CANADA'S OIL & NATURAL GAS PRODUCERS

Ensuring Canada's Competitiveness

2019 Pre-Budget Consultation Submission

Summary of Recommendations:

- The government implement immediate 100% deductibility of tangible capital investment on par with recent reforms in the U.S.

- Introduce EITE protection of approximately 80% coverage of aggregate costs related to climate policy in order to address the competitiveness gap with the U.S.

- For industry and governments to jointly examine innovative approaches to financing for small/medium sized firms, so as to contribute to the ongoing viability of this sector of the industry

- The government proceed with their commitment in the 2017 budget to review the Scientific Research and Experimental Development tax credit program, with a view to making it more effective through risk-sharing and inclusion of operational innovation within scope

- Duty relief on Specialized World Asset Vessels be provided on the basis that there is no Canadian supply, nor sufficient work to warrant Canadian flagged vessels, and that Canadian capacity to construct these vessels is limited

- The government recognize the context of the 2009 G-20 commitment to phase out inefficient fossil fuel subsides and:
    - Acknowledge Canada's leadership in pricing/taxing carbon through the entire value chain from the end user right up to the producer thereby preventing "*wasteful consumption*";
    - Acknowledge Canada's record in establishing an incentive laden tax framework for renewable energy vis a vis other sectors, thereby not "*impeding investment*" in renewables;
    - Acknowledge Canada's oil and gas sector is *not* subsidized, by confirming that remaining oil and gas tax measures are part of the benchmark tax system, therefore not subsidies pursuant to our G-20 commitment, as stated by the Department of Finance in the 2017 Auditor General's Report.[1]

1) Introduction

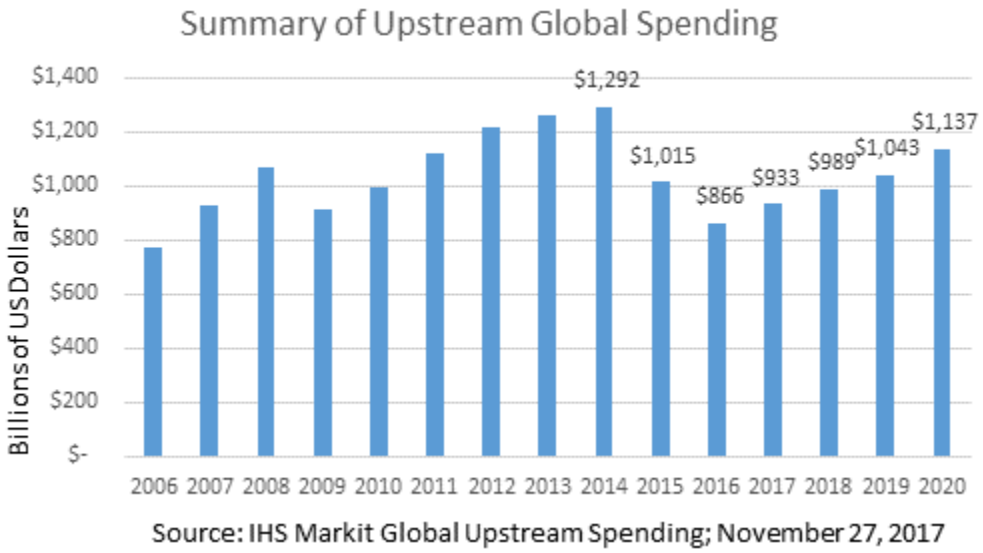
Canada should be the global hydrocarbon supplier of choice to meet increasing future demand because of its world class resources, leadership in carbon pricing, workers and human rights, and robust environmental regime. A strong oil and gas sector can move the needle on key federal government priorities of expanding the middle class via job

[1] 2017 Spring Reports of the Auditor General of Canada to the Parliament of Canada: Report 7-Fossil Fuel Subsidies

creation, improving access to opportunities in our sector to traditionally under-represented groups, incenting innovation and technological development, lessening our carbon footprint, and increasing Indigenous participation in the workforce (Indigenous people are 6% of our sector's total labor force vs. 4% average in all other industries, but we can still do better).

