CANADA'S OIL & NATURAL GAS PRODUCERS

Productivity and Competitiveness:

ECONOMY AND ENVIRONMENT IN PARTNERSHIP

CAPP Submission on 2018 federal pre-budget consultation

TO: House of Commons Standing Committee on finance

1 Introduction

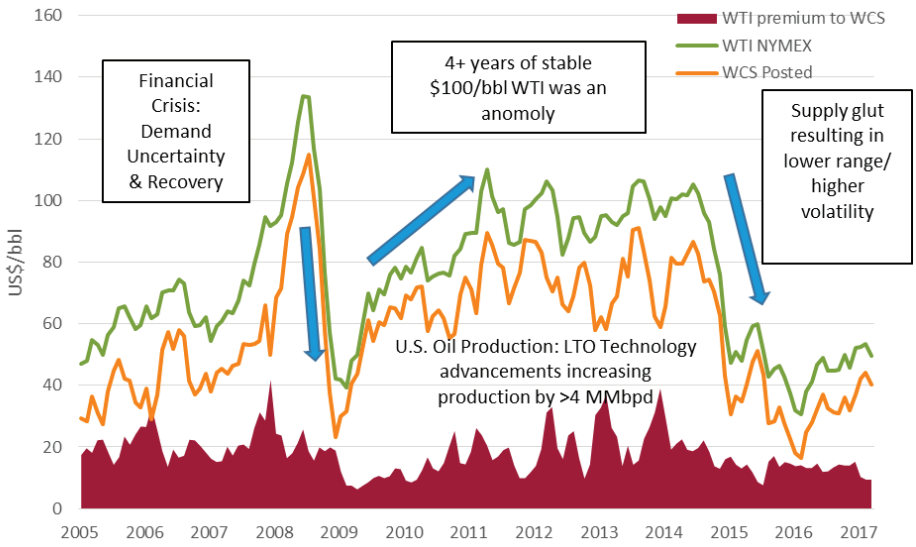
The Canadian Association of Petroleum Producers (CAPP) is the voice of Canada's upstream oil and natural gas industry. This submission seeks to assist the government in identifying measures to help Canadian businesses be more productive and competitive, while continuing to develop our resources in a socially and environmentally responsible manner.

2 Economic Context:

North American Oil and Gas Market Dynamics

The dynamics of North American oil and gas markets have changed dramatically since 2014. Technological advancements have unlocked an abundance of oil and gas resources, at lower prices, that only a decade ago was thought to be impossible. The U.S. has benefited from this development as U.S. tight oil production is now following a similar path as the U.S. shale gas revolution's transformation of North America's gas markets. The U.S. is now poised to produce a record amount of crude oil in 2018, according to the US Energy Information Administration (EIA).

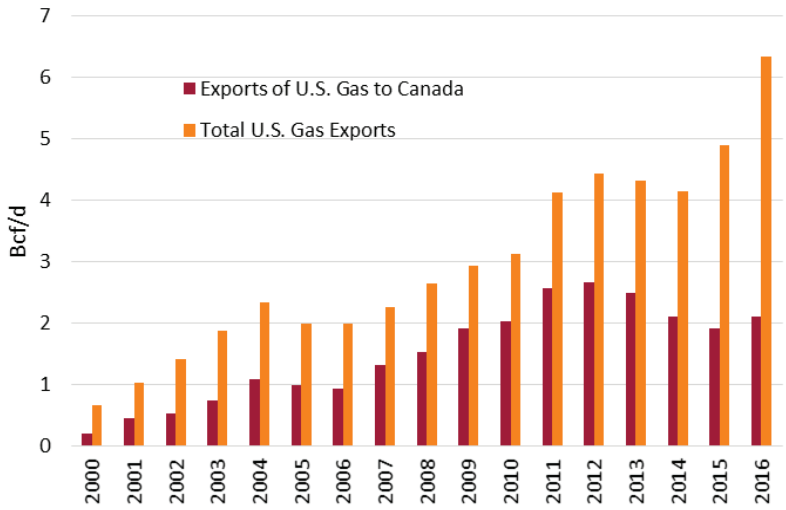
Figure 1: New Price Paradigm



Source: CAPP

Canadian oil and gas producers are not only competing for market share in the U.S. – they are competing against U.S. supply in Canada. Imports of U.S. natural gas have increased substantially since about 2005. Some of these sources are closer to markets in central Canada, which means western Canadian producers are challenged to compete.

