South Slavey

Tłįchǫ yati k'ęę̀ dè wegodıì wek'èhoızǫ nęęwǫ dè, gots'ǫ̀ goahde.

Tłįchǫ

Foreword

One of our greatest strengths as Northerners is the value we place on our land and its resources. The concept of a Heritage Fund is part and parcel of that value and fits with the long term vision of the 16th Legislative Assembly.

The NWT is blessed with a vast treasure of non-renewable resources. However, once these resources are taken out of the ground they are gone forever. Our challenge is to ensure that the transformation from a non-renewable resource to dollars provides a lasting legacy for both current and future NWT residents.

A Heritage Fund is a way to save for future generations. However, before a Fund is established, we need to determine how much should be saved and what form these savings should take. When we talk about leaving a legacy for future generations, do we mean a rainy day fund or lasting investment in human and physical capital? The investments we make now in education, health care, affordable housing, and infrastructure to grow and diversify the economy will also be of benefit to future generations. How much more in the form of a Heritage Fund is a fair balance between now and the future?

This paper provides a short background of the issues and raises a number of questions for discussion. Our aim is to seek the views of NWT residents about the creation of a long term savings plan that could maximize the benefits of non-renewable resources to NWT residents, present and future.

I encourage all NWT residents to provide their views.

Hon. J. Michael Miltenberger
Minister of Finance

Introduction

The NWT has vast non-renewable resource wealth and the prospects for development of these resources are substantial. However, the revenue from this development is different from most other sources of government revenue, as it represents the transformation of non-renewable assets into financial form.

The Government of the Northwest Territories (GNWT) is considering establishing a Heritage Fund to save income from NWT non-renewable resources. A Heritage Fund could play an important role in preserving the benefits of resource development by funding long-term investments in infrastructure or financial assets and thereby ensuring the revenues earned from developing NWT non-renewable resources benefit this and future NWT residents.

Once devolution of the NWT's non-renewable resources is achieved, royalty revenues currently flowing to Canada will be paid to NWT governments. Although a portion of these revenues will be offset by a lower Territorial Formula Financing Grant, the GNWT will receive a net fiscal benefit since the Grant reduction will be less than the royalty revenues received.

The government will face a number of choices for the use of the net fiscal benefit, including:

- Allocating the funds, or a portion of the funds, to current spending, augmenting programs or reducing the need to constrain forced growth pressures;
- Allocating the funds to a long-term savings fund, with no portion of the funds used for current expenditures or capital investment; or
- Allocating the funds to a savings fund, which could make investments either in infrastructure or in financial assets that will pay a future return to NWT residents.

This paper discusses some of the considerations that would arise from the establishment of an NWT Heritage Fund and presents two saving fund options for consideration by NWT residents, to help determine what approach would best suit the needs and vision of the NWT now and in the future.

Difference between a Heritage Fund and a Revenue Stabilization Fund

- A savings fund can be used as a way to protect governments against the volatility associated with boom and bust economic cycles in the resource sector by providing stability in the face of unpredictable resource prices. Revenues would be deposited in the fund when resource prices are high and withdrawn when prices decline.

- A savings fund used to stabilize short or medium-term volatility in royalty revenues is not consistent with long-term savings or investments. The establishment of a Heritage Fund would enable the GNWT to set aside the net revenues from resource development and make them available for investment in long-term assets for future generations.

- If the GNWT goal is to invest the net fiscal benefit from royalties for the long-term through either infrastructure or financial assets, this would require a savings type fund, such as a Heritage Fund. However, this would also serve to reduce the risk of large revenue swings because royalty revenues will not be included in the government's current expenditure base.

Purpose of a Heritage Fund

The purpose of a Heritage Fund would be to address the issue of inter-generational inequity by setting aside funds from non-renewable resource activities in order to protect the net fiscal benefit received from resource revenues from use for ongoing expenditures and provide a source of financial resources for the GNWT to invest for the long-term. The funds could be used for economic development or legacy infrastructure.

