GREEN BUDGET COALITION

ENERGY SUBSIDY REFORM

The Green Budget Coalition recommends that the Government of Canada begin the phase-out of production subsidies to the fossil fuel industry starting in Budget 2016 by:

- Eliminating the Mineral Exploration Tax Credit (METC) applied to the coal industry for flow-through shares, set to expire in March 2016;
- Revoking the new Accelerated Capital Cost Allowance (ACCA) provided to Liquefied Natural Gas projects that was introduced in Budget 2015;
- Eliminating the duty exemption for imports of mobile offshore drilling units in the Atlantic and Arctic;

And Further:

- Announce a comprehensive review to quantify and publicly report the costs of all federal direct spending, federal public financing, production subsidies and tax deductions available to coal, oil and gas, natural gas industry either specifically or through broader mining schemes, including pipeline and refinery expansion. This information should be provided to the Parliamentary Budget Office and the Department of Finance in time for the pre-budget economic and fiscal outlook so that anticipated revenues can be included in Budget 2017 and subsequent federal budgets;
- Announce a clear timeline to phase out all remaining federal tax credits, production subsidies as well as all public financing provided by Export Development Canada by 2020 that support coal, oil and gas (including liquefied natural gas). This phase out should include the seven federal tax expenditures, direct federal spending and public financing measures identified below.

Investment required:
For 2016/2017: $1 million (Estimated additional 10 FTEs in the Department of Finance to conduct the review and reporting of tax expenditures to the fossil fuel energy sector, as well as direct federal spending and public financing, in collaboration with officials in the Department of Natural Resources Canada, Export Development Canada and the Treasury Board, and establish a timeline for phase-out.)

For ongoing: $500,000 per year over five years

Estimated savings: $CAN 4.694 billion per year*

* Estimate of federal tax expenditures is $CAN1.8 billion per year, public financing provided to the oil and gas sector by Export Development Canada is estimated at $CAN2.894 billion per year. Source: Oil Change International, Overseas Development Institute, International Institute for Sustainable Development. November 12, 2015. G20 subsidies to oil, gas, and coal productions: CANADA, available at: http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9988.pdf

Summary

A recent report estimated that Canadian federal production subsidies to the fossil fuel industry amounted to a minimum of $CAN 1.8 billion annually,[1] mainly through tax expenditures, and an additional estimated minimum of $CAN 2.894 billion per year was provided in public financing to oil and gas producers and pipeline companies in Canada and in the U.S.[2]

The Minister of Finance and the Minister of Environment and Climate Change were both mandated to work together "to fulfill the G-20 commitment to phasing-out fossil fuel subsidies to over the medium-term" as outlined in their Mandate Letters.[3]

The Green Budget Coalition recommends a set of early actions through Budget 2016 and has identified seven tax expenditures that should be targeted for phase-out by 2020 to deliver on this commitment.

In addition, the Minister of Finance was mandated to:

> "Ensure that our fiscal plan is sustainable by meeting our fiscal anchors of balancing the budget in 2019/20 and continuing to reduce the federal debt-to-GDP ratio throughout our mandate."

There are a many oil and gas (including liquefied natural gas) projects in the application stage in Canada, with some start-up dates for these projects extend out to 2030 and beyond. With these tax credits still in place, the Government of Canada risks foregoing billions of dollars in additional tax revenues from accelerated deduction rates for pre-production costs for new projects over decades to come.[4] Phasing-out of fossil fuel subsidies and other federal support to this sector will allow the Government of Canada to reap significant fiscal benefits over the medium and long-term by recouping foregone tax revenues, thus significantly facilitating the return to balanced budgets by 2019/20.

> "Work with the President of the Treasury Board and your Ministerial colleagues to conduct a review of tax expenditures and other spending to reduce poorly targeted and inefficient measures, wasteful spending, and government initiatives that are ineffective or have outlived their purpose."

