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## National Priorities 2016

# The Future of Canadian Energy Policy

by

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“Getting Canadian energy to world markets will remain a key priority in 2016. Having a robust regulatory approval system is critical for governments – and the energy sector – to ensure that Canada’s energy products get to world markets safely and in environmentally friendly, socially accepted ways. But, social acceptance entails more than the regulatory process. It requires governments to take the lead in areas outside the remit of regulators.”

Few in the Canadian energy sector – and the many Canadians who depend on it – are sad to see 2015 move into the history books. In 2016, the energy sector will be nervously watching government policies. What should policymakers do? The key issues that governments of all levels should keep in mind are as follows:

- Provincial governments should do more to improve the competitiveness of their energy sectors. Royalty reform is making headlines in Alberta, but an emerging issue is the economic damage that municipal property taxes cause to investment. Provincial governments should also focus on the cost competitiveness of electricity for consumers.
- This year looks to be one of potential changes in federal regulatory reviews of major infrastructure projects, including pipelines and rail. When it comes to the pipeline review process, however, the federal government should focus on minor changes, not major reforms, and should be especially wary of changing the review process for pipelines already underway. Furthermore, any transition to a new regulatory regime should be quick and smooth. Governments should task regulators only with matters they can address, while they themselves tackle broader issues concerning greenhouse gases and First Nations.

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- Integrating federal and provincial carbon-pricing policies likely will be the key collaborative governance issue of 2016. The new federal government, with its commitment to allow provincial freedom in carbon pricing, along with emerging provincial policies, raises the risk of a provincial patchwork that leads to higher costs of doing business. Energy producers and transportation companies should look to their own practices to improve their chances of getting project support. Both federal and provincial regulators should examine how their securities and competition policy will affect potential mergers in the energy sector.
- Rather than focus innovation and diversification policies on what is physically produced in Canada, governments should focus on how to enable Canadian companies to become global leaders in the specific technologies they are best at applying.

## The Global Competitiveness of the Canadian Energy Industry

Top of mind for most stakeholders in the Canadian energy industry in 2016 will be the global competitiveness of its oil and gas and electricity sectors, and the effects of changes to federal tax policy.

### Oil and Gas

With the recent and sustained drop in oil and natural gas prices, energy producers are looking at how to reduce costs. One of the largest costs energy producers face is the current gross-revenue royalties they pay to provincial governments in western Canada. In addition to applying to the early phases of oil sands production, these gross-revenue royalties also apply to conventional wells. Accordingly, a key step that western Canadian governments could take is to replace gross-revenue royalties with modern cash-flow royalties. As Alberta embarks on a major review of resource royalties, likely to be completed in early 2016, it should look to international best practice of cash-flow tax design (see Figure 1).



Cash-flow royalties apply only to companies after they have recouped their all-in cost of production – for details, see Boadway and Dachis (2015). A well-designed cash-flow tax allows companies to fully deduct their exploration and development costs and to carry deductions forward at the long-term government bond rate.<sup>1</sup> But the details matter: an interest rate that is too high would give companies an incentive to take on extra costs, knowing that they could get an otherwise larger deduction. Alberta's oil sands tax regime, which is a cash-flow tax, has the appropriate interest rate.

The first model to look at is that of Norway, which has a cash-flow tax that allows companies to claim expenses on projects even if they never end up producing. Australia has also introduced a cash-flow tax for both off-shore and on-shore oil and natural gas production. Australia's experience is especially important, as the types of natural-gas-producing companies there look similar to those in western Canada – for details, see Mayo (2015).

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1 The alternative is to allow companies to receive immediately a cash rebate from the provincial government equivalent to the cash-flow tax rate. For example, with a 40 percent tax rate, a \$1 million investment would result in a cash rebate of \$400,000.

Figure 1: Resource Tax Design, Alberta and Norway

System Criteria	Alberta Conventional Oil and Natural Gas 	Alberta Oil Sands 	Norway Off-shore Oil 
Cash-flow tax	X	✓	✓
Carry forward expenses at appropriate interest rate	X	✓	✓
Claim expenses if projects don't produce oil/gas	X	X	✓

Source: Adapted from Boadway and Dachis (2015).

Other government-imposed costs are critical, too. In particular, municipal property taxes are becoming increasingly important costs for business. These taxes have an appreciable effect on the return an investment must yield to be economically viable (see Found, Tomlinson, and Dachis 2015).