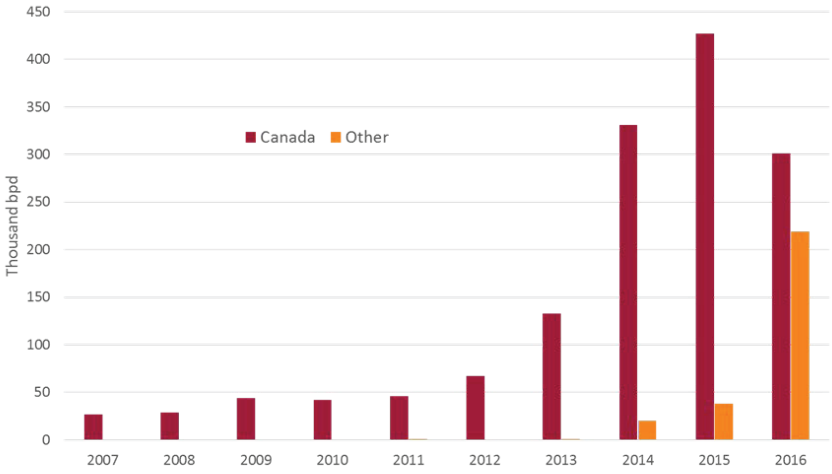
Figure 2: U.S. Exports of Natural Gas



Source: EIA

U.S. crude oil exports into Canada have also increased sharply. In 2012, Canada imported 67,000 barrels of crude/day from the U.S – which more than quadrupled by 2016, when Canada imported 301,000 barrels of crude/day.

Figure 3: U.S. Crude Oil Exports



Source: EIA

Given these challenges, a rebound of Canada's upstream oil and gas industry cannot be expected solely from an increase in commodity prices, as the future paradigm is a lower price range with higher volatility and uncertainty, with increased competition for market supply and access. It is estimated that each stalled pipeline that would access world markets costs the Canadian economy $30 to $70 million in foregone economic benefits every day, or between $11 and $25 billion annually.[1]

If Canada is to maintain or even expand its market share, it needs to be competitive with the U.S. Recent U.S. measures that seek to attract investment include:

- Removal of the oil export ban.
- Beginning to export LNG.
- Order that would require agencies to revoke two regulations for every new rule.[2]
- Withdrawing from North American commitments on methane emissions reduction.

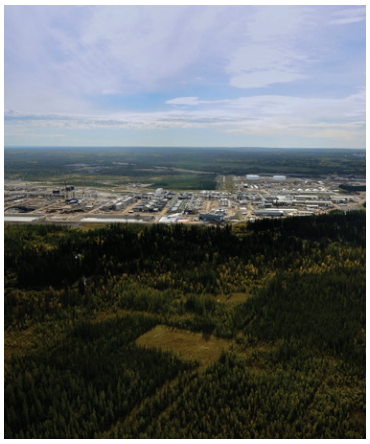
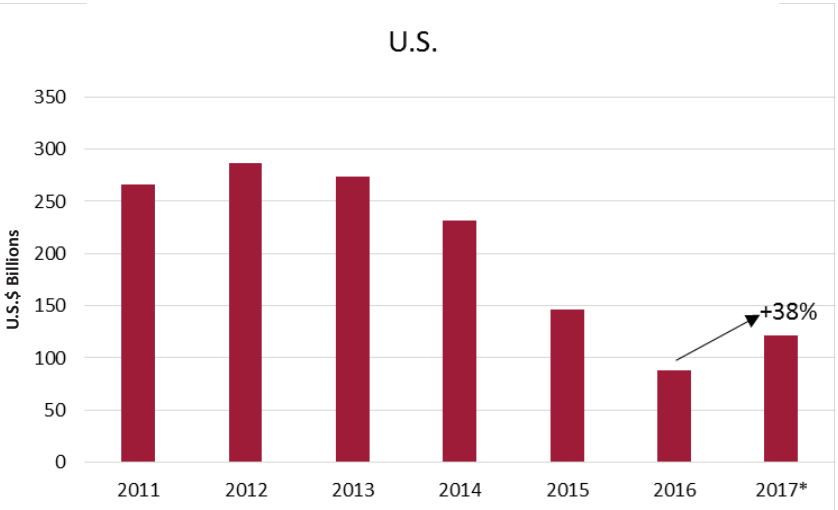


Figure 4: CAPEX spending in the U.S.