A comprehensive review of all federal direct spending, public financing and production subsidies to coal, oil and gas, natural gas, is an essential deliverable in the proposed review of tax expenditures and other government spending led by the Treasury Board and the Department of Finance. As described below, many of those tax expenditures have not achieved their intended policy objectives, have outlived their original purpose and are currently contrary to this Government's objective of making the tax system competitive for investments in clean technologies.

> "Work with the Minister of Natural Resources to enhance existing tax measures to generate more clean technology investments and work with the provinces and territories to make Canada's tax system highly competitive for investments in the research, development, and manufacturing of clean technology."

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1 This does not include production subsidies provided by provincial and territorial governments.

2 Oil Change International, Overseas Development Institute, International Institute for Sustainable Development. November 2015.

3 Prime Minister of Canada, Mandate Letter to the Minister of Finance, available at: http://www.pm.gc.ca/eng/minister-finance-mandate-letter#sthash.gRot0eb3.dpuf

4 Pembina Institute. July 2014. Fossil Fuel Subsidies: An Analysis of federal financial support to Canada's oil sector, ©204 The Pembina Institute.

Phasing out production subsidies to oil, gas, natural gas and coal will significantly enhance the neutrality of the tax system thus making investments in clean energy technologies more attractive. In addition, this phase-out will generate significant savings over the medium and long-term that can be re-directed to support the Government of Canada's investments in new and clean technologies through the proposed Low Carbon Economy Trust[5].

Recommendations

The Green Budget Coalition recommends that the following tax credits be eliminated immediately in Budget 2016:

The Mineral Exploration Tax Credit (METC) for flow-through shares (applied to coal mining).

The METC was renewed in Budget 2015 and will expire on March 2016. The METC available to the coal sector should not be renewed in Budget 2016. The METC complements flow through shares,[6] enabling individuals who invest in flow-through shares to claim an amount equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors.[7] Exploration subsidies are particularly inefficient as they represent tax expenditures for projects that may not even go to full development eventually, and thus will not yield an employment in the sector nor royalties or tax revenues for provincial and federal governments.

Estimated savings: $CAN17.5 million per year (over two years)[8]

The Accelerated Capital Cost Allowance (ACCA) provided to Liquefied Natural Gas projects.

Budget 2015 introduced a new ACCA treatment for assets used in facilities that liquefy natural gas. Capital cost allowance is the means by which Canadian businesses may claim depreciation expenses for their investments in capital, for calculating taxable income under the Income Tax Act. This new ACCA allows investments in eligible equipment used for natural gas liquefaction to be written-off from taxable income at a substantially higher rate; a 22 per cent allowance that brings the CCA rate up to 30 per cent for those eligible expenses. For non-residential buildings used at a facility that liquefies natural gas the ACCA was brought up to 10 per cent.

Estimated Savings: $CAN9 million per year[9]

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5 Prime Minister of Canada, Mandate Letter to the Minister of Finance, available at: http://www.pm.gc.ca/eng/minister-finance-mandate-letter#sthash.gRot0eb3.dpuf

6 "Flow-through shares allow companies to renounce or "flow through" tax expenses associated with their Canadian exploration activities to investors, who can deduct the expenses in calculating their own taxable income". (Budget 2012, Annex 4). http://www.budget.gc.ca/2012/plan/pdf/Plan2012-eng.pdf

7 Budget 2012, Annex 4. http://www.budget.gc.ca/2012/plan/pdf/Plan2012-eng.pdf

8 Budget 2015 projected a net reduction in federal revenues of $35 million over the 2015–16 to 2016–17 periods from the METC for the mining sector as a whole data is not disaggregated by sector. Economic Action Plan 2015, Strong Leadership, a balanced budget, low tax plan for jobs, growth and security, tabled in the House of Commons on April 21, 2015 p.212. http://www.budget.gc.ca/2015/docs/plan/toc-tdm-eng.html

9 Budget 2015 projected the deferral of tax associated with this measure is expected to reduce federal taxes By $45 million over the 2015–16 to 2019–20 period. Strong Leadership, a balanced budget, low tax plan for jobs, growth and security, tabled in the House of Commons on April 21, 2015 p.212. http://www.budget.gc.ca/2015/docs/plan/toc-tdm-eng.html

Duty exemption for imports of mobile offshore drilling units in the Atlantic and Arctic.