### Electricity

Competitiveness in electricity means low costs and reliable service for end consumers, and the price of electricity can have a major competitive impact on business. The competitiveness of electricity prices is critical across the country, but Ontario's electricity policy has raised the most concerns. For example, both residential and large industrial electricity customers in Toronto face higher total electricity costs than do customers in both categories in Calgary, Montreal and Vancouver (Table 1).

Ontario has introduced a peak-power-pricing policy that has dramatically reduced the electricity bills of some large industrial electricity customers, but the program has resulted in higher costs for industrial consumers with inflexible demand and for residential consumers (see Sen 2015). The high cost of electricity in Ontario is the result of many factors, the main one being generous fixed contracts for electricity generators, the root cause of which is the lack of an effective electricity market due to provincial directives that dictate market outcomes. A first step to restoring an effective electricity market in Ontario would be to introduce a capacity market, which is a wholesale electricity market in which electricity buyers enter into contracts with electricity generators for

**Table 1: Electricity Prices, Selected Cities, Canada, 2010 and 2015**

	2010		2015	
	Large Industrial	Residential	Large Industrial	Residential
	<i>(cents per kWh)</i>			
Montreal	4.8	6.9	5.2	7.2
Toronto	9.7	11.9	9.2	14.3
Calgary	5.0	10.7	4.7	11.7
Vancouver	5.3	7.8	7.0	10.3

Note: Large industrial consumers are those with a monthly consumption of 3,060,000 kWh and a power demand of 5,000 kW; residential consumers are those with a monthly consumption of 1,000 kWh. Rates are as of April 1 each year. The cost includes all energy, transmission and distribution costs. Source: Hydro-Québec (2010, 2015).

supply. With a capacity market, generators would compete to offer supply at a lower price than they do now (Goulding 2013; Wyman 2014). The province has already committed to introducing such a market, and it should follow through on that commitment in 2016.

2016 will mark the start of a three-year tax holiday on provincial transfer taxes in Ontario on the sales of municipally owned local electricity distribution companies (LDCs). Rather than only merge with other municipally owned LDCs, a better approach would be for municipal governments to sell their LDCs. Municipal governments do not need to own distribution companies to keep electricity costs down, since the Ontario Energy Board keeps a close regulatory eye on all price changes regardless of who owns the companies. As of 2013, municipal governments in the province held \$14 billion worth of distribution property and equipment (Dachis 2015a). The proceeds from such sales would complement those that the province is looking to apply toward its share of transportation infrastructure investment. Furthermore, private investors are usually best placed to make the decisions about the appropriate boundaries of companies, geographically and across distribution, transmission and even generation investment. Private investors in LDCs would bear the consequences of poor choices, but reap some of the rewards of good mergers (Fyfe, Garner, and Vegh 2013).

## Federal Tax Policy

The other emerging competitiveness issue for the energy sector in 2016 is the potential fallout from the new government's campaign commitment to phase out subsidies for the fossil fuel industry. Its specific commitment was limited to making Canadian Exploration Expenses deductible only in the case of unsuccessful exploration. Before making changes to the federal tax code for the energy sector, however, the new government should determine the objectives of the current tax system and whether current policies are achieving these objectives; only then should it judge whether a current policy is a subsidy. The new government should also determine what other parts of the federal tax system might be seen as a subsidy for the oil and gas sector, and look to eliminate policies that no longer are the best means of achieving the policy goals of the tax system.

## Social Acceptance to Enable Market Access for Canadian Energy

Getting Canadian energy to world markets will remain a key priority in 2016. Having a robust regulatory approval system is critical for governments – and the energy sector – to ensure that Canada’s energy products get to world markets safely and in environmentally friendly, socially accepted ways. But, social acceptance entails more than the regulatory process. It requires governments to take the lead in areas outside the remit of regulators.

### Pipeline and Major Infrastructure Review Policy

All energy sector participants should brace for a potential review in 2016 of the federal process – particularly on the part of the National Energy Board – for approving major infrastructure projects. The federal Liberals made this a major policy plank during the 2015 election campaign in response to changes made to the federal regulatory process in 2012. It will be critical, however, for the new government to put in place clear rules about which project reviews will be subject to a new review process.

On what should such a review focus? It is important that regulatory bodies are asked to adjudicate only on issues that they have the power to address. In the case of pipelines, matters such as greenhouse gas emissions should not be part of the regulatory approval process. As Doucet (2012) argues, a greenhouse gas policy led by governments would mean that a regulatory decision on building a pipeline would have no net effect on Canadian emissions.

