Memorandum

Security classification: Secret

To: Minister of Finance

From: Michael Horgan

March 18, 2010

Subject:

G-20 Commitment - Fossil Fuel Subsidies

This memorandum is for decision by March 24, 2010. At the Pittsburgh Summit, G-20 Leaders committed to “[r]ationalize and phase out over the medium term inefficient fossil fuel subsidies that encourage wasteful consumption”. The current proposed timelines call on each G-20 member to self-identify a list of fossil fuel subsidies at the Finance Ministers’ meeting on April 23, and to present an implementation strategy and timeframe for rationalizing/phasing out inefficient subsidies by the June Leaders’ summit in Toronto.

This note sets out two broad possible approaches to respond to the commitment:

1) explore opportunities for selective rationalization by Canada (which we recommend); or 2) seek to minimize the commitment. Once we have your view, we would draft a letter from you to the PM setting out the proposed approach.

G-20 Commitment

In preparation for the September 2009 Pittsburgh Summit, the U.S. pressed at a late stage for a commitment on reducing fossil fuel subsidies. The intention is to reduce both demand for scarce energy resources and greenhouse gas emissions. The Leaders’ Statement noted that “inefficient fossil fuel subsidies encourage wasteful consumption, distort markets, impede investment in clean energy sources and undermine efforts to deal with climate change.” They committed to “[r]ationalize and phase out over the medium term inefficient fossil fuel subsidies that encourage wasteful consumption”. They tasked Finance and Energy Ministers to develop national implementation strategies and timeframes, based on national circumstances, and to report back to Leaders at their next Summit in Toronto. G-20 Finance Ministers committed to this work in St. Andrews.

Recognizing that fossil fuels are often subsidized as an anti-poverty policy, Leaders acknowledged “the importance of providing those in need with essential energy services, including through the use of targeted cash transfers". They also agreed that "this reform will not apply to support for clean energy, renewables, and technologies that dramatically reduce greenhouse gas emissions".

International institutions, (OECD, IEA, the World Bank and OPEC) were tasked to prepare a joint report on the scope of energy subsidies and suggestions for the implementation of the initiative for the next G-20 Finance Ministers meeting in April.

G20 Process

A group of Energy Experts representing each country in the G-20 has been nominated to plan implementation of the commitment. Chris Ragan is representing Canada. An interdepartmental working group is providing him with analytic support.

A key issue of contention has been the scope of the commitment. Some elements of the Pittsburgh statement suggest that the commitment would focus on consumption subsidies - measures that reduce the price of energy products for consumers, which are common in many emerging economies like India, Russia, China and Saudi Arabia. These measures were the subject of an IEA study cited by the leaders and would explain the references in the communiqué to mitigating impacts on the poor. Canada likely has few such federal measures, though there are measures at the provincial level (e.g., home heating rebates).

The U.S. and the international organizations have pressed for the inclusion of production subsidies in this exercise, and most G-20 Energy Experts seem to support this approach. **The inclusion of producer subsidies could have important policy implications for Canada because of federal policies such as tax incentives for oil and gas production.**

The U.S. push to include producer measures has been concretely backed up by the Administration's proposal in its 2011 budget, explicitly linked to the G-20 commitment, to eliminate twelve different tax preferences for producers of oil and gas and coal. It is not certain, however, whether there will be Congressional support to enact these proposed changes.

The timetable proposed by the U.S. for the G-20 commitment is ambitious. If adopted, it will require important policy decisions in the coming months:

1. April 12 - countries to provide a preliminary list of consumer and producer fossil fuel subsidies. We note that countries may be unlikely to list measures that they are not prepared to phase out.

2. April 23 G-20 Finance Ministers' meeting - countries provide a final list of consumer and producer fossil fuel subsidies.

3. Each G-20 country to develop implementation strategies and timeframes for rationalizing/phasing out their inefficient fossil fuel subsidies.

4. June 4-5 G-20 Finance Ministers' meeting - countries table drafts of their implementation strategies and timeframes.

5. June 26-27 G-20 Leaders Summit (Toronto) - countries present final implementation strategies and timeframes.

<u>Considerations</u>

This commitment offers an opportunity to, if desired: (1) identify inefficient subsidies and eliminate them; (2) reap the fiscal benefits of removing such measures; and (3) include a green deliverable at the Toronto Summit, which could help mitigate climate change.

From a Canadian perspective, this commitment raises a number of sensitivities:

• As host of the June Leader's Summit in Toronto, Canada will be expected to lead by example in delivering on the commitments agreed to in Pittsburgh.

• Under the proposed G-20 plan, Canada will have to determine the list of subsidies it is willing to provide at the April Ministerial, and is prepared to commit by June to rationalize/phase out, along with a proposed timetable.

• There is a risk, acknowledged among the G-20 Energy Experts, that characterizing measures as subsidies for this exercise could invite trade retaliation.