This tax break was originally designed to promote oil and gas exploration in the offshore Atlantic and Arctic. There regions are among the world's most vulnerable in terms of environmental risks of oil and gas production as well as being financially highly risky investments.

Estimated Savings: Unknown

In addition, the Green Budget Coalition recommends that the Department of Finance undertake a comprehensive review to quantify and publicly report the costs of all production subsidies and tax credits to coal, oil and gas, natural gas, including pipeline and refinery expansion. This will require that tax expenditures specific to fossil fuels be disaggregated from the tax expenditures available to the mining sector[10]. In addition, categorizing the tax expenditures available within the energy sector (i.e. to oil, gas, coal, wind, geothermal, solar etc.) will be necessary to determine the impact of the tax system on investments in clean energy, and to enhance existing tax measures to generate more clean technology investments.

Based on this review, the Government of Canada should announce in FY 2016/2017 a clear timeline to phase-out all remaining federal tax credits, production subsidies as well as all public financing provided by Export Development Canada by 2020 that support coal, oil and gas (including liquefied natural gas) including:

The Canadian Development Expense (CDE).

Oil and natural gas producers can claim up to 30 percent of their expenses against taxable income for drilling, converting or completing an oil well in Canada, sinking or excavating a mine shaft, main haulage way, or similar underground work for a mine in a mineral resource in Canada built or excavated after the mine came into production; and pre-production mine development expenses after 2017. The cost of any Canadian mineral property, or of any right to or interest in any such property, also qualifies as a CDE. CDE are accumulated in a pool called Cumulative Canadian Development Expenses (CCDE). The taxpayer can deduct up to 30% of the unclaimed balance in that pool at the end of each year. Unclaimed balances may be carried forward indefinitely.[11]

Estimated Savings: $CAN 1.127 billion per year[12]

The Canadian Exploration Expenses (CEE) tax break.

The CCE allows for further deductions, at a rate of 100 per cent, for costs incurred for geological, geophysical, and geothermal (G3) surveys and exploratory drilling (in the coal sector this includes the intangible costs of mine development). CEE are expenses incurred for the purpose of determining the exis-

10 The following tax deductions are particularly problematic to accurately and reliably estimate: the Canadian Development Expenses, the Canadian Exploration Expenses, the Canadian oil and gas property expense, the Foreign Resource Expense and Foreign exploration and development expense. These are deductions of capital costs that can be pooled each year and then be claimed whenever the owner chooses to, and the data specific to these tax deductions does not appear to be readily available. The most recent analysis for this from Finance Canada appears to be Part 2 of the Tax Expenditures and Evaluations 2012, Tax Expenditures for Accelerated Deductions of Capital Costs. Mostly, the document explains why it may be too difficult to come up with accurate figures in such cases, due in part to the intricate relationship with other tax deductions.

11 Natural Resources Canada. 2014. 'Mining-specific Tax Provisions'. Ottawa. Government of Canada. http://www.nrcan.gc.ca/mining-materials/taxation/mining-taxation-regime/8892#lnk10

12 Oil Change International, Overseas Development Institute, International Institute for Sustainable Development, November 2015. Estimate based on 2012 and 2013 data, originally reported in $US, converted to $CAN using the 2014 IRS rate.

tence, location, extent, or quality of a mineral resource, or petroleum or natural gas, in Canada. CEE also include expenses incurred for the purpose of bringing a new mine into production, including clearing, removing overburden and stripping, and sinking a mine shaft.[13]

Estimated savings: $CAN 182 million per year[14]

The Canadian oil and gas property expense (COGPE).