### Rail Transportation Policy

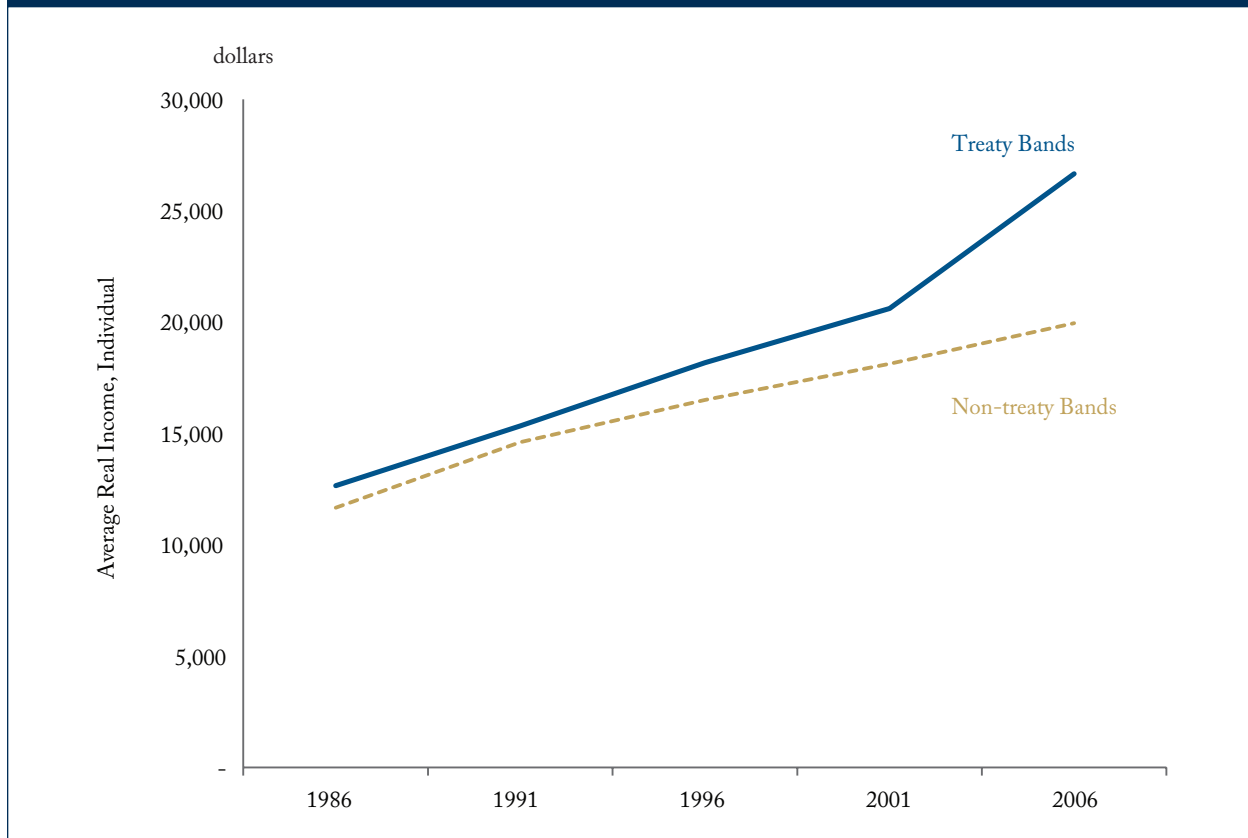
Another important issue for the energy sector in 2016 is the decision the new federal government will have to make on whether to accept the recommendations of a major review of the *Canada Transportation Act*, which was due by the end of 2015. Rail has become especially important for crude oil exports because of recent delays to pipeline approvals. Although the drop in oil prices in 2015 has meant a recent drop in crude-by-rail shipment, shipping oil by rail has inherent benefits beyond reducing reliance on pipelines. Oil can get to market faster by rail than by pipeline and reach otherwise inaccessible markets. Moreover, rail transport offers more responsiveness to changing demands, less dilution for transport, and lower capital costs (see Dachis 2015b). The review should recommend that the federal government place all sectors on a level playing field – and the government should accept that advice in 2016.

### First Nations Policy

An issue for everyone in the energy sector is how to address First Nations’ concerns about resource and infrastructure development. No one-size-fits-all approach is possible to address these concerns, since they differ among First Nations across the country, but evidence from one part of the country can inform other parts.

The most common practice has been for energy companies to enter into impact benefit agreements with First Nations to secure their local approval. However, revenues that Ontario First Nations communities have raised from business sources have not resulted in increased spending for First Nations priority issues, such as health or education spending (Richards 2015). Accordingly, the federal government, not resource companies, should take the lead in providing adequate funding for First Nations social priorities. Companies should use 2016 to review their practices of financing First Nation communities ahead of the looming effects of the *Extractive Sector*

Figure 2: Evolution of Real Income in Treaty and Non-treaty Bands (\$1991)



Source: Aragon (2015).