A Heritage Fund could be established in advance of resource devolution. However, until Devolution, the GNWT does not receive royalties from resource development and therefore any investment in the Fund would have to come from existing revenue sources.

Questions:

What sources of revenue should be considered non-renewable resource revenues for the purpose of the Heritage Fund? Resource developments provide revenues to governments in the form of royalties, land fees, property taxes, corporate income taxes, commodity taxes, permits and licensing fees.

Do NWT residents want ALL the revenue from non-renewable resources, less offsets under Territorial Formula Financing arrangements to be included in the Heritage Fund?

Should a portion of the Heritage Fund be available for investment in infrastructure that would provide long-term economic benefits to current and future NWT residents?

Do NWT residents want some of the revenue to fund programs and services for current NWT residents?

Other Heritage Funds (Appendix B provides more details)

Norway Pension Fund (established 1990, value C$473 billion at Sept. 30, 2009)

The Norway Pension Fund's purpose is to invest parts of the large surplus generated by the Norwegian petroleum sector, to counter the effects of the future decline in income as petroleum resources decline and to smooth out the disrupting effects of highly fluctuating oil prices.

Alaska Permanent Fund (established 1976, value C$36.0 billion at Jan. 14, 2010)

The Alaska Permanent Fund is a dedicated fund to conserve 25 per cent of the state's annual revenue from mineral resources (mineral lease rentals, royalties, royalty sales proceeds, and federal mineral revenue-sharing payments and bonuses) for future generations. The Alaskan legislature may spend realized Permanent Fund investment earnings (stock dividends, bond interest, real estate rent and income made or lost by the sale of these investment assets).

Alberta Heritage Savings Trust Fund (established 1976, value C$14.5 billion at Sept. 30, 2009)

The *Alberta Heritage Savings Trust Fund* has three objectives: to save for the future, to strengthen or diversify the Alberta economy, and to improve the quality of life of Albertans. All Fund income, except for amounts retained for inflation proofing, is transferred to the General Revenue Fund and used to fund Albertans' priorities. Fund income does not include unrealized capital gains or losses.

Amount of the Expected Net Fiscal Benefit Following Devolution

Federal royalty revenues from the NWT averaged $71 million from 1999-00 to 2008-09. After devolution, these royalties would flow to NWT governments, but, even though the total royalties would be recorded as GNWT revenues, the offsets under Territorial Formula Financing must be taken into consideration when determining how much the GNWT would receive in net resource revenues.

Based on the current resource revenue sharing offer from Canada, the GNWT would receive a net fiscal benefit of 50 per cent of NWT resource revenues, which will be capped at an amount that has yet to be determined. Appendix A provides an update of the status of devolution negotiations.

The current federal cap proposal would amount to about $60 million per year.

The GNWT has committed to sharing 25 per cent of this amount with Aboriginal governments.

This would leave the GNWT with a maximum $45 million per year in non-renewable resource royalty revenues, equivalent to less than 3 per cent of GNWT 2009-10 operating and infrastructure expenditures.

Issues to Consider

1. *Infrastructure Needs* – The GNWT has a large infrastructure deficit and faces extremely high costs to address this deficit. Infrastructure investments are capital assets that provide longer-term benefits. A Heritage Fund which allowed for investment in infrastructure that provided long-term economic benefits to the NWT could address this and provide a source of funds for the GNWT's share of a federal-territorial cost-sharing partnership in infrastructure investments.

2. *Size of program expenditures compared to proposed net fiscal benefit* – Annual GNWT program expenditures are over $1.2 billion. A $40 million net fiscal benefit under resource revenue sharing would be about 3 per cent of annual program expenditures, or one year's increase in expenditures due to price increases and other expenses that are out of the government's control. By way of comparison, Alberta received $12 billion in non-renewable resource revenue for the 2008-09 fiscal year, which represented 31 per cent of that year's $39 billion in total expenditures by the Government of Alberta. As well, in Alaska's 2008-09 fiscal year, the State raised US$5.7 billion in petroleum-related revenues, which was equivalent to 60 per cent of its general-fund expenditures of US$9.5 billion for that year. Given the relatively modest size of the projected GNWT net fiscal benefit under devolution, it is even more important to use the funds to provide a long-term benefit to current and future NWT residents.