Source: Oil and Gas Journal
**2017 is estimate*

While the U.S. is reducing the cost of environmental regulations and streamlining, Canada is moving in the opposite direction. There are between 40 and 50 policy and regulatory initiatives under way with the potential to adversely impact the upstream oil and gas industry. These are conservatively estimated at between $450 and $760 million annually which is over and above the annual base policy and regulatory cost of $3.6 billion.[3] At the federal level, these include the NEB Modernization, the CEAA review, Federal Caribou Recovery Strategy, Federal Methane Emissions Reduction Framework, West Coast Tanker Moratorium, and changes to the Canadian Exploration Expense (CEE).

1. Canada West Foundation; Pipe or Perish: Saving an Oil Industry at Risk. February 2013 http://cwf.ca/research/publications/pipe-or-perish-saving-an-oil-industry-at-risk/

2. The Hill Times. "Trump Signs 2-for-1 Order to Reduce Regulations." http://thehill.com/homenews/administration/316839-trump-to-sign-order-reducing-regulations January 30, 2017

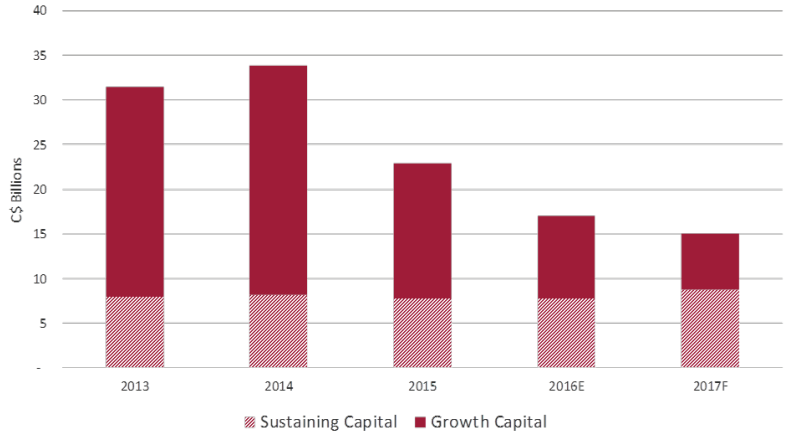
3. CAPP: "A competitive policy and regulatory framework for Alberta's upstream oil and natural gas industry" pg.3

3 Measures to help Canadian businesses to be more productive and competitive

3.1 Canada's Oil Sands Innovation

Oil sands investments have declined for the fourth straight year - from a high of $34 billion in 2014, to a recent low of $15 billion in 2017.

Figure 5: Oil Sands Capital Expenditures

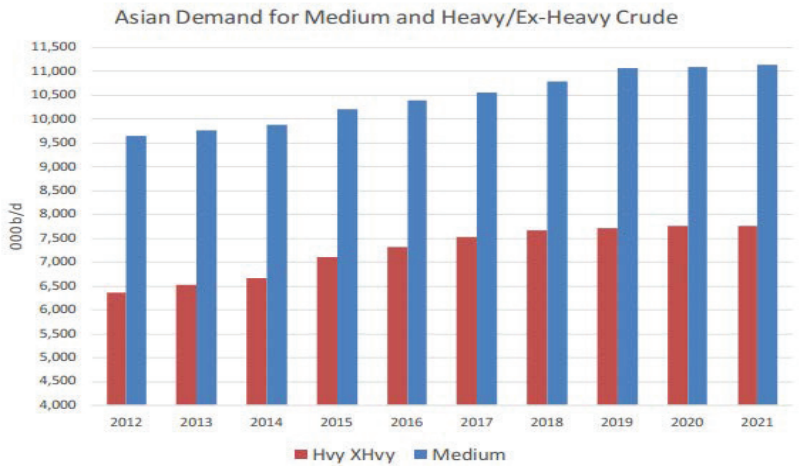


Source: CAPP

Much of this investment is sustaining existing developments – only about $6 billion is new investment. In addition, long cycle oil and gas investment continues to be prioritized by companies across the globe, however, not in Canada.

The potential for Canada's oil sands to responsibly and sustainably meet future global energy needs is enormous. Since 2012, the Asia market alone has added and is planning to add more than 1.1 million bpd of heavy oil feedstock.