*Transparency Measures Act*, which will require resource companies to publish all payments to First Nation communities by 2017.

The alternative to addressing First Nations property rights through impact benefit agreements is for the federal and British Columbia governments to return to negotiations with First Nations communities to clarify the property rights of those communities. The evidence from previous treaties is that they result in more resource development agreements (Aragon 2015). Treaties also benefit First Nations and result in higher incomes for the people in and near First Nations communities (Figure 2).

## Collaborative Governance

Carbon pricing likely will be the key collaborative governance issue in 2016, and the new federal government will need to tackle a provincial policy patchwork on climate issues. The four largest provinces already have carbon prices in place or are planning to introduce them. Is a decentralized and uncoordinated approach to climate policy – with the associated costs – the unavoidable price of Canadian federalism? Or is the most important aspect of collaboration and competitiveness a common carbon price – rather than common pricing



mechanisms themselves – as argued by the Ecofiscal Commission (2015)? Policymakers should ask what the key dimensions of tax coordination should be. Indeed, a one-size-fits-all approach may also not be best. With a new federal government committed to a decentralized carbon-pricing policy, how should it involve itself, if at all, in coordinating provincial carbon-pricing policies? The past shows that a federal government presence and negotiated incentives are needed as a catalyst for provincial harmonization (Snoddon 2015).

2016 also looks to be a year of consolidation in the energy sector. Securities regulators across the country are looking to make changes to how companies can react to takeover bids. Securities regulators are proposing that takeover bids be open for a minimum of 120 days – a significant increase from the current requirement of 35 days (Anand 2015). Such a change could be damaging to the prospects of mergers occurring. In sum, Canadian regulators should not move to the proposed 120-day minimum bid period and should keep the current 35-day period.

In addition, federal merger policy will be key to the sector. A recent Supreme Court of Canada decision in *Tervita Corp. v. Canada* raises the evidentiary standard and places a strong onus on the Commissioner of Competition when it challenges mergers (C.D. Howe Institute Competition Policy Council 2015). The implications of this case will be revealed in time, depending on the manner in which future cases rely on the *Tervita* decision.

### **Collaboration in Regulatory Approvals**

Three main groups must do more to establish confidence in the project review system: the federal and provincial governments, industry participants and regulators.

Governments should demonstrate to the public that they will not interfere in regulatory decisions, and should allow sound, but timely, regulatory reviews of projects without directives to decide one way or the other. Industry bodies and companies themselves should make better use of international benchmarks, certifications and reporting requirements to demonstrate best-in-class regulatory adherence (Hale and Belanger 2015). Provincial and federal regulators should also promote multistakeholder groups, and disclose more about emergency response plans. Canadian regulators and businesses are likely among the best in the world in delivering energy to markets safely. They should seek and earn international certifications that demonstrate that high quality to the public.