• In Canada, fossil fuel measures are likely more prevalent at the provincial/territorial level. For example, consumer measures include direct petroleum subsidies in the territories for home heating and electricity generation for communities without viable alternatives. On the producer side, incentive features of provincial royalty regimes may be relevant. Options relating to provincial measures include: proceeding without provincial participation; inviting provinces to participate (but recognizing take-up would likely be limited); or actively trying to engage provinces. The U.S. and Germany have also expressed concerns regarding their sub-national jurisdictions. While the issue is open, given the tight timeframes and complexity, there seems to be sympathy for the idea that measures at the sub-national level might in practice not be covered, even though this could reduce the effectiveness of the exercise.

<u>Options</u>

There are two broad possible approaches that Canada could take to this commitment:

1) Use the commitment as an opportunity to undertake selective rationalization of Canadian measures (which we recommend), or

2) If Canada is not prepared to undertake any substantive reforms, minimize the obligation so that Canada can still position itself as meeting the commitment.

Each approach is discussed in turn. The focus in this note is on tax measures, which are under your jurisdiction, where Canada is probably most exposed at the federal level. Tax measures for fossil fuel producers include accelerated deductions for exploration and development expenses and flow-through shares. (More information on tax measures is included in an annex.)

With respect to program measures, work is currently underway with line departments to identify measures that could be considered fossil fuel subsidies and determine whether there are any good candidates for rationalization. Preliminary results suggest that the federal government does not appear to have significant programming in this area. Examples include grants and contributions to energy companies and universities for research and development and technology investments (e.g., NRCan¹s Program of Energy Research and Development, National Science and Engineering Research Council, Sustainable Development Technology Canada, regional development agencies). The exclusion in the G-20 declaration for clean energy assistance, however may exempt many of these programs. Incentive features of federally-determined royalty regimes for oil and gas exploration and development in the North and frontier areas could be relevant. Federal resources also support investments in fossil fuel projects abroad through the portfolios of Export Development Canada, CIDA and the World Bank.

Option 1 (recommended) Active Engagement: Take opportunity to selectively rationalize fossil fuel measures (e.g. tax preferences for producers)

Considerations

• Canada has a number of tax preferences that apply 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. 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.

• Given provincial ownership of resources, federal preferences increase fiscal room for provincial royalties, resulting in a potential "treasury transfer" to the provinces with strong resource bases.

• Selective rationalization would be consistent with the Advantage Canada goal of enhancing growth by improving the sectoral neutrality of the tax system. It could also assist the return to fiscal balance. The OECD has recommended rationalization of our resource preferences on both economic and environmental grounds.

• Rationalization of resource tax preferences was supported by Minister Prentice in his pre-Budget 2010 letter to you. It could also help respond to his concern about maintaining Canada's reputation as a "clean energy superpower", and help defend against U.S. government or individual company actions targeted, for example, against oil sands.

• Like removal of trade impediments, this type of exercise involves some risk that Canada would make a commitment and honour it, but others would not. For example, it is quite conceivable that the U.S. administration will not find enough Congressional support for its oil and gas tax reform proposals. Many Canadian reforms may be beneficial, even if undertaken unilaterally. Where unilateral action raises competitiveness concerns, or Canadian gains could be enhanced through similar action by other countries, the process could be staged so that Canada's obligation to implement is conditional on actions by others.

Possible Rationalization Options (Tax Illustrations)

• For illustration, two of the more modest tax preferences that could be rationalized are presented.

• Align tax depreciation rates for oil sands leases and the intangible costs of building oil sands mines with rates in the rest of the oil and gas sector, rather than the more generous mining rates currently applicable. Preliminary estimates suggest savings on the order of $50 million per year once phased in.

-This would be consistent with the phase-out of accelerated CCA for tangible assets in oil sands and could reduce criticism that Canada subsidizes oil sands.

• Phase out accelerated CCA for tangible assets used in coal mining. Preliminary estimates suggest savings on the order of $5 million per year once phased in.

-This change would be modest in impact, but could be symbolically important. It would also be consistent with the oil sands accelerated CCA phase-out. There is already a precedent for treating coal differently than other minerals - it does not benefit from the temporary 15 % flow-through share tax credit or the 10% corporate pre-production tax credit.

• If there is interest, these and other options on the tax and program side could be explored in more detail.

• Under this first approach, Canada could actively support the G-20 initiative and cooperate with the U.S. to garner the support of others.

• After completing an internal assessment, Canada would list the fossil fuel measures that it is prepared to rationalize at the April Finance Ministers' meeting. If necessary, it could also list those which it plans to maintain, being prepared to defend them.

• Assuming other countries do likewise, it would present its plan for rationalizing the selected measures in June at the Finance Ministers' meeting and then at the Leaders' Summit in Toronto, along with the justification for any listed measures that it plans to maintain.