Building on the Joint Working Group (JWG) process, this submission aligns with the *Barton Report* of 2017 and the recent *Generation Energy Council* report calling for the federal government to take a leadership role to define Canada's vision in global oil and natural gas markets. To realize this opportunity, the oil and gas industry sees near term imperative for actions by industry and governments to address significant competitiveness gaps relative to competing jurisdictions. Upstream oil and natural gas investment in Canada is now expected to decline in 2018, at a time when, as shown in Figure 1, global energy demand and upstream investment is projected to rise:

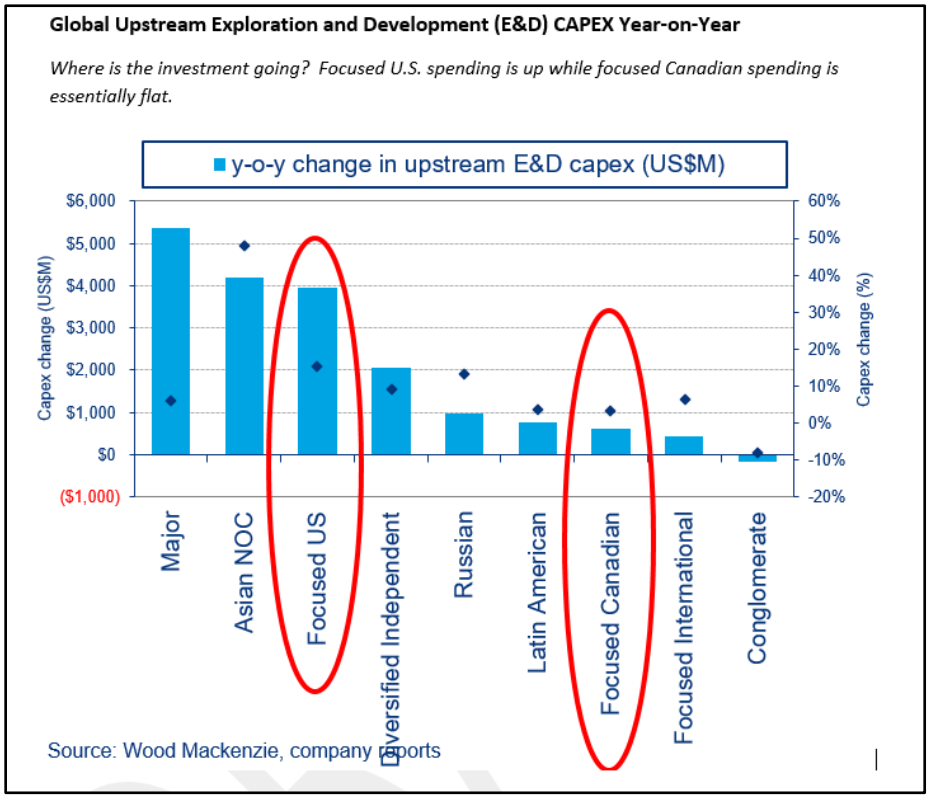
Figure 1



2) Competitiveness Analysis

Canada's oil and gas sector has experienced reduced investor confidence over the past several years. As seen in Figure 2, while investment in the U.S. is increasing, it is decreasing in Canada:

Figure 2



Smaller oil and gas firms face the same competitiveness challenges as those faced by larger firms however their ability to mitigate these challenges is limited and struggle to finance growth. Access to capital has all but disappeared for junior E&P's as the number of small/intermediate public companies has dropped approximately 50% since 2012.[2] Exacerbating these challenges driven by market forces and policy headwinds in Canada, are the recently enacted U.S. tax reforms, including allowing immediate deductibility for tangible capital investments and a drop in the federal corporate income tax rate from 35% to 21%.

Immediate Deductibility

Canada now finds itself trailing the U.S. on key factors which impact investment attraction. A faster depreciation schedule improves industry's project economics by reducing tax liability in the earlier years of a project. It also provides for significantly reduced investment uncertainty and risk, as companies can achieve project payout sooner and increase the likelihood of at least recovering their initial investment.

Capital asset class distinctions are a significant portion of oil and gas taxpayer disputes, as most large oil and gas corporate taxpayers surveyed have at least 40% of their CRA disputes arise from

[2] National Bank, Financial Markets, 2018

CCA class issues. Allowing immediate capital deductibility would also reduce the complexity of the tax system by virtue of allowing all eligible assets to be deducted at the same rate.

Solving competitiveness issues allows companies to proceed with investment in innovation which further induces competitiveness. For example in the oil sands, capital intensive steam reduction technologies would become more viable under immediate deductibility, and substantially improve industry emissions performance while driving down costs.