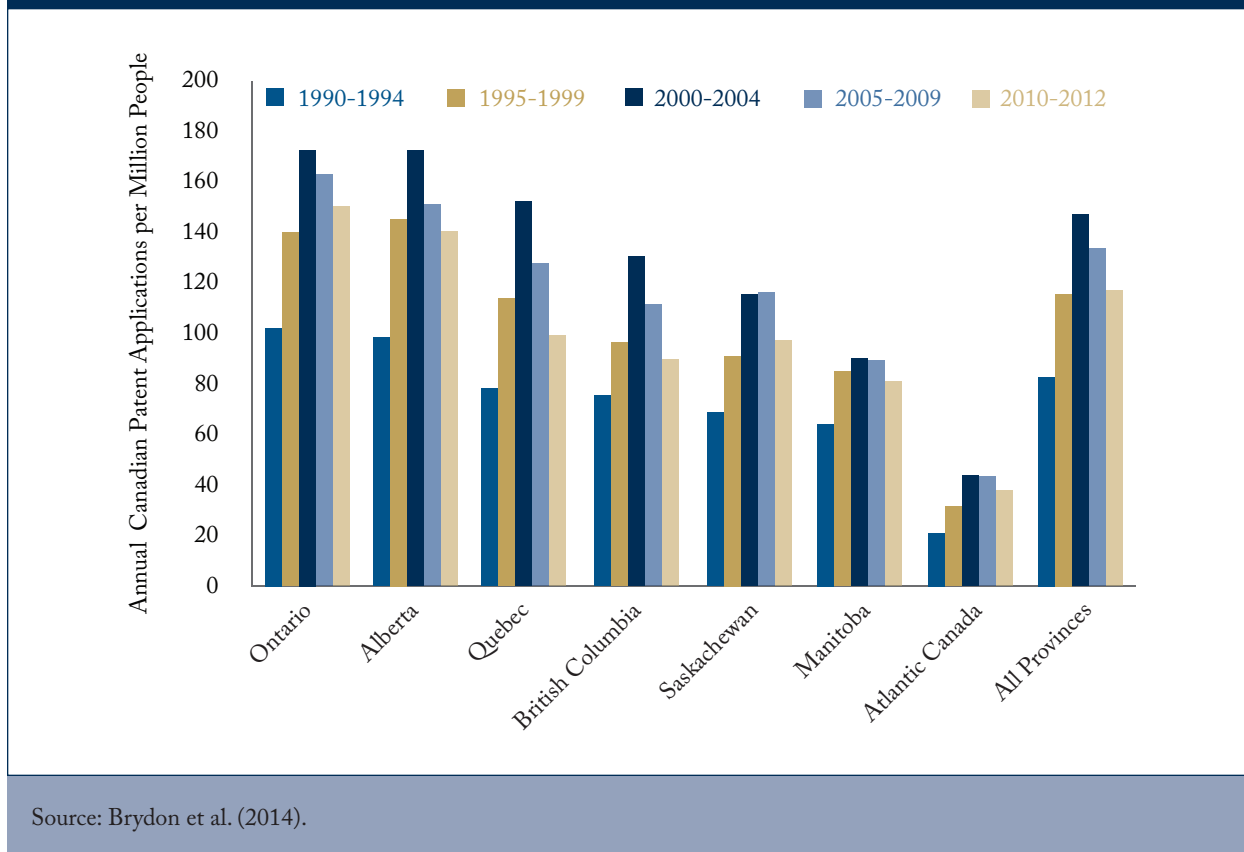
### **Electricity Trade**

Unlike interprovincial oil and gas trade via pipelines, interprovincial electricity trade is an expressly provincial domain. The result until now has been little electricity trade between provinces (Carr 2010). In the fall of 2015, however, Ontario and Quebec entered into a Memorandum of Understanding to swap electricity generating capacity. As the two provinces begin to implement this plan through 2016, they should ensure that their respective capacity offerings are placed in the emergent capacity market in Ontario, rather than being treated as a government-mandated supply. Other provinces, such as British Columbia and Alberta, should also be looking to enhance interprovincial electricity trade.

### **Innovation for Canada to Realize the Energy System of the Future**

Across all parts of the Canadian energy sector, innovation will be key to success in 2016. Innovation can drive productivity and diversification, and improve economic prosperity.

Figure 3: Average Annual Patent Applications, by Province, 1990–2012



## Measuring Innovation in Alberta's Economy

Innovation is in many ways intangible, and for that reason is difficult to measure. Patents provide one possible, although by no means final, measure of the output of innovation.<sup>2</sup> Alberta has consistently been a leader in Canadian patent applications per capita among the provinces (Figure 3). That knowledge might end up being used in unpredictable parts of the economy – new ideas often find their most fruitful application far from what the inventor intended – and could have surprising end uses that lead to greater economic diversification in the future.

The Alberta and Canadian governments should re-examine tax credit supports for research and development. One approach would be to lower taxes on income from intellectual property, such as patents, to encourage

2 Common measures include research and development spending, the number of personnel employed in this sector and innovation surveys. But these are inputs to the innovation process. Patents also have some limitations as a measure of innovation. Some inventions are never patented, many patents are acquired and never used and even those patents that are used tend to vary widely in value, with a small fraction of the total having enormous value to their owners while the majority are worthless or impose a social cost by impeding innovation elsewhere (see Brydon et al. 2014).



commercialization. The new federal government has also promised hundreds of millions of dollars in support of innovative research in the energy sector. Alberta also should consider doing likewise with revenues it raises from any prices on carbon.

## Conclusion

The energy sector has many policy issues to address in 2016. Those policy issues fall under four main themes:

- the global competitiveness of the Canadian energy system;
- the social acceptance of ways for Canadian energy to access world markets;
- collaborative governance; and
- the innovation Canada needs to realize the energy system of the future.

Policymakers have much evidence to draw on as they look to improve the prospects for a beleaguered energy sector. In 2016, they should act to provide a competitive resource tax and fiscal regime, competitive electricity prices, a robust but prompt regulatory review system, collaborative carbon policies and an economy that encourages an innovative energy sector. 2016 is likely to be critical for moving these policy priorities forward.

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