3. *Heavy dependency on the federal government through transfers* – Transfers from the federal government are typically about 80 per cent of the GNWT total revenues, either through Territorial Formula Financing or specific purpose transfers. Even with resource revenue sharing, the GNWT will depend on the federal government for the majority of its revenues for the foreseeable future.

4. *Uncertainty as to the timing of major development of NWT oil and gas deposits, or devolution of control over non-renewable resources from the federal government including a resource revenue agreement*. Given the uncertainties in these crucial matters, the GNWT will likely not be receiving a significant amount of resource revenues in the near to medium term. Given this, there is no immediate source of funds for a NWT Heritage Fund. The introduction of a resource tax has been suggested by some as a potential source, however in the absence of devolution such a tax would represent double taxation of resource development. The introduction of other taxes as a source of revenue would need to be considered in light of economic conditions and the Government's overall revenue needs.

Options

Option 1: Long-term savings fund, with no portion of the funds used for current expenditures or capital investment.

Under Option 1, all of the net fiscal benefit would be allocated to a long-term savings fund, with no portion of the funds used for current expenditures or capital investment. Under this scenario, however, current NWT residents would receive no immediate fiscal benefit from resource development. Costs associated with addressing the impacts of development, or investments to take advantage of development, would need to come from other sources of government revenue.

Option 2: Savings fund, which would make investments either in infrastructure or in financial assets that will pay a future return to NWT residents.

Under Option 2, all or a portion of the net fiscal benefit would be allocated to a savings fund, with all or a portion of the funds used to finance investments in infrastructure. This investment could possibly be the GNWT's share of investment in infrastructure that would provide lasting benefits to NWT residents. Segregating the net fiscal benefit in a separate fund would ensure that the money is used to provide long-term benefits, rather than being used for current programs. However, if all of the funds are used for infrastructure, there would be no financial assets available for future generations, although future residents would benefit from investments in transportation or energy infrastructure.

A variation of Option 2 would be to establish a fund with segregated purposes, where a portion is dedicated to infrastructure investment, and the remainder is protected for long-term financial investments. The portion going to each purpose could be established in legislation, but could be adjusted by the Legislative Assembly if relative needs or priorities of GNWT residents change. Such a variation would involve the creation of two separate funds.

Income from the Fund

Under either option decisions will have to be made about how to handle the income in the Fund. For examples, the income generated in the Norway Fund remains in the Fund to be used when oil resources are depleted; while all income generated by the Alberta Heritage Fund, net of amounts kept to counter the effects of inflation, are transferred to the Alberta government's General Revenue Fund.

In some years, the Fund could have investment income from interest and dividends in a fiscal year while incurring losses in the value of its investments. However, it may not be prudent to draw income from the Fund while capital losses are ignored.

If unrealized capital losses (or gains) are included in the definition of income, the Fund's income stream will vary significantly. Policy makers will have to be aware of this risk and

What is the Definition of Income?

The GNWT follows the accounting rules of the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants.

This body defines income under a savings type fund as interest, dividends, rental income, security lending income, net realized gains and losses as a result of disposals, and write-downs of investments.

However, the Public Sector Accounting Board is currently reviewing its definition of income and will likely change the definition to include unrealized capital gains and losses in income.

plan accordingly. Income from the Fund should not be relied on as steady revenue in the budget planning process.

Once the assets of the Fund start to become significant, it will be possible to have a steady stream of income. However, this is a choice that has implications for long-term growth of the Fund. As a policy decision, it is important to decide the balance wanted between Fund growth and income generation.