The COGPE allows companies to claim a 10 per cent deduction from taxes for the costs of acquiring oil and gas wells and rights.

Estimated savings: $CAN40 million per year[15]

The Foreign Resource expense (FRE) and Foreign Exploration and Development Expense (FEDE).

Canadian companies can deduct 30% of exploration expenses incurred overseas. Data is not available to estimate the amount of foregone federal tax revenues for these two measures.

Estimated savings: Unknown

Direct federal spending and public financing

The Government of Canada has provided significant amount of public funds in support of the oil and gas industry, in the form of advertising, outreach and research funding.[16] In addition, the Government of Canada provides public financing for fossil fuel projects domestically and internationally through Export Development Canada. [17] Public financing for fossil fuel production in Canada and overseas, provided by the Export Development Canada alone is estimated at $CAN 2.894 billion annually.[18] The Green Budget Coalition recommends the Government of Canada conduct a systematic review of the financing portfolio of Export Development Canada as well as Canada's financial contributions to multilateral development banks aimed at supporting investments in fossil fuel projects in Canada and abroad, with a goal to phasing out those contributions starting in Budget 2017.

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13 Budget 2011 proposed that development expenses incurred for the purpose of bringing a new oil sands mine into production in reasonable commercial quantities be treated as Canadian Development Expenses (CDE) rather than CEE as in the past. Budget 2013 further proposes that pre-production mine development expenses be treated as Canadian Development Expenses (CDE) which are deductible on a 30% declining-balance basis. (Source, Natural Resources Canada, 2014)

14 Oil Change International, Overseas Development Institute, International Institute for Sustainable Development, November 2015. Estimate based on 2012 and 2013 data, originally reported in $US, converted to $CAN using the 2014 IRS rate.

15 Oil Change International, Overseas Development Institute, International Institute for Sustainable Development, November 2015. Estimate based on 2012 and 2013 data, originally reported in $US, converted to $CAN using the 2014 IRS rate.

16 The Auditor General of Canada estimated that the Government of Canada provided an estimated total direct spending to the sector of $508 million over the fiscal period 2007–08 to 2011–12. Source: Commissioner of Environment and Sustainable Development (February 3, 2012). 2012 Fall Report of the Commissioner of the Environment and Sustainable Development, Chapter 4—A Study of Federal Support to the Fossil Fuel Sector. Ottawa, Canada. http://www.oagbvg.gc.ca/internet/docs/parl_cesd_201212_04_e.pdf

17 For example EDC reported one transaction between $435 million and $870 million to India Reliance Industries Ltd. EDC's reporting of its financing is not precise and should be investigated and publicly reported.

18 Oil Change International, Overseas Development Institute, International Institute for Sustainable Development, November 2015. Estimate based on 2012 and 2013 data, originally reported in $US, converted to $CAN using the 2014 IRS rate.

Background and Rationale

A recent report by Oil Change International, the Overseas Development Institute and the International Institute for Sustainable Development estimates that Canadian federal production subsidies to the fossil fuel industry amounted to a minimum of $CAN 1.8 billion annually[19], mainly through tax expenditures, and an additional estimated minimum of $CAN 2.894 billion per year in public financing to oil and gas producers and pipeline companies in Canada and in the U.S.[20]

Most of the subsidies provided by the Government of Canada benefit conventional oil, oil sands, conventional gas and natural gas production providing tax breaks to exploration activities, field development, and extraction. Initial progress towards fossil fuel subsidy reform was made in previous federal budgets through the phase out the Accelerated Capital Cost Allowance (ACCA) and Intangible Capital Expenses (ICE) provided to oil sands projects, the Atlantic Investment Tax Credit – Oil & Gas and Mining, the Accelerated Capital Cost Allowance for Mining and Pre-production and the Mine Development Expenses.[21] However, Budget 2015 introduced a new ACCA to the liquefied natural gas sector. Other countries, such as Germany, have phased-out all subsidies to the hard coal industry and both France and the U.S. have committed to phasing out public financing to the coal sector.