Potential Reaction

• The fossil fuel industry would likely be critical of any rationalization, though the reaction would depend on the scope of change. Provinces with active oil and gas and coal mining industries (BC, AB, SK, NS, NL) may also be critical; other provinces (ON, QC) may be quietly supportive. In contrast, organizations like the OECD, IMF and environmental NGOs would be supportive. It could also help improve Canada's international image, e.g. with respect to oil sands.

Option 2 (alternative) - No Policy Change: Seek to minimize the commitment

Considerations

• If there is no interest in rationalizing Canadian measures. Canada would need to carefully manage the G-20 commitment, especially given its role as host of the June Leaders' summit. This option would also encourage other G-20 members to minimize their obligations, diminishing the prospects for mutually beneficial rationalization. If Canada undertakes no reforms, it would eliminate the need to coordinate action internationally, though justifying inaction could be challenging if others are taking action.

• In their most recent discussion, G-20 Energy Experts agreed on the importance of country ownership in this process and on the need for G-20 members to self-identify by the next G-20 Ministerial (based on their own definitions of a fossil fuel subsidy and on their national circumstances) a list of subsidies.

<u>Potential Position</u>

• Canada could support keeping both the commitment and the timelines for implementation general, with no common definition of subsidy, and retaining maximum flexibility to take into account "national circumstances".

• On the consumption side, Canada could take the position that it has no inefficient federal measures. On the excise tax side, it could argue that fuel tax rebates like those to charities and the disabled are designed for social policy objectives and are not "inefficient" in the way envisaged by the G20, and that non-taxation of some fossil fuels (e.g. coal) or differential tax rates (e.g. on gasoline and diesel) are not a "subsidy".

• Canada could argue that producer subsidies are not within the scope of the original commitment, which focussed on consumer measures. It is not clear, however, that this position would get much support. The international organizations are planning to cover producer measures and a focus only on consumption would likely lead emerging countries (the largest users of consumer measures) to argue that the richer countries are trying to impose a one-sided commitment.

• If producers subsidies are covered, Canada could take the position that it has already removed significant producer tax preferences, and must be given credit for its early action:

-earned depletion deduction (eliminated 1989);

-favourable tax treatment provided under the Syncrude Remission Order (expired 2003); and

-resource allowance (replaced with royalty deductibility in 2003-2006).

Implementing the phase-out of accelerated capital cost allowance for oil sands over the 2011-2015 period (announced in Budget 2007) could be cited as a current action helping to fulfill the commitment.

• If necessary, it could be argued that remaining Canadian tax measures are not "inefficient" on the basis that they serve other policy goals.

-For example, it could be argued that flow-through shares support access to capital for small companies (though critics would argue that there is no clear market failure and that the policy instrument is inefficient).

• In terms of comparison with other countries' actions, Canada could argue, for example, that a number of tax measures that the U.S. administration is proposing to phase out have no equivalent in Canada.

-Depletion deductions, for example, have already been eliminated in Canada, and unlike the U.S., Canada does not provide an effectively lower tax rate for goods-producing sectors. (That said, the U.S. could point to aspects like immediate expensing for all exploration costs and flow-through shares, where Canadian treatment is more favourable).

Potential Reaction

• Depending on the extent of action undertaken in other countries, this approach could have some cost in terms of Canada's reputation in the G-20. The oil and gas and coal industries would presumably be supportive. Provinces with active fossil fuel production (B.C., AB, SK, NS, NL) may be quietly supportive, though other provinces (ON, QC) and opposition parties may be critical. NGOs would be critical. The international Institute of Sustainable Development, for example has commissioned a study to highlight Canadian fossil fuel subsidies.

Next Steps

As Leaders committed to this process, including a follow-up at the Toronto Summit, we have alerted PCO, who will brief the Prime Minister regarding the potential scope and implications of the commitment. Once you have indicated your preferred approach to us in the decision box below, we will draft a letter to the PM either on your behalf or on behalf of you and Minister Paradis to seek the PM's feedback. If you accept our recommended approach (Option 1), we will develop more detailed options on relevant tax and program measures for your consideration.

DECISION

Please indicate your preferred approach to this commitment:

Option 1: (recommended) - Use the commitment as an opportunity to pursue selective rationalization of Canadian fossil fuel measures. Please develop more detailed options on relevant tax and program measures for consideration.

Option 2 - No policy change; seek to minimize the commitment.

Please indicate your preferred approach for seeking feedback from the Prime Minister:

Letter from you; or

Letter from you and Minister Paradis (since Finance and Energy Ministers were jointly tasked by G20 Leaders).

ANNEX - Federal Tax Measures Relating to Fossil Fuels

This document sets out the main federal tax measures that are specific to fossil fuel production and consumption.