Typically, the return (income growth) of an investment fund is measured net of the effect of inflation. This “real” rate of return is the per cent increase in the fund less the rate of inflation. For example, if the fund grows by 5 per cent annually while prices increase at 2 per cent, the real rate of return for the fund is 3 per cent. If the general increase in prices (inflation) is not taken into account, the true growth of the fund will be overstated.

Part of the balance will depend on the decision made about the purpose of the income generated from the Fund. Is the income to be directed towards infrastructure investments, human capital investments, economic development, or used to fund general government programs and services?

Questions:

What amount should be allocated to financial investments and what amount for infrastructure investments?

Where should the income earned on fund investments go – back into the Fund or into the GNWT’s consolidated revenue fund (will assume that growth in the Heritage Fund is net of the general increase in prices)?

If the annual income is to be treated as GNWT revenue, what happens if the value of the fund decreases because of investment losses? Should losses be taken into account when determining annual income?

Technical Details

Fund Governance

Typically the Minister responsible for a Heritage Fund would be the Minister of Finance. However, there could also be an oversight committee, possibly made up of Members of the Legislative Assembly or an appointed board. The purpose of this committee would be to review and approve the annual business plan of the Heritage Fund, review and approve reports, and inform the public of the results of the Heritage Fund.

Questions: Who should oversee the Fund, review reports and approve business plans, approve investment strategy guidelines and investment strategies? Who should audit the Fund? Who should manage the Fund?

For example, the NWT could follow a model similar to Alberta's:

Alberta Heritage Savings Trust Fund – Governance Structure

Minister Responsible

The Ministry of Finance and Enterprise is responsible for the fund and its investments. The Minister is required to report on the performance of the fund quarterly within 60 days of the end of each quarter and to make public the annual report within 90 days of the end of the fiscal year.

Standing Committee

The Standing Committee on the Alberta Heritage Savings Trust Fund reviews and approves the business plan and annual report of the Fund. The Standing Committee receives regular reports on the performance of the Fund and conducts public meetings on an annual basis in different locations in the Province. The purpose of these meetings is to update Albertans on the management of the fund and to solicit input from Albertans.

Secretary

The Assistant Deputy Minister, Treasury and Risk Management, Finance and Enterprise acts as secretary for the Fund.

Investment Manager

The investment portfolio of the Heritage Fund is managed by a government body called the Alberta Investment Management Corporation.

Auditor

The Auditor General of the Province of Alberta serves as the Fund's auditor.

Fund Goals, Strategies and Performance Measures

Question: What should the Fund's goals, strategies and performance measures?

The Fund's goals will depend on the option chosen.

Examples of possible goals for an NWT Heritage Fund:

- To maximize the long-term return of the Fund, without allowing for withdrawals from the Fund until it reaches a certain size or until other criteria have been met;

- To generate positive returns while allowing, under specified circumstances, for withdrawals from the Fund in order to meet any government operating or capital expenditures shortfalls as may exist from time to time;

- To grow the Fund to a certain target size (either in nominal or real terms), past which point withdrawals will be made for pre-determined purposes such as to fund government expenditures or to pay dividends to residents of the NWT;

- To invest in economic or regional development schemes;

- To achieve respectable returns on monies in the Fund while following a socially responsible manner of investing and supporting business ventures in the NWT.

Once the Fund's goals are defined, strategies will have to be put in place to achieve the goals. There are many dimensions to investment approaches and the categorization of individual securities. It may be that the strategies would be developed by the organization responsible for managing the Fund, subject to approval of the Fund's governing body.

The performance measures used to determine the effectiveness of the strategies to achieve the Fund's goals will need to be defined. In order to gauge performance, most investors compare their returns to a benchmark, which typically is a certain index, for example the Toronto Stock Exchange (TSX) index or combination of indices. Outperformance is said to occur when a portfolio's return exceeds its benchmark. Underperformance occurs when a portfolio fails to keep pace with the benchmark.