The Government of Canada's primary remaining subsidy programs for the oil and gas sector are the Canadian Development Expense (CDE) and the Canadian Exploration Expense (CEE) tax deductions, which quicken production growth by providing accelerated deduction rates for pre-production development and exploration expenses respectively. The Government of Canada provides additional tax preferences that apply only to oil and gas and mining (including coal, which is considered a fossil fuel), such as accelerated deductions for some exploration and development expenses and flow-through shares.

Many of these tax preferences and accelerated deductions recommended for reform date back to the 1970s and have since outlived their original objectives.[22] These measures were historically premised on factors such as exploration risk, spillover benefits of exploration to third parties (similar to R&D), large capital requirements, price volatility, and a desire to be competitive. Today, however, it is not clear that these factors are unique to the sector or merit preferential treatment.

More importantly, these tax preferences are now contrary to the Government of Canada's global commitment to greenhouse gases emissions reductions as well as Canada's domestic policy with regards to carbon pricing and supporting investments in clean technology.

The Government of Canada, along with 39 other countries and major corporations, has endorsed the Fossil Fuel Subsidy Reform Communiqué submitted at the Conference of the Parties to the United Nations Framework Convention on Climate Change in Paris in November 2015. Supporters of this Communiqué have recognized that the elimination of fossil-fuel subsidies would make a significant contribution to reducing global greenhouse gas emissions and that accelerating the reform of fossil-fuel subsidies is therefore an urgent priority. The Green Budget Coalition's recommendations would allow the Government of Canada to meet the principles agreed to in the Communiqué related to communication and transparency and ambition in

19 This does not include production subsidies provided by provincial and territorial governments.

20 Oil Change International, Overseas Development Institute, International Institute for Sustainable Development. November 2015.

21 "Summary of Progress Reports on the Commitment to Rationalize and Phase Out Inefficient Fossil Fuel Subsidies: Canada, available at: https://g20.org/wp-content/uploads/2015/10/Summary-of-Progress-Reports-on-the-Commitment-to-Rationalize-and-Phase-Out-IFFS.pdf

22 Sawyer, Dave and Seton Stiebert, 2010, http://www.iisd.org/gsi/sites/default/files/ffs_awc_3canprovinces.pdf

the scope and timeframe for implementing subsidy reform.[23]

Reform of the Government of Canada's preferential tax treatment, direct spending and public financing to the fossil fuel sector would place the federal government in a position to encourage similar subsidy reform by provincial governments.[24] Federal leadership on energy subsidy reform could be a key contribution to the pan-Canadian framework for addressing climate change to be negotiated with the provinces and territories following the UNFCCC COP21 meeting in Paris. The Green Budget Coalition recommends the pan-Canadian framework include an agreement to a set of common fiscal principles to reform federal and provincial tax systems to support investments in clean energy. For more details, refer to the Green Budget Coalition's Recommendation to support renewable energy.

23 Fossil Fuel Subsidy Reform Communiqué, available at: http://fffsr.org/communique/

24 Estimates of provincial tax breaks amount to a minimum of $CAN 1,125 billion annually, mostly delivered for oil and natural gas exploration activities as relief on royalties by the provinces of Alberta and British Columbia. Source: Oil Change International, Overseas Development Institute, International Institute for Sustainable Development

Budget Announcement

"The Government of Canada commits today to transparency by reporting to Canadians the amount of public funds used to support the oil and gas, coal and natural gas sector in Canada."

"In keeping with our commitment to the G20, we also announce a gradual phase out of all production subsidies to this sector. By removing the preferential tax treatment and public financing previously offered to the oil and gas sector, the Government of Canada will ensure the tax system support our commitment to support investments in clean energy."

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