Treatment of Emissions Intensive Trade Exposed ("EITE") Sectors

As Canada enacts stringent GHG emissions policies, many competing jurisdictions are not. For example, of the top ten oil exporters in the world, Canada is the only jurisdiction with carbon pricing policies and without appropriate measures to address EITE sectors, carbon leakage could occur. Carbon leakage occurs when production and investment shifts from jurisdictions with more stringent carbon policy to jurisdictions with no carbon policy or with lower carbon policy standards.

Industry-led modelling indicates that EITE protection of approximately 80% coverage of aggregate costs related to climate policy (carbon pricing, methane emissions reductions, and clean fuel standards) is required in order to address the competitiveness gap with the U.S. This assumes that the immediate capital deductibility discussed above is also implemented.

Modelling Competitiveness Impacts

Third party economic modelling shows that implementing the following levers would collectively address the majority of the gap for both oil sands and liquids rich natural gas (LRNG):

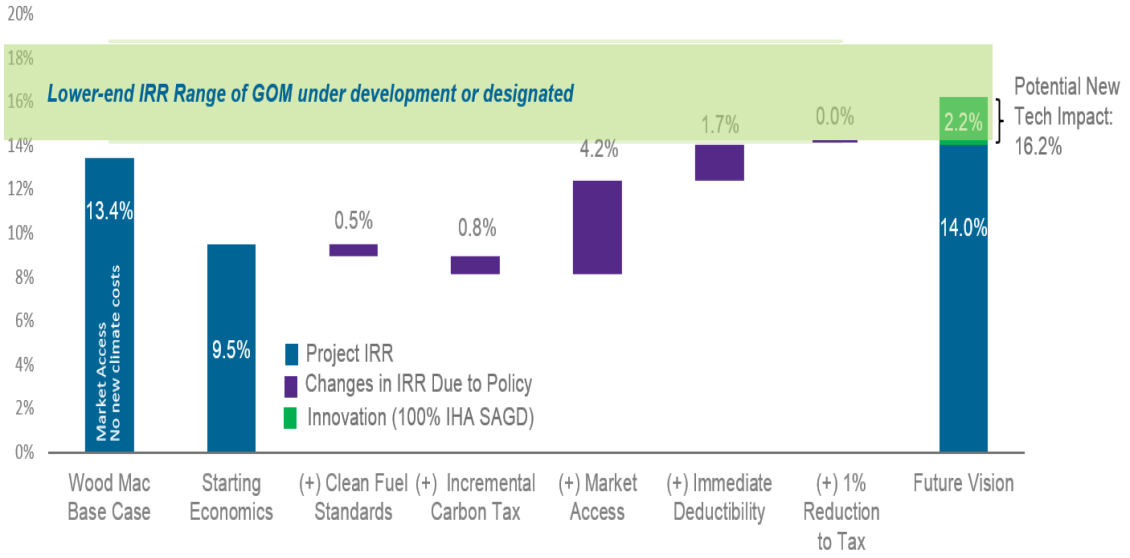
- Market access
- Implementing immediate capital deductibility
- Providing 80% EITE coverage protection on the aggregate cost of Canadian climate policy

The modelling approach utilized was to assess the competitiveness gap resulting from the uplift in economics due to U.S. tax changes and the diminishing of economics due to Canadian climate costs:

<u>Oil Sands</u>

Solving market access issues alone will not be enough to solve competitiveness issues for Canada's oil sands. Assuming market access and no climate policy costs, oils sands projects remain competitively challenged compared to other long cycle plays like Gulf of Mexico (GOM) opportunities:

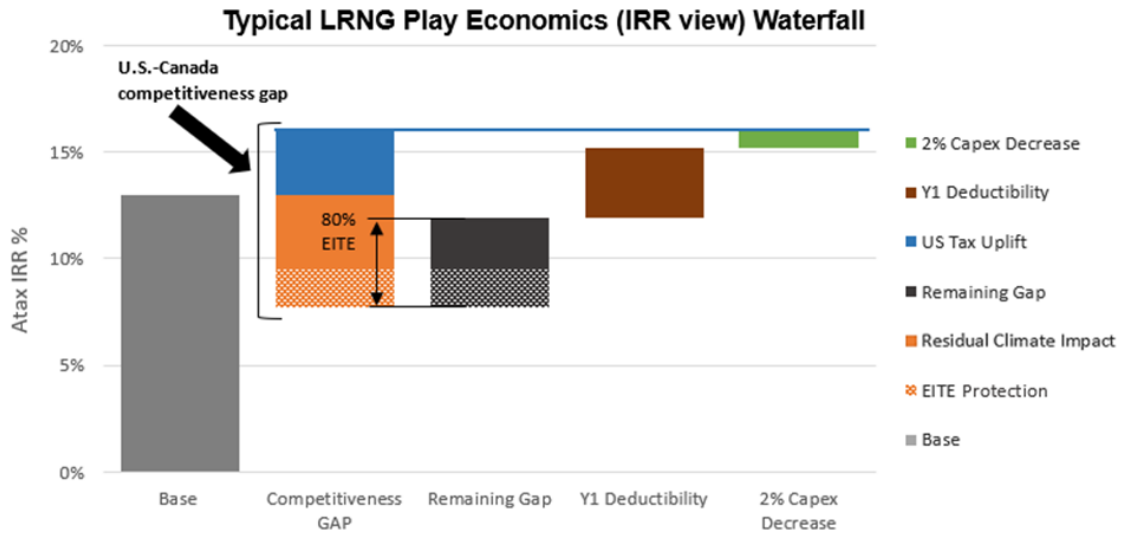
- The pending addition of Clean Fuel Standards and incremental carbon tax increases the gap further
- Implementing 100% immediate deductibility in a manner similar to the U.S. is a key lever to improve competitiveness and incent capital intensive investment in technology and innovation.



- In summary, U.S. GOM investments currently have 2X Net Present Value (NPV) and absolute Internal Rate of Return (IRR) 2.5% higher than oil sands investments.
- Addressing these levers bring oil sands SAGD projects into a competitive position with comparable U.S. GOM projects.

LRNG:

- Modelling demonstrated a competitiveness gap between Canadian LRNG investments and similar opportunities in the U.S., as a result of recent U.S. tax regime changes implemented plus the impact of incremental regulatory cost of existing and pending climate policies in Canada.
- The competitiveness gap between typical U.S. and Canadian LRNG investments is significant. U.S. investments provide roughly double the rates of return.



Competitiveness in the Offshore

Specially designed marine vessels are essential to assist in the exploration and development of offshore oil and gas which do not necessarily have a home port but are used on an international, as required basis, for short durations. These vessels are constructed to meet support demands of the global offshore industry or adapted for use in a region due to their design criteria for other uses. These vessels are subject to import duties in Canada which is the only country in the world imposing such taxation which hinders the competitiveness of Canada's offshore energy sector.

3) *Subsidies*

CAPP firmly disagrees with current views on what constitutes a subsidy, however, this section will instead focus on the context of Canada's 2009 G-20 pledge, trends in taxation for both renewable energy and oil and gas, and Canada's track record in that space.