Alternatively, a more qualitative measure (or measures) could be used to evaluate performance. However, regardless of the measure chosen, it should allow for the timely, reliable and consistent measurement of performance over time, in a manner that can be meaningfully and comprehensibly communicated to stakeholders.

Conclusion

This paper is available on the Department of Finance's web site at www.fin.gov.nt.ca. This paper will be translated into other official NWT languages on request.

Comments on the creation of a Heritage Fund should be submitted by April 30, 2010 to:

By mail to:

Heritage Fund Discussions
Fiscal Policy Division, Department of Finance
Government of the Northwest Territories
PO BOX 1320 L-5
YELLOWKNIFE NT X1A 2L9

Or by e-mail to: Heritage_Fund@gov.nt.ca

APPENDIX A

CURRENT STATUS OF DEVOLUTION AND NET FISCAL BENEFIT DISCUSSIONS WITH CANADA

The NWT has not yet achieved devolution of its non-renewable resources. The current round of devolution discussions between Canada and the GNWT has been ongoing since 2003. However, even if an agreement were reached in the near future, implementation constraints would mean that resource revenues would not flow to NWT governments for several more years.

Post devolution, the royalties generated from non-renewable resource development would accrue to NWT governments. However, a large portion of the value would be “clawed back” by Canada through lower transfer payments. This is consistent with the treatment of provincial resource revenues under the federal Equalization Program.

Under the current offer from Canada, the GNWT would receive a net fiscal benefit of 50 per cent of resource revenues (not including Norman Wells revenue), which will be capped at an amount that is yet to be determined. The current federal proposal for the cap would amount to about $60 million per year, but would grow over time. In addition, the GNWT has committed to share 25 per cent of this amount with Aboriginal governments. This would leave the GNWT with a maximum $45 million per year. However, if the GNWT had devolution over the past decade, there would have been a number of years when the amount received would be less than the proposed cap.

The GNWT continues to pursue completion of an agreement-in-principle on devolution and resource revenue sharing with the Government of Canada and NWT Aboriginal governments. Discussions on an agreement-in-principle are expected to resume in the Spring 2010.

APPENDIX B: EXAMPLES OF OTHER HERITAGE-TYPE FUNDS

NORWAY PENSION FUND

The Norway Pension Fund (renamed in January 2006 from the Petroleum Fund) was established in 1990 to counter the effects of the future decline in income as petroleum resources decline and to smooth out the disrupting effects of highly fluctuating oil prices. The Fund's purpose is to invest parts of the large surplus generated by the Norwegian petroleum sector, generated mainly from taxes on companies, but also payment for licenses to explore as well as the State's Direct Financial Interest and dividends from partly state-owned StatoilHydro. The funds deposited are invested in financial markets entirely outside Norway in order not to inflate the Norwegian currency.

The Norway Pension Fund is the second largest fund of its type in the world and is valued at C$473 billion as at September 30, 2009. The largest single sovereign wealth fund in the world is believed to be the Abu Dhabi Emirate's Abu Dhabi Investment Authority (ADIA), upon which some sources have placed a value of U$875 billion. This figure cannot be verified because the ADIA does not report any of its results publicly.

ALASKA PERMANENT FUND

The Alaska Permanent Fund was established in 1976 as a dedicated fund to conserve 25 per cent of the state's annual revenue from mineral resources (mineral lease rentals, royalties, royalty sales proceeds, and federal mineral revenue-sharing payments and bonuses) for future generations. As at January 14, 2010, the Fund was valued at U$35.2 billion (C$36.0 billion).

The Alaskan legislature may spend realized Permanent Fund investment earnings (stock dividends, bond interest, real estate rent and income made or lost by the sale of these investment assets). To date, the Legislature has used the Fund income to inflation-proof the Fund's principal, to pay dividends to qualified applicants, to make special appropriations to the Fund's principal, and to pay some Fund related state expenses.

