To the House of Commons Standing Committee on Finance
2015 Pre-Budget Consultations

Mr. James Rajotte, MP
Chair of the Standing Committee on Finance

Christine Lafrance
Clerk of the Standing Committee on Finance

Submission of The Explorers and Producers Association of Canada

22 July 2014

Contact Information:
Gary C. Leach, President
gleach@explorersandproducers.ca
Tel: 403 444 0115

Background

The Explorers and Producers Association of Canada (EPAC) represents 250 member companies, the large majority being oil and gas production companies, Canadian owned and operating primarily in Western Canada.

Our producer members invest approximately $10 billion dollars each year buying mineral rights from the Crown, drilling and equipping new oil and gas wells, laying related pipelines and constructing roads and facilities for the production and processing of crude oil, natural gas and natural gas liquids (ethane, propane, condensate, etc.). These levels of annual investment support tens of thousands of well paid jobs, primarily in rural areas of British Columbia, Alberta, Saskatchewan and Manitoba.

Our member companies operate in a business environment with high capital costs, high labour costs and associated risks, where individual wells can cost millions of dollars to drill. Oil and natural gas prices are volatile and Western Canadian producers are price takers in a North American market, typically at substantial discounts to North American benchmarks due to distance from major markets and lack of market and transportation alternatives.

In such a world oil and gas producers must focus on controlling costs to maintain Canada's competitiveness as a destination for investment capital, yet government "red tape" continues to be among the most rapidly rising costs we face. Examples of this growing regulatory burden include the federal government's 2014 "extractive industries transparency initiative" which will compel hundreds of Canadian producers, small and large, to report on thousands of payment transactions for property taxes, linear taxes, machinery and equipment taxes paid to rural municipalities in Western Canada as well as payments of provincial taxes, mineral leases and royalties made annually to the four western provincial governments.

Equity markets reflect weak investor appetite for junior resource company investing

Junior and intermediate Canadian oil and gas producers typically invest more than their cash flow in drilling new wells and related capital costs. With typical production declines at 20% or more each year producers must continuously drill new wells to replace and grow their production base. Access to capital, both debt and equity, is an essential foundation of a healthy Western Canadian oil and gas sector.

Junior and intermediate oil and gas companies in Canada have faced difficult and challenging capital markets since the 2008-09 financial market collapse. Investors have preferred to look to the US oil and gas sector when making investment choices. In 2013 equity (stock) offerings by Canadian oil and gas producers declined by an alarming 43% compared to 2012 to only $6.1 billion from $10.6 billion the prior year, the third consecutive year of decline. "Flow through shares" offered by Canadian junior and intermediate producers raised $404 million (out of a total equity market of $6.1 billion) in 2013. That this category was down "only" 10% compared to the 43% reduction in the total equity capital raised likely reflects the vital role that the "flow through share" market plays in sustaining access to capital for junior and intermediate producers. (Source: Sayer Energy Advisors, Calgary).

While the first half of 2014 has seen growing investor interest in Canadian oil and gas stocks, this has been very selective and particularly companies with market capitalizations below $50 million continue to face challenges finding “early stage” capital as investors favor larger corporations.

Proposals from EPAC to improve and strengthen the flow through share framework

Lower overall corporate tax rates, while a laudable goal of the government, do not address the unique financing requirements of junior and intermediate oil and gas companies to compete for investment capital because the majority of these companies are not in a taxable position. The flow-through of eligible exploration and development expenses to investors is a deferral of tax only and the capital invested creates jobs, mostly in rural Canada, which in turn generates corporate and personal taxable income. Junior and intermediate producers, having passed on their deductible expenses to investors, will be in a taxable position sooner, all other factors being equal. In addition, the investor will have an adjusted cost base of zero on a flow through share so all proceeds are taxable on disposition.

Overall, Canada’s “flow through share” program has played an important role in supporting the flow of investment capital to Canadian junior and intermediate oil and gas producers. The “flow through share” advantage enables Canadian producers to compete for capital from Canadian investors in a North American market dominated by large multinational and state owned oil and gas production companies. The program should be preserved and improved.

There are two aspects to our recommendations on how to improve the existing flow-through share program:

a) Increase the annual limit of Canadian Development Expense (“CDE”) convertible to Canadian Exploration Expense (“CEE”) from $1 million to $4 million.
b) Increase the corporate taxable capital ceiling for eligibility to access the annual CDE to CEE conversion from $15 million to $50 million.

As the Western Canadian Sedimentary Basin (“WCSB”) moves towards a “mature” status in terms of exploration potential the opportunities in our industry increasingly require taking on risk through application of evolving technologies and recovery methods in new resource plays. As a consequence fewer wells qualify for designation by the CRA as “exploration” wells and are denied CEE status even as the costs and risks associated with drilling and completing these wells has increased rapidly. The evolving nature of resource recovery in the WCSB has created a need for greater flexibility in allowing for the conversion feature mentioned above in sub-paragraph (a). The specified ceiling tests described in both subparagraphs (a) and (b) were established many years ago and have atrophied in terms of relevance to today’s high cost and technology oriented industry. They need to be updated as proposed by EPAC.

Countering misinformation about whether our industry is "subsidized"

In recent years it has become common for opponents of the oil and gas industry to claim that the oil and gas industry was "subsidized". The original context for this debate was focused on countries (e.g. India, Venezuela and many Middle East nations) whose policies encouraged domestic energy consumption through subsidized cheap prices for gasoline, kerosene and diesel. More recently this language has been turned against any fiscal policy that encouraged investment in the increased production of energy from oil and natural gas. A paper released by the *Montreal Economic Institute* (May 2014) effectively demolished the argument that the CDE and CEE programs are "subsidies".

The MEI Report stated:
"*Other tax expenditure programs…must however be considered not as subsidies but as a particular tax treatment for an industry faced with specific economic reality, common to the natural resources sector as a whole….Like the mining industry, the oil industry needs large amounts of start-up capital for its high risk undertakings.*

…The Canadian Development Expenses program allows a company to recoup most of its initial investments before paying a substantial amount of taxes and royalties at the end of the production cycle. This tax treatment has only a very limited effect on the total amount of taxes that a corporation must pay.

…The Canadian Exploration Expenses program and flow through shares compensate companies and investors that take substantial risks. Despite an initial reduction in government revenue, these tax expenditures have the potential to ensure the economic profitability of certain projects that would never have seen the light of day if the companies involved had to pay their taxes at the beginning of their production cycles. This means more tax revenue when these projects are finally carried through and wealth is created.

Annual taxation, which is the norm in industries that have the ability to produce profits on an annual basis, would not be well adapted to this kind of industry, and would even constitute a significant handicap for a sector that cannot count on production revenue in the short term. This is why, if we value the neutrality of the tax system, this kind of tax expenditure [CDE and CEE] should not be considered a subsidy".

Summary and Conclusion

Investment by the Canadian oil and gas industry is a major driver of economic prosperity in Canada and the Canadian headquartered junior and intermediate producers are a vital component of Canada's energy sector. The proposals submitted above will enable our member companies to compete in Canada within an industry dominated by large corporations, including multi-national and state owned companies, whose size and ownership structure allows them access to cheaper capital.

Respectfully submitted,

The Explorers and Producers Association of Canada