CANADIAN GOVERNMENT POLICY IN THE OIL AND GAS INDUSTRIES

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This is not the best time to make statements about the policies of the Dominion Government. The election of June 10, 1957, ended twenty-two years of Liberal control, and the new ministry has not yet had time to define its policy at all clearly. The laws that are on the statute book are those that reflect the policy of the past government, so that when we discuss them we are not dealing with a fixed programme that the Government is prepared to defend. Rather, we are examining a past policy of a defeated government with the same detached curiosity that the new ministers must themselves be bringing to bear on the matter. Therefore, if the policy is to be considered as very much on trial, and accordingly somewhat tentative, we can compensate ourselves with the realization that what we are discussing is topical and changeable. The issue is open and very much alive.

Since Canada is a federal state, we must always check whether a matter of government falls under federal or provincial jurisdiction. So often we find, to use the words of the Judicial Committee of the Privy Council, that "subjects which in one aspect and for one purpose fall within Section 92 (provincial jurisdiction) may in another aspect and for another purpose fall within Section 91 (federal jurisdiction)". This is true of oil and gas. The major share of power, however, here falls to the provincial government, since it controls the "*Management and Sale of the Public Lands belonging to the Province*"[1] and has jurisdiction over "*Property and Civil Rights in the Province.*"[2] As a result, each province has been free to develop its resources of oil and gas in its own way, with the federal government supplying scientific and technical aid, imposing taxes, and regulating those aspects of gas and oil transmission and transportation that lie beyond the powers of the provinces. In addition, the federal government has complete jurisdiction in the Yukon and Northwest Territories, and in the national parks and Indian resrevations.

Perhaps the most important and certainly the most controversial aspect of what at first seems a small area of federal jurisdiction is the power to tax. The federal government can impose "*any Mode or System of Taxation*"[3] it wishes. What in fact it has done is to impose the sort of taxes that appear to encourage the development of Canada's natural resources. The regulations permit deductions of exploration and development costs, and

allow a depletion allowance to the operators of producing oil or gas wells. In addition, there are the depreciation allowances on plant and equipment which apply to all businesses. No capital gains tax is imposed, and the law is much simpler than those of most foreign countries, notably the United States. Fairness of application is ensured by the comprehensiveness of the statute itself, which leaves virtually no room for administrative discretion. There is a right of appeal to the Income Tax Appeal Board and to the Exchequer Court of Canada.

Why, then, should this matter be in any way controversial? Certainly the Canadian laws themselves appear equitable, just, and enlightened.

The reason lies not in the Canadian laws themselves but in the way they interact with others — notably those of the United States. The day is past when a country can impose tax laws, hoping to raise revenue and influence business trends within the country, without considering how these laws will accommodate themselves to those of other countries with which large business relationships exist. When we look at Canadian taxes, we must ask ourselves certain questions. Do they encourage the sort of economic developments we want? Do they give adequate opportunities to our own citizens in their competition with foreigners? Are they as considerate of our citizens as the tax regulations of certain foreign countries are of theirs?

These questions are important when we consider the oil and gas industries in particular, because of the exceptionally large foreign (mainly American) interest in the development of these resources in Canada. For example, if the American government permits its citizens and corporations to deduct more development costs from taxable income than does the Canadian government, then American interests will have an advantage over Canadian ones in developing Canadian oil and gas. In the stages of exploration and development, no profits are being made, so no taxes are paid. However, if the American company can use profits from other operations to pay for developing Canadian wells and deduct these profits from taxable income, then its government is in fact paying part, and perhaps a very large part, of its development costs. If the Canadian government does not permit as large deductions as the American, then the Canadian operator cannot use tax exemptions to finance as much development as his American competitor. Therefore, he will suffer a competitive disadvantage in the development of the resources of his own country. Is this in fact true? It is the contention of many Canadian oil and gas operators that it is. Let us look at the regulations of the two countries.

This is a subject fraught with complexities and technicalities, so that what follows is an admittedly simplified discussion of the essentials only.