In 1982, the Legislature established the Alaska Permanent Fund Corporation to manage the Fund investments.

ALBERTA HERITAGE SAVINGS TRUST FUND

The *Alberta Heritage Savings Trust Fund* was established in 1976 with three objectives: to save for the future, to strengthen or diversify the Alberta economy, and to improve the quality of life of Albertans. In the first year, the Heritage Fund received funds from thirty per cent of the non-renewable resource revenue received by the Government of Alberta ($620 million) and a special contribution of $1.5 billion of cash and other financial assets transferred from Alberta's General Revenue Fund to the Heritage Fund.

The Fund's market value as at September 30, 2009 was $14.5 billion (Canadian).

Alberta is the only Canadian province or territory to have a heritage fund. Because Alberta is a "have" province for the purposes of the federal-provincial Equalization program, no federal "clawbacks" apply to Alberta's resource revenues. Alberta is the only province that has net financial assets. If another province were to set up a heritage fund it would either assume new debt or not be able to retire debt that it would otherwise be able to retire. A heritage fund in this instance would only make sense if the return on the fund were greater than the debt changes.

The structure of the Heritage Fund has changed over the past 32 years. From 1977 to 1982, Manitoba, Quebec, Newfoundland, New Brunswick, Nova Scotia and Prince Edward Island borrowed $1.9 billion from the Heritage Fund. In the 1980s a portion of the Fund was used for capital projects to help improve Albertans' quality of life (developing parks, enhancing libraries, and maintaining forests), to diversify the economy and to meet the needs of a growing population. These projects have been paid for and benefit Albertans today. In 1987, the transfer of natural resource royalty revenues to the Fund was stopped.

In 1995, following public consultation, the Alberta government restructured the Heritage Fund so that the fund is not longer used by the government for direct economic development or social investment purposes. A new Legislative Standing Committee operating at arm’s length from the government was put in place to review and approve the business plan and ensure that the objectives and goals of the Fund are met. All Fund income, except for amounts retained for inflation proofing, is transferred to the General Revenue Fund and used to fund Albertans’ priorities.

In 2003, survey results on the Trust indicated that 61 per cent of Albertans felt the Fund should continue to operate primarily as an endowment fund, compared to 24 per cent who disagreed.

Throughout its 32-year history, the Fund has generated more than $30 billion in investment income that has been transferred to the General Revenue Fund to support program spending in areas such as health care, education, infrastructure, debt reduction and social programs. The Heritage Fund's portfolio consists of stocks, bonds and real estate, private equities and absolute return strategies. About half of the Fund is invested in equities. Historically, equities have outperformed fixed income securities over the long-term although, at certain times, as in late 2008 and early 2009, equities have lost considerable value in the short term.

On November 19, 2008 the Government of Alberta released a report on the province’s savings and investment strategy. The report was prepared by a five-member commission tasked with making recommendations aimed at maximizing the benefits received from Alberta’s savings and investment funds. The Chair of the Commission was Dr. Jack Mintz, Professor of Economics at the University of Calgary. The commission made 17 recommendations. The first was that, given that the non-renewable resource revenues received by the Government of Alberta will eventually decline, a share of the province’s revenues should be saved to preserve key public services and low taxes in the future. The Commission recommended that Alberta establish a target of saving $100 billion in net financial assets by 2030. However, the Commission also felt that there are sound reasons for using a portion of the Fund’s income to support current priorities, stating that “It is consistent with our view that the benefits of today’s prosperity should be enjoyed not just by future generations but by Albertans today. It reflects the fact that there are costs associated with economic growth, particularly in terms of infrastructure projects such as highways, schools and hospitals, and that those costs have to be borne today by the current generation of taxpayers. It reflects a disciplined approach where a portion of Alberta Heritage Savings Trust Fund revenues help support essential projects and initiatives and provide more constant and predictable revenues.”