<u>Production</u>

There are a number of targeted income tax provisions that apply to the exploration for, and production of, oil and gas and minerals (including coal, a fossil fuel). As discussed in the memo, over time, many of these preferences have already been phased out. Concurrently, tax support has been expanded for investment in clean energy generation projects by provision of accelerated CCA for equipment (under CCA Class 43.2) and flow-through share financing for project start-up costs (Canadian Renewable and Conservation Expenses - CRCE). Nonetheless, a number of targeted measures for the oil and gas sector, as well as for the mining sector (applicable to coal) remain.

<u>Deductions for Intangible Capital Costs</u>

Capital costs are those incurred to acquire tangible or intangible assets that contribute to a corporation's earnings over a number of years. A neutral tax system generally would spread the deduction of for capital costs over the useful life of the relevant asset, thereby matching the expenses with the revenues which they help produce.

An accelerated deduction - one that is faster than consistent with useful life - provides a cash-flow benefit to firms. While it does not change the total amount of tax deductions, by moving those deductions forward in time, it defers taxes providing a financial benefit in present value terms.

Canadian exploration expense (CEE)

CEE is deductible at a rate of 100% in the year incurred. CEE includes the cost of determining the "existence, location extent or quality" of a petroleum or mineral resource through such means as seismic surveys and exploration wells.

For the mining sector (which includes coal and oil sands mining), CEE also includes the intangible costs of mine development (e.g. removing overburden) up to the point of commercial production. These expenses may therefore be written off more quickly than they would in the conventional oil sector where they would qualify as CDE (see below).

In a "neutral" tax system, an immediate (100%) deduction for <u>unsuccessful</u> exploration expenditures may be reasonable, since these costs don't contribute to ongoing revenues. However, costs of successful exploration and development of projects likely would be required to be amortized over the expected life of the asset or project.

Canadian development expenses (CDE)

CDE is a deductible at a rate of 30% per year on a declining balance basis. CDE includes the cost of drilling, converting or completing an oil or gas well in a known reservoir and the cost of building mine haulage ways and other workings after a mine has come into commercial production.

For the mining sector (which for these purposes includes coal mines and all oil sands projects), CDE also includes the cost of acquiring a mineral property or a right to explore. These expenses may therefore be written off more quickly than they would in the conventional oil and sector where they would qualify as Canadian oil and gas property expenses (COGPE), deductible at 10 % per year.

Under a "neutral" tax system, these expenses would arguably be amortised over the expected life of the project. Depending on the particular resource in question, the 30% rate, which allows 88% of the cost of an investment to be written off in the first 6 years, may be somewhat accelerated.

Flow-through shares (FTS)

Flow-through shares are a sanctioned tax shelter that allows mining, oil and gas and renewable energy companies to sell unused tax deductions on account of CEE and CDE to investors. This provides non-taxable companies (typically junior companies) with a kind of indirect refundability of tax losses arising from exploration and development expenses.

Experience is mixed in terms of the effectiveness of flow-through shares as a means of providing government support. A significant portion of the tax benefit is effectively captured by the investors (often high net worth individuals) rather than the issuing corporation, or consumed in transaction costs.

Reclassification of Expenses under Flow-Through Shares

Junior oil and gas companies can reclassify up to the $1 million per year of CDE (deductible at 30% per year) as CEE, 100% deductible in the year, when the expenses are transferred to a holder of flow-through shares.

<u>Deductions for Tangible Capital Costs</u>

Accelerated CCA for Mining

The cost of equipment and structures used in resource extraction and initial processing is normally deductible at a CCA rate of 25% per year. For new and expanded mines (including coal mines) and oil sands projects, however, accelerated CCA allows a deduction of up to 100%, limited by the amount of income from the project. This provision results in no tax being paid on income from the project until all eligible capital expenses have been deducted.

The Government announced in Budget 2007 that it will phase-out the accelerated CCA for oil sands assets over the 2011-2015 period. The provision for conventional mines will not be affected.

Consumption

At the federal level, we would not characterize any of the differences in the way in which fossil fuel related commodities are treated for tax purposes as “subsidies.” That said, some countries could argue that the non-taxation or low rate of taxation of some fossil fuels fails to take into account the negative externalities associated with their consumption, constituting a kind of preference that they could argue is akin to a subsidy.

The few clear commodity tax preferences that are in place, at the federal level, involve refunds or rebates of tax to achieve social policy objectives. For example, charities, Canadian amateur athletic associations and individuals suffering from a permanent impairment to their locomotion can obtain a rebate of 1.5¢ of excise tax per litre of gasoline. They are not, in our view, “inefficient” fossil fuel subsidies as envisaged under the G-20 description.

Importantly, provincial product taxes on fossil fuels are also subject to a range of exceptions, which countries could argue to be forms of “inefficient” subsidization.