Figure 6



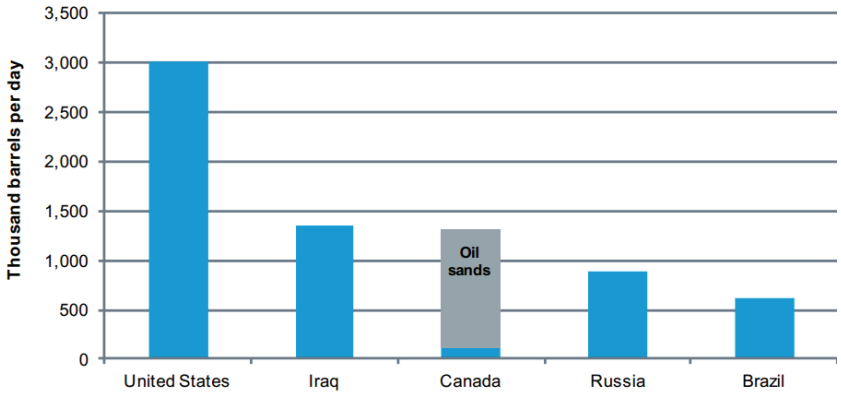
Source: ESAI Energy 2017

The key is to develop these resources in a manner that minimizes environmental impacts. A number of technologies hold significant promise to reduce our GHG footprint and position the Canadian oil sands as the cleanest oil in North America, including solvent injections and partial upgrading. CAPP estimates that a 5% reduction in average steam-to-oil ratios of in situ facilities could increase production by 140,000 bbl/day, generate 24,000 jobs, and $500mm in taxes and royalties under the same GHG profile for the industry.

What is needed is the right fiscal framework to encourage commercialization of these technologies. Current market conditions make it very difficult for companies to commercialize new technologies due to the drain on cash flow during the commercialization stage of technological development. This has led to postponement or discontinuing the commercialization together with the loss of potential economic and environmental benefits.

The amortization of capital is the most efficient fiscal lever available to governments to promote investment in large value-added and innovation investments. This approach, known as the Accelerated Capital Cost Allowance (ACCA), is a deferral of taxation until project costs have been recovered, and is suitable for industries with high upfront capital costs and long lead times until projects are cash-flow positive. The ACCA is currently available to the manufacturing, LNG and (temporarily) to mining sectors. While the ACCA is no longer available for oil sands, it is widely recognized as a key driver for the successful oil sands investment envisioned by the 1993 National Oil Sands Task Force.

Figure 7: Top five national sources of global supply growth 2005-2014



Source: IHS

CAPP RECOMMENDS the federal government introduce an Accelerated Capital Cost Allowance (ACCA) for investment in oil and gas technology/value add that improves the environmental performance and/or efficiency of the sector. More specifically this approach should:

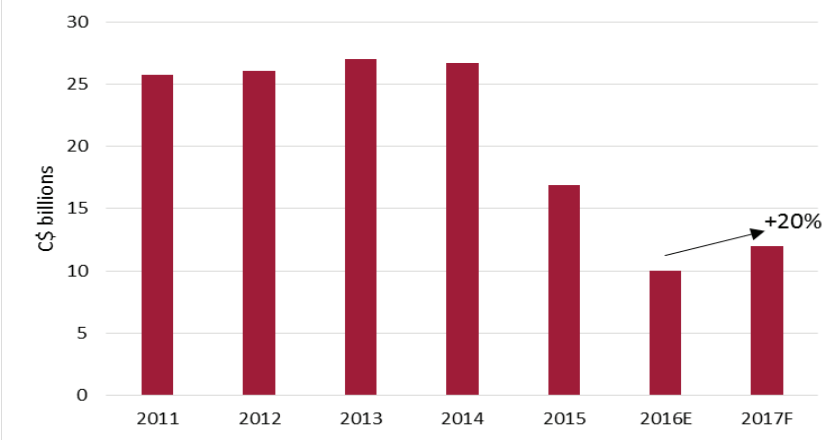
- Not be limited to oil sands but to all industries that aspire to "clean tech" and "value add" of a low-carbon economic environment.
- Apply to capital cost for all "clean tech" research and development at 100 per cent.
- Apply to all corporate income
- Have no available-for-use restrictions

The Scientific Research and Experimental Development (SR&ED) Tax Credit is another key fiscal tool for enabling investment in oil and gas R&D and technology, and CAPP recommends that the government engage with industry to update the SR&ED to encourage investment in technologies that diminish our impact on the environment, improve competitiveness, and spur productivity.

3.2 Strengthening Conventional Oil and Gas Fiscal Equity

On the conventional side, Canada continues to be challenged to attract significant capital relative to the U.S., which has seen an increase in capital spending by 38%.

Figure 8: Alberta Conventional Capital Expenditures



Source: CAPP

The Western Canadian Sedimentary Basin (WCSB) has transformed over the past decade from one of predominately exploration to development due to advances in technology, horizontal drilling, and multi-stage hydraulic fracturing. Larger more proliferate plays dominate the development landscape (i.e. tight oil & shale gas). Given the WCSB is now more of a 'development' basin, the Canadian Exploration Expense (CEE) was updated in the March 2017 Budget to reflect the evolution of the basin as "the success rates for exploratory drilling have increased substantially since the 1990s and, in a majority of cases, discovery wells now lead to production."[5]

5. March 2017 Budget, Minister of Finance, Government of Canada pg. 209

However, the development of the basin has become increasingly uncompetitive. For example, in a recent Scotiabank report comparing the economics of basins in Canada and the US, the authors concluded "The Permian basin offers the highest near-term returns, growth measures, and valuation." Reserves growth remains far higher than production growth in Canada. These measures should ultimately translate into value, but at low prices there has been a reckoning with booked reserves that require higher prices or future development capital (FDC)[6].

The Canadian Development Expense (CDE) is the tool available to oil and gas companies for expensing intangible capital costs associated with the development of the basin, and is a key attribute of the federal fiscal system driving industry investment and job creation. However, the Canadian system has fallen behind relative to the U.S. when it comes to the treatment of CDE (see Figure 9 below). Similar to its approach to CEE, CAPP encourages the government to update the CDE regime to ensure that investments in Canadian resources are not seen as less attractive relative to competing jurisdictions.

Figure 9: Canada, US, and UK Treatment of Intangible Development Expenses for Tax Purposes

Country	Tax Treatment of Development Expenditures
Canada	Canadian Development Expense (CDE): Intangible capital expenses related to development are accumulated in a pool, with a maximum 30% deductible in a tax year.
United States	Intangible Drilling Cost (IDC): 100% deductible in year incurred for most companies, 70% deductible in year incurred for integrated oil companies (balance amortized over 60 months).
United Kingdom	First-year allowance (FYA): Intangible capital expenses related to development activities are ring-fenced from downstream activities and 100% deductible in year incurred.

Source: Ernst and Young 2016 Global Oil and Gas Tax Guide (http://www.ey.com/GL/en/Services/Tax/Global-oil-and-gas-tax-guide---Country-list)

CAPP RECOMMENDS:

- That the federal government re-calibrate the current CDE rate provision to 100% to align with normal taxation rates for this particular expense, to ensure it remains current, internationally competitive and achieves government priorities.

6. Scotiabank: The Valuation Book; February 2017: https://scotia.bluematrix.com/docs/pdf/d367b60d-2e96-41e3-8c35-912d1e877c4d.pdf

It is important to recognize the legitimacy of applying this approach. Political opponents often characterize the Canadian oil and gas industry as heavily subsidized while in reality the opposite is true. The Department of Finance identified tax measures specific to fossil fuels that provide a preference or benefit to taxpayers[7]. Accordingly, the deductibility of capital expenditures is a cornerstone principle in Canada's benchmark corporate taxation framework[8]. Indeed, under the current framework, "there is not a special tax regime for oil and gas producers[9]." Equity, efficiency, and international competitiveness require that capital spending remain deductible. This is especially true given Canada's position as a high cost producer in a low commodity price environment. The Canadian Exploration Expense (CEE), the Canadian Development Expense (CDE), the Canadian Oil and Gas Property Expense (COGPE) and the foreign resource expense tax measures are a part of the benchmark income tax system and they would not generally be considered subsidies covered by the G20 commitment[10].

3.3 Strengthening Investment and Job Creation in Atlantic Canada

Canadian offshore development occurs in challenging geographic and environmental conditions. The remote location, harsh weather, and presence of icebergs require additional planning, specialized resources during construction and development, and specialized technologies required to minimize environmental, health and safety risks.

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 specifically constructed to meet support demands of 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. This hinders the competitiveness of Canada's offshore energy sector. Industry is seeking the elimination of import duties on specialized world asset vessels of the Dive Support, Pipe-lay, Flexible Fall Pipe, Multipurpose Offshore Construction, Accommodation, and Seismic variety respectively.

CAPP RECOMMENDS that duty relief 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.

7. http://www.oag-bvg.gc.ca/internet/English/parl_oag_201705_07_e_42229.html#

8. Department of Finance Canada, 2016, Report on Federal Tax Expenditures: Concepts, Estimates, and Evaluations, 10-11.

9. Ernst and Young, 2015, 2015 Global Oil and Gas Tax Guide, http://www.ey.com/GL/en/Services/Tax/Global-oil-and-gas-tax-guide---XMLQS?preview&XmlUrl=/ec1mages/taxguides/GOG-2015/GOG-CA.xml, accessed February 26, 2016.

10. http://www.oag-bvg.gc.ca/internet/English/parl_oag_201705_07_e_42229.html#