Both Canada and the United States permit certain costs of exploration and development to be deducted from taxable income. In Canada, most of the costs of acquiring property[4] may not be deducted, whereas in the United States, they can be. This means that the American operator, other things being equal, is able to outbid his Canadian competitor for properties because part of the money he bids is money that would otherwise be paid out in the form of taxes.

The other main difference between the regulations of the two countries relates to depletion allowances. Both governments recognize oil and gas as wasting assets, and they allow deductions from taxable income to compensate for this wastage and to encourage the companies engaged in the industry to carry out programmes of exploration and development. However, the allowances made by the American government are more generous than those made by the Canadian. The result is a considerable advantage for American companies over Canadian.

The most important difference relates to when the allowances for depletion can be claimed. Under Canadian law, a company must deduct all its exploration and development costs before it can claim any depletion allowance at all. If it is carrying on an extensive programme of development, it may find that it gets little or no depletion allowance. Clearly this acts as an incentive *not* to undertake exploration in order to obtain a depletion allowance — just the opposite incentive to what we might expect the Canadian government to offer its producers.

The American government, however, is more generous with its allowances. American law permits depletion to be claimed as soon as the well begins to produce. This means a clear tax advantage over the Canadian operator. In addition, there are advantages in the way depletion can be claimed that benefit the American producer.[5]

A comparison of the tax position of American and Canadian operators appears in a study prepared for the Gordon Commission.[6] A representative programme was considered in which the sum of one million dollars is invested every year for ten years. The significant difference appeared in the depletion allowances permitted. The American operator's deduction would amount to $3.7 million over the ten year period, whereas the Canadian would be allowed from $1.5 million to $1.8 million.[7] Clearly the American allowance is much more generous than the Canadian.

The differences in actual taxes payable were also considerable. An American company operating entirely in the United States would pay less than $700,000 over the ten years. If it carried out this programme in Canada, it would pay $900,000 to the two governments on the profits of this programme. However, a Canadian company would pay from $1.2 million to $1.4 million, depending on whether it had an income from marketing or not. In short, the American operator developing Canadian oil resources pays only 65 to 75 per cent of the tax that the Canadian operator pays in developing these same properties in his own country. This is so because American law permits him to recover taxes otherwise payable on his United States income in the early years.

The result of the operation of the American and Canadian tax laws is clearly to give pronounced advantages to American over Canadian interests engaged in oil and gas development in Canada. It must not, however, be argued from this concession that Canada can be expected to be equally generous to Canadian operators.

The problem arises in the case of only one foreign government, whose nationals already possess the lion's share of oil properties in Canada. It would be folly indeed for the Canadian government to draw up its taxation scheme without carefully calculating how, side by side with the American, it will affect the development and ownership of Canadian resources. Moreover, in view of the competitive disadvantage encountered by the Canadian operator, there is reason to believe that the whole situation should be reviewed. The major criticism of the present system centres in the requirement that all exploration and development costs be deducted from the profit upon which depletion is based. This gives the greatest advantage to the foreign operator in the early stages. However, any change should be undertaken only after the most thorough study of a matter which is of no small complexity.

Certain principles, however, might be stated:

(1) Incentives should be provided Canadian operators for taking the risks that are necessary to develop the industry.

(2) Canadians should be able to compete on at least a basis of equality with foreigners under normal conditions.

(3) Exploration companies should not suffer discrimination by comparison with the large integrated producing, refining, and marketing corporations.

The other important aspect of federal policy on the oil and gas industries relates to the transportation and transmission of oil

and gas over provincial and national boundaries. This is considerably less complex and technical than the question of taxation, and it attracted great interest in Parliament at an early date. Pipeline companies came before Parliament seeking incorporation, so that their proposed arrangements were brought under parliamentary scrutiny. A few members thought that any natural gas pipelines authorized by Parliament should be built entirely in Canadian territory. An exception would be permissible if an American market was necessary to make a Canadian pipeline project economically feasible.