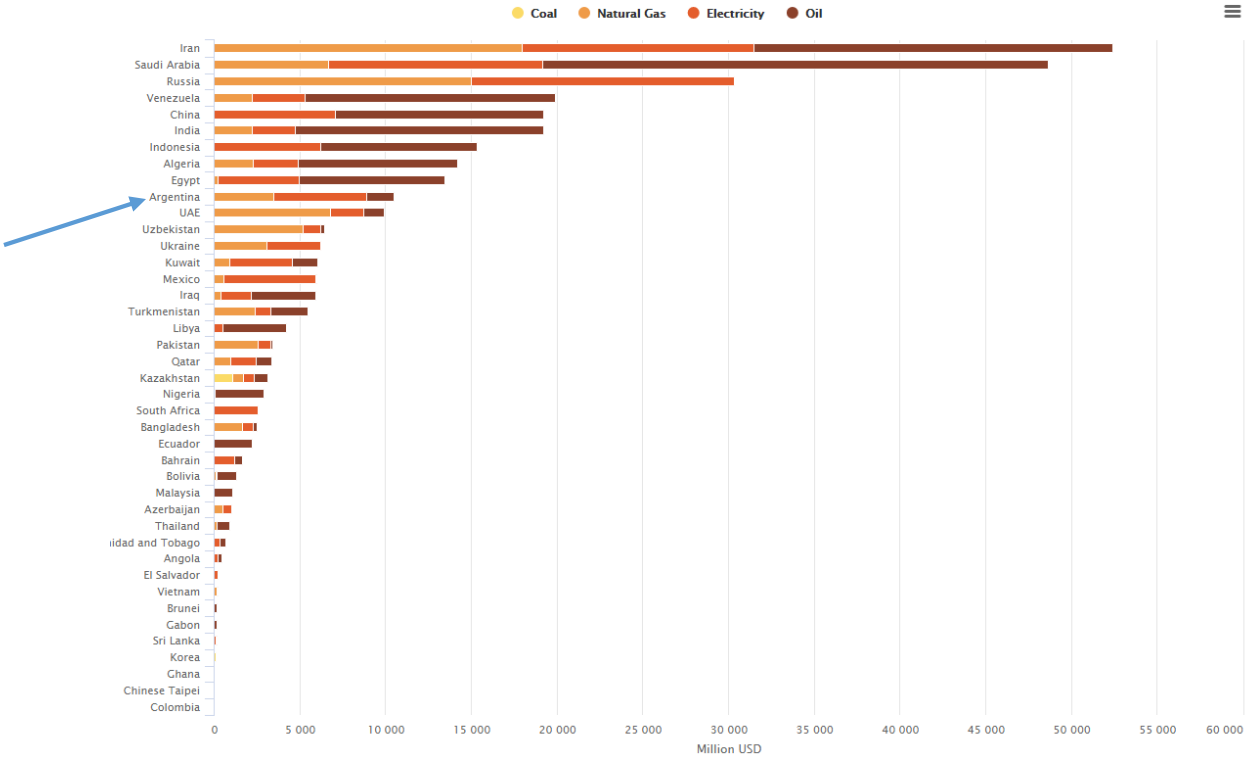
The G-20 commitment in 2009 was to eliminate inefficient fossil fuel subsidies that "*encourage wasteful consumption and impede investment in clean energy sources*."[3] Subsidies that reduce the cost of fossil fuels to end users can lead to superfluous consumption and increased GHG emissions, and is where the majority of global fossil fuel subsidies reside[4]. Contained in the chart below are IEA estimates of fossil fuel subsidies that are targeted to/consumed directly by end users or consumed as inputs to electricity generation, ranked by country. In Canada, the consumption of fossil fuels is heavily taxed, the opposite of a subsidy.

[3] March 2017 Budget, Minister of Finance, Government of Canada

[4] IEA, OPEC, OECD, The World Bank, Joint Report: Analysis of the Scope of Energy Subsidies and Suggestions for the G-20 Initiative, 2010

(Note: Argentina, Canada' subsidy peer review partner, ranks 10th in the world in subsidies, whereas Canada does not even rank.)

Figure 3:
Energy subsidies by country, 2015 (Million USD)



Source: IEA, World Energy Outlook 2016

The other driver behind the G-20 commitment was not to "*impede investment in clean energy sources.*" As far back as 2000, the Government of Canada has been examining whether fossil fuel producers receive preferable tax treatment when compared to the renewable sector. The Commissioner of the Environment and Sustainable Development concluded that "*Overall, we found that with a few exceptions, federal government support today (year 2000) for energy investments, including support through the tax system, does not particularly favor the non-renewable sector over the renewable sector.*"[5] Tax measures for renewables such as the accelerated capital cost allowance and measures for deducting intangible capital have received expansions/extensions in federal budgets 2012, 2013, 2014, 2016, and 2018.

In contrast, the oil and gas sector has seen the opposite trend. Prior to Canada's G-20 commitment, Canada had already begun to phase out specific tax measures available for oil and gas as the OECD stated that the "*Income tax treatment of the oil, gas and mining*

[5] Office of the Auditor General: Report from Commissioner of the Environment and Sustainable Development, 2000

sectors in Canada has been undergoing fundamental reforms."[6] Since the G-20 in 2009, this trend only accelerated as federal budgets from 2011 through 2017 have seen successive removal of various oil and gas specific tax measures, the most recent being the curtailment of the Canadian Exploration Expense(CEE) in Budget 2017. (Approximately 11 specific tax measures were removed from 2003-2017).

In summary, over the past several years and changes in government, the federal government has expanded tax measures for renewable energy investment while simultaneously curtailing measures for oil and gas.

[6] OECD: "Inventory of Estimated Budgetary Support and Tax Expenditures for Fossil Fuels", 2011