

EQUALIZATION: IMPLICATIONS OF RECENT CHANGES

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INTRODUCTION

Canada's equalization program has been in a state of perpetual evolution since it was first introduced in 1957. Recently, major changes to the program were introduced through two initiatives: the new funding framework announced in October 2004, and the equalization-related Atlantic offshore agreements in early 2005. The significance of these changes has been somewhat understated; they are likely the most important developments in Canada's system of fiscal equalization in over 20 years.

This paper examines the recent changes related to equalization, their effect on the distribution of payments, and the broader policy implications of the new approach to interprovincial fiscal equalization.

CONTEXT: HOW DID EQUALIZATION WORK BEFORE 2004-2005?

In order to understand the significance of the recent changes, it is useful to review how equalization worked up to 2003-2004. As it is widely understood, equalization was a federal formula-based program designed to assist provinces with weak tax bases and relatively poor resource endowments. Put simply, if a province fell below a national standard for provincial revenue-generating ability, then it received equalization payments – as much as necessary to reach that standard. In this way, the federal government has worked to ensure that all provinces have access to a reasonably similar revenue base from which to fund government services.⁽¹⁾

(1) Provincial governments are, of course, free to decide how to tax that base, as well as the level of services to provide.

Payments made via this equalization formula can be thought of as a two-step process. The first step is to create a frame of reference with which to compare provincial revenue-generating ability.⁽²⁾ In essence, the formula strives to determine how much revenue each province could raise (per person) if all provinces were to apply identical tax rates to their respective tax bases. To do this, the formula identifies 33 different provincial revenue sources, ranging from income taxes to service fees to energy royalties. It then calculates the average provincial tax rate on each of these.⁽³⁾ This hypothetical set of taxes is the basis for the calculation of equalization entitlements.

With a common frame of reference in place, the equalization formula proceeds to the second step: comparing each province's revenue-generating ability. This is done by taking the 33 average tax rates as calculated above, and determining how much revenue each province would generate (per person) if it used those rates.

In each of the 33 categories, a province's per capita revenue-generating capacity is then compared to a national standard – the average revenue-generating capacity of Ontario, Quebec, Manitoba, Saskatchewan and British Columbia. This is known as the “five-province standard.”⁽⁴⁾ If a province falls below the standard in any revenue category, it receives a “positive entitlement” equal to the difference between the two. Similarly, if a province is above the standard in any revenue category, it counts as a “negative entitlement.”

All 33 positive and negative entitlements are then summed up. If a province's *total* per capita entitlement is positive (i.e., below the standard), it qualifies for that much money in per capita equalization payments. If a province's total entitlement is negative (i.e., above the standard), then it does not receive any equalization money.

As a final note, under the previous formula, estimates of equalization payments were recalculated twice annually – in February and October – as revised and final data on

(2) This is necessary because provinces have different tax rates, access to different revenue sources and, in some cases, define their tax bases differently.

(3) This is done by calculating the value of the national tax base and the value of all taxes collected from that base. Ontario and Quebec have a large impact on the national average tax rate for major revenue sources such as income taxes and sales taxes.

(4) It is important to note that, under this program, the federal government can “equalize” provinces to any standard it wishes. In the past it has used a 10-province average and, in the early days of the program, the average of the two richest provinces. It could just as easily use fractions of these or any other standard (108% of the 10-province average, for example). In theory, the federal government is limited only by affordability concerns and its own imagination.

incomes, population, and other relevant measures became available. There were eight such recalculations, meaning that, for example, estimates of equalization payments for the year 1999-2000 began in February 1999, but were not finalized until October 2002.

A. Equalization Payments in Recent Years

Based on the formula described above, total equalization payments depended on the degree of variation in provinces' revenue-generating capacities. The wider the spread between rich and poor provinces, the more money was paid out in equalization. Conversely, the closer the gap, the less was paid out.

In 2003-2004, the federal government made equalization payments of \$8.69 billion to the provinces. Seven provinces qualified for equalization that year – Quebec, Manitoba, British Columbia and the four Atlantic provinces.

It is important to note that since equalization is a formula-based program, there was no active “decision” on the part of the federal government to pay that \$8.69 billion. That amount – as well as each recipient province's share – was determined solely by the formula mechanism.⁽⁵⁾

The \$8.69 billion in equalization payments in 2003-2004 was the lowest total since 1995-1996. Payments rose steadily through the 1990s, largely because of strong economic growth in Ontario.⁽⁶⁾ Equalization payments peaked at \$10.95 billion in 2000-2001.⁽⁷⁾ That trend of rising payments reversed itself early in the present decade. Most other provinces' economies have grown more quickly than Ontario's since 2001. As their economies became richer, revenue-generating capacity grew and total equalization payments were pushed lower.

As for the distribution of equalization payments, each qualifying province's entitlement depended on the interplay between two factors: the strength of its own tax base, and the strength of the tax base in the “national standard” provinces. In other words, if an

(5) As mentioned in the previous footnote, the federal government can, however, affect the total amount it pays out by making changes to the formula or to the equalization standard.

(6) Ontario's revenue-generating capacity rose faster than that of most other provinces, raising the national standard and making recipient provinces seem poorer by comparison.

(7) Payments would actually have been slightly higher, but a “growth ceiling” provision within the agreement was triggered that year, preventing the full payment of entitlements. The ceiling was intended to protect the federal government from sudden increases in payment obligations.

equalization-receiving province became richer relative to the standard, its equalization entitlements fell. However, this decrease in payments could have occurred either because the province itself had become richer, or because the standard had fallen.⁽⁸⁾

Of the seven provinces that qualified for equalization in 2003-2004, Quebec received the largest total amount – approximately \$3.8 billion. However, this was due entirely to its population size relative to that of other equalization-receiving provinces. On a per capita basis, Prince Edward Island was the largest recipient, at about \$1,689 per person. The smallest was British Columbia, at \$77 per person.

RECENT CHANGES TO EQUALIZATION

A. The “New Funding Formula Framework”

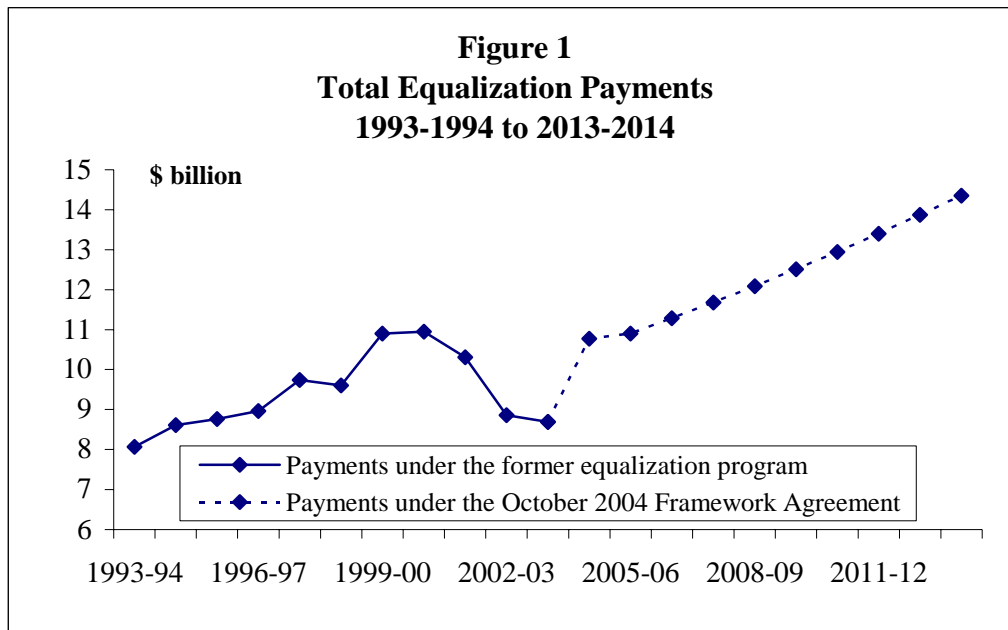
1. Overview

Equalization is an evolving program. Every five years, the program is reviewed and adjustments are made to reflect the availability of better data or new methodologies; to keep up to date with changes in provincial tax bases; or to make other refinements. These adjustments are usually technical in nature, although occasionally more substantive changes are made. The most recent such renewal was in April 2004.

Just six months after that renewal, however, the program was altered significantly. At the First Ministers’ Meeting on 26 October 2004, the Prime Minister announced a departure from the strictly formula-based funding of years past and made a commitment to increase equalization and territorial financing formula (TFF) funds by \$33 billion over 10 years. Growth in equalization accounts for about \$28.7 billion of that total increase.

The new framework placed a guaranteed floor on equalization payments; effective 2004-2005, total entitlements to all receiving provinces would never fall below \$10.0 billion. A special provision was also included to protect individual provincial entitlements that year. This provision will be discussed in detail below. In 2005-2006, equalization payments would be set at \$10.9 billion. Thereafter, and subject to a review after five years, payments will grow by a guaranteed rate of 3.5% per annum.

(8) For provinces such as Manitoba and Quebec, changes in the strength of their tax bases also influence the national standard, of which they are a part.



Source: Department of Finance

Finally, as part of the new framework, it was announced that an Expert Panel would be set up to determine how this money would be distributed among equalization-receiving provinces in 2006-2007 and beyond. The panel's role is an advisory one; the Government of Canada will make any final decisions on equalization based on the Panel's findings, as well as on advice from provincial and territorial governments. The Panel was expected to issue its findings by the end of 2005, but this has been delayed until the spring of 2006.

a. Equalization Payments in 2004-2005 and 2005-2006

When the new framework was announced, two estimates of equalization entitlements for 2004-2005 had already been completed under the old formula – one in February 2004 and one in October of that year. According to the October estimate, total equalization payments would have been \$8.9 billion in 2004-2005.

As mentioned above, the old equalization system recalculated entitlements semi-annually, incorporating more accurate data as it went along. The new framework put an end to this process. The October 2004 estimate of \$8.9 billion for 2004-2005 would be distributed to the province as dictated by the formula. The remaining \$1.1 billion (to reach the framework's \$10.0 billion floor) would be distributed across recipient provinces in proportion to their share of the \$8.9 billion.

In addition to the \$1.1 billion top-up in 2004-2005, the new equalization framework also included a special provision to protect individual provinces from a decrease in payments that year. This provision relates directly to the fact that the books had not yet been closed on previous years' entitlements. In 2004, the equalization formula was not only calculating payments for the 2004-2005 fiscal year, but updating previous years' estimates, all the way back to 2001-2002. This process also stopped with the implementation of the new framework.

Essentially, the special provision guaranteed that no individual province would receive less in the October 2004 estimate of equalization payments than it would have received in the February 2004 estimate, bearing in mind that updates were still being made extending back to 2001-2002. In other words, under the special provision, the total amount of payments to each province from 2001-2002 through 2004-2005 was summed up twice – in February 2004 and again in October 2004. If the former amount was greater than the latter for any province, then that province received the difference as a lump-sum payment.

Two provinces qualified for payments under this special provision – Saskatchewan and British Columbia. Saskatchewan received \$583 million, and British Columbia \$192 million. These amounts were paid on top of the \$10.0 billion floor mentioned above, meaning that total equalization payments in 2004-2005 were \$10.77 billion – up 24% over the previous year.

In 2005-2006, the same \$8.9 billion will be used as the basis for the distribution of that year's entitlements. However, the top-up of \$2.0 billion (to reach the level of \$10.9 billion as set out in the framework) will be distributed differently. Half of the \$2 billion will be distributed on an equal-per-capita basis, while the other half will be allocated according to each province's share of total equalization payments over the past three years.

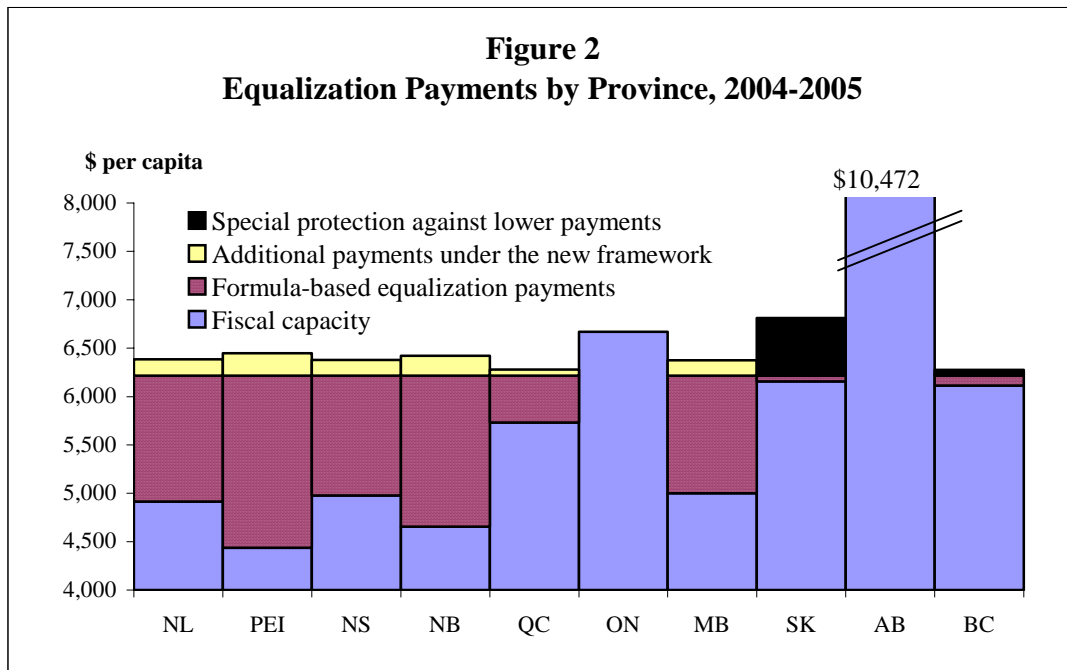
Because of the delay in the Expert Panel's report, the federal government announced in November 2005 that it will allocate 2006-2007 equalization payments according to the same distribution mechanism used in 2005-2006, only updated to reflect more recent economic and fiscal information.⁽⁹⁾ This was done for two reasons: to allow the Expert Panel the time necessary to complete its work; and to provide greater budget certainty to the provinces.

(9) This information is according to a Department of Finance press release dated 8 November 2005.

b. Distribution by Province

The new framework guarantees that every qualifying province will receive more equalization money in 2004-2005 under the new framework than it would have under the old system. However, these funds are not distributed evenly across all recipient provinces. Figure 2 compares the allocation of equalization payments in 2004-2005 before and after the October 2004 framework agreement.

According to the last official estimate of the former equalization formula, the per capita standard revenue-generating capacity was \$6,217. As discussed above, any province below this level qualified for as much equalization as needed to reach it. In Figure 2, this is shown as the combination of a province’s fiscal capacity and resultant formula-based equalization payments, if applicable. Also shown is the amount provinces receive (per capita) because of the new framework, including the special protection provision.



Source: Author’s calculations using Department of Finance data.

As is clear from Figure 2, some provinces benefit more than others from the new arrangement. Specifically, this method of distributing the additional equalization favours large per capita recipients such as the Atlantic provinces. Prince Edward Island and New Brunswick see the biggest increase in per capita entitlements – \$231 and \$203, respectively. The increase is smallest in British Columbia – about \$13 per capita.

However, for 2004-2005, Saskatchewan emerges as the largest beneficiary. As mentioned above, Saskatchewan received \$583 million because of the guarantee that no province would get less equalization according to the October 2004 estimates compared to the February 2004 estimates. When combined with its share of the \$1.1-billion equalization top-up, per capita payments to Saskatchewan were \$586 higher because of the October 2004 framework agreement. In fact, in 2004-2005, Saskatchewan was “equalized” to a higher fiscal capacity than Ontario.⁽¹⁰⁾

Even though total equalization payments rise to \$10.9 billion in 2005-2006, the new framework is not a guarantee that each province’s payments will rise in perpetuity. As mentioned above, half of the \$2-billion increase in 2005-2006 is distributed according to historical shares, while the other half is allocated on an equal-per-capita basis. This means that per capita equalization payments to some provinces increase, while they fall in others. Specifically, Saskatchewan, British Columbia, Manitoba and Prince Edward Island receive less equalization (per capita) in 2005-2006 than in 2004-2005, while payments rise in Quebec and the other three Atlantic provinces.

2. The Implications of the Framework Agreement

This new funding framework will have a significant effect on the size and distribution of future equalization payments. From 2003-2004 to 2013-2014, payments will rise by a total of 65.2%. By comparison, growth in the previous 10 years was 7.8%, not enough to offset the effects of inflation over that period.

Furthermore, although the exact distribution of funds is still unknown, the guaranteed growth in payments through 2013-2014 will likely assure equalization-receiving provinces of a predictable source of revenue from the federal government. In the past, some provinces had voiced concerns that large fluctuations in their annual entitlements made it difficult to plan budgets. Predictability in total payments makes budget-planning easier for the federal government as well.

However, while it has advantages, both for recipient provinces and the federal government, the new framework fundamentally changes the nature of the equalization program. As described above, the value of equalization payments in any given year normally depends on

(10) It should be noted that this large payment is an aberration. Saskatchewan’s equalization payments fall to \$82 million in 2005-2006.

the relative revenue-generating capacity of the provinces in that year. For example, real (inflation-adjusted) equalization payments fell from 1993-1994 to 2003-2004 largely because the fiscal gap between rich and poor provinces was closing.⁽¹¹⁾

Pending the outcome of the Expert Panel process, by contrast, under the new framework, annual measures of fiscal capacity beyond 2004-2005 do not factor in to the amount, or allocation, of equalization funds. Subject to a five-year review, total payments will grow steadily through to 2013-2014, regardless of whether (and by how much) the *year-to-year* fiscal gap between provinces widens or narrows over that period. In this sense, equalization is no longer “equalizing” what it once did.

Another significant change is that, at least until 2007-2008, the new framework no longer attempts to align all have-not provinces to the standard. As shown in Figure 2, variations exist. This issue could have been easily addressed by distributing additional “top-up” funds on an equal-per-capita basis.⁽¹²⁾

This situation will likely change when the Expert Panel releases its findings in the spring of 2006. Nevertheless, how the federal government decides to distribute payments under the new system will likely be a contentious issue. The provinces have strong views on the type of equalization program they would like to see. All will be sensitive to any distribution mechanism that limits their own entitlements, especially given that there is a set amount of equalization money available. Under the old system, one province’s entitlement had little or no bearing on that of another province. However, with a pre-determined total payment, any increase in one province’s entitlement comes directly at the expense of the other provinces. This could be a source of interprovincial conflict in the future.

B. The 2005 Atlantic Accords

1. Content

In February 2005, the federal government signed new agreements with the provinces of Nova Scotia and Newfoundland and Labrador to address a long-standing concern with regard to the treatment of provincial offshore energy resources under the equalization

(11) It should be noted that some technical adjustments to the equalization formula also served to restrict growth in payments over that period.

(12) In 2004-2005, this would have been the equivalent of equalizing provinces to 102% of the five-province standard. This would also have cost \$10.77 billion, but would have had the effect of distributing most of the extra funds to Quebec.

program.⁽¹³⁾ The concern related to the mechanics of the formula; for every additional dollar in offshore royalties collected by the two provinces, there was the potential for a dollar-for-dollar decrease in equalization entitlements.⁽¹⁴⁾

This issue was first raised in the 1980s and it has triggered a lengthy debate on the subject. Some felt that this “clawback” was a powerful disincentive for provinces to develop their resources, since they effectively received no royalties for doing so, and suffered no fiscal penalty for *not* proceeding with development projects. On the other hand, some maintained that as provinces become wealthier, they should qualify for less equalization. In that sense then, they saw the “clawback” as evidence of equalization doing exactly what it was supposed to do.

In any event, some changes have been made over the years to lessen the impact of the clawback. The 2005 Atlantic Accords were the most recent of these. Under the agreements, the federal government made a commitment to compensate Newfoundland and Labrador, and Nova Scotia, for 100% of lost equalization payments resulting from higher offshore revenues. It is important to note that these offshore agreements do not make any changes to the equalization program itself. Rather, they offset the *effects* of the program.

The two agreements are similar. In the case of the Canada-Newfoundland accord, the federal government agreed to compensate the province for 100% of its offshore energy-related clawback through to 2011-2012. This was done via an up-front payment of \$2.0 billion, which represents a “pre-payment” of the anticipated clawback through 2011-2012. If the total clawback over that period exceeds \$2.0 billion, then the federal government will provide the difference in cash. Payments will be made annually once the province’s \$2.0 billion “credit” is exhausted. If the total value of the clawback does not exceed \$2.0 billion by 2011-2012, then the province will keep all of the up-front payment.

If Newfoundland and Labrador qualifies for equalization payments in 2011 or 2012, and its debt-servicing charges remain high, then a successor agreement would be negotiated through to 2019-2020. Any such agreement would guarantee 100% compensation for the clawback on offshore revenues. Moreover, if the province should stop qualifying for

(13) The federal government had signed similar, but less generous, Atlantic Accords with those two provinces in the 1980s.

(14) Certain technical provisions of the agreement (for example, a floor on year-over-year losses) could prevent the loss from being strictly dollar-for-dollar.

equalization payments between 2012-2013 and 2019-2020, it would still receive (reduced) offset payments from the federal government for up to two years.⁽¹⁵⁾

The Canada-Nova Scotia Accord is virtually the same, except that the value of its up-front payment is \$830 million. As well, Nova Scotia has explicitly committed itself to using that \$830 million to pay down the provincial debt, while Newfoundland and Labrador has made no such commitment (that province's accord merely states that the federal cash "will allow the province to reduce its outstanding debt").

2. Implications

It is difficult to speculate what the effects of these accords will be. As discussed above, the equalization formula – as it existed in 2003-2004 – is not being used to determine payments. Since the Expert Panel has not yet made any recommendations on how equalization (under the new framework) is to be distributed, the only known effect of these accords to date is the immediate value to the two provinces of their up-front payments.⁽¹⁶⁾

Moreover, it is possible that the entire clawback issue will become irrelevant when the Expert Panel presents its report. The Panel may recommend a distribution mechanism that does not include non-renewable natural resources, or that addresses the clawback issue in some other way.

A more pertinent implication of these accords is the precedent they set. Nova Scotia and Newfoundland and Labrador are by no means the only provinces to have experienced significant reductions in their equalization payments because of energy royalty revenues. Saskatchewan, in particular, has experienced a similar clawback for years. The province estimates that over the past 10 years, it has essentially forgone \$4 billion in equalization payments because of its energy resources, while the Atlantic Accords ensure that Nova Scotia and Newfoundland and Labrador will not experience any such loss.⁽¹⁷⁾

(15) If a province did not qualify for equalization in one year, it would receive two-thirds of the previous year's offset payment. If it again did not qualify the following year, it would receive one-third of the offset payment from two years prior.

(16) Given that there was no equalization formula (in the traditional sense) at the time these accords were negotiated, it is a matter of speculation as to the basis for the \$2 billion and \$830 million up-front payments.

(17) Province of Saskatchewan, *Equalization Reform: A Fair Deal for Saskatchewan*, presented to the Expert Panel on Equalization and Territorial Formula Financing, Regina, June 2005.

Indeed, the magnitude of the clawback in Saskatchewan has been growing. Research on this topic shows that Saskatchewan's equalization entitlements in non-energy tax bases are rising faster than in any other province.⁽¹⁸⁾ This suggests that Saskatchewan is becoming poorer, except for its energy resources. For this reason, Saskatchewan is vigorously campaigning to have its energy resources treated similarly to those of Nova Scotia and Newfoundland and Labrador.

CONCLUSION

The federal government has made significant changes to its program of provincial fiscal equalization in recent years. In October 2004, extra funds were added to equalization and the program was set on a predictable growth path – 3.5% growth per year through to 2013-2014, subject to a review after five years. The program awaits the results of an Expert Panel's findings on how to allocate those funds; the Panel's report is expected in the spring of 2006. In the interim, equalization payments are being made on the basis of population size and past entitlements. Not long after the October announcement, the federal government signed accords with Nova Scotia and Newfoundland and Labrador, compensating those provinces for losses in equalization payments resulting from their increasing oil and gas royalties.

In the eyes of some, these two changes represent a significant departure from the fundamental principles underlying Canada's system of fiscal equalization. The intent of the program had been to provide cash to provinces with weak revenue bases so that all provincial governments were capable of providing reasonably similar levels of government services at reasonably similar levels of taxation. Now, however, the combination of guaranteed growth and special consideration for Atlantic offshore revenues mean that year-to-year changes in provincial fiscal capacities have little or no bearing on the amount of cash provinces receive.

Ultimately, equalization is a federal program financed by federal tax dollars. As such, it is the federal government's prerogative to operate, administer and distribute equalization in any way it chooses.

(18) Tom Courchene, "Confiscatory Equalization: The Intriguing Case of Saskatchewan's Vanishing Energy Revenues," *Choices*, Vol. 10, No. 2, Institute for Research on Public Policy, Montréal, March 2004.

One issue that may arise from the recent changes is that federal-provincial relations over the distribution of equalization payments could become more acrimonious in the near future. While the conclusions of the Expert Panel could go a long way towards mitigating these concerns, the fact that the value of payments is set through to 2013-2014 means that the distribution of those funds (and the special exemptions for Nova Scotia and Newfoundland and Labrador) will continue to be an issue. It is thus very likely that some provinces will feel that they are being short-changed compared to others.

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