At first, the Liberal government opposed this plan. Only when private companies themselves were willing to accept the proviso "that the main pipeline or lines. . . .shall be located entirely within Canada"[8] did the government members agree. This proviso was included in the subsequent bills relating to oil and gas pipelines that were considered. In addition, a requirement that the head offices of the corporations be located in Canada came to be included in the acts of incorporation.[9] This policy, which began as a bee in the bonnet of a few M.P.'s (Conservative, C.C.F., and Liberal), gradually came to be accepted by the government as its own policy.

On March 13, 1953, Mr. Howe announced the official Government policy in the House of Commons:

> We now come to a discussion of Government policy related to the distribution and sale of natural gas. Here we are dealing with energy similar in many ways to electrical energy, in that export under conditions that call for investment in another country obligates Canada to maintain a continuous supply of that energy. Therefore, the policy that has governed electrical energy since 1907 must apply, within reason, to the export of natural gas. Canada has consistently refused to authorize firm contracts for the export of electrical energy, and this, in spite of great pressure at times from producers of electrical energy. That consistent policy has paid large dividends to the Canadian economy. . . . Therefore, the policy of the government of Canada is to refuse permits for moving natural gas by pipe line across an international boundary until such time as we are convinced that there can be no economic use, present or future, for that natural gas within Canada.[10]

This statement was welcomed by all parties, as it expressed the attitude the House itself had assumed in handling the various pipeline bills that had come before it. Here was a case of Parliament working out a general approach to a problem which the Government accepted as official Government policy. Since 1953, despite the stormy debates about pipelines that have taken place, this policy has been maintained, and it has obtained general support in Parliament and in the country.

Naturally, this policy has been restricted to the transmission of natural gas. Oil is a commodity that is bought and sold on the world market and that can be shipped anywhere. In these circumstances, the market will rule, and there has been no need for the development of a special government policy on the subject, and beyond the ordinary licensing and regulating powers already being applied. The statute that provides for control over the movement of oil and gas across the international boundary is the Exportation of Power and Fluids and the Importation of Gas Act. This Act removed the authority of the Government to impose export duties on gas, oil, and other fluids, and denied the Government the power to revoke export licences except in cases of failure to comply with the terms of the licences themselves. The movement of oil remains relatively free of restriction by the federal government.

The other activity of the federal government that should be mentioned is not controversial: the provision of technical aid. The oil industry has benefited from the geological mapping carried out by the Geological Survey of Canada, whose field investigation memoirs are made available to companies and persons interested. Laboratory investigations are conducted on the processing of hydrocarbons. Economic studies relating to production costs, markets, and similar problems are issued by the Dominion Bureau of Statistics and by the departments concerned. These services are provided free or at nominal cost, and they are intended to encourage the development of Canadian petroleum resources by private capital, both Canadian and foreign.

In general, it would be fair to conclude that the Canadian policy is both generous and lenient. It has imposed the minimum of restriction, and it has treated all parties, domestic and foreign, on a scrupulous basis of equality. It has even carried this to the point where the foreigner in Canada now finds himself in a preferred position as compared with Canadian operators.

NOTES

1. B.N.A. Act, 1867, Sec. 92:5.
2. *Ibid.*, Sec. 92: 13.
3. *Ibid*, Sec. 91: 3.
4. Except for payment of Crown leases, and lease rentals up to one dollar per acre per annum
5. American law permits an operator to claim either cost depletion or percentage depletion, whereas the Canadian law allows only percentage depletion. This gives the American a greater assurance of recovery of high cost acreage, and costs of marginal wells.
6. *Certain aspects of Taxation Relating to Investment in Canada by Non-Residents*: A study for the Royal Commission on Canada's Economic Prospects. By J. Grant Glassco. 1956.
7. Depending on whether he had refining and marketing profits from which to deduct his exploration costs.
8. *Standing Committee on Railways, Canals and Telegraph Lines* (Minutes of Proceedings), April 28, 1950, p. 147.
9. *Ibid*, June 11, 1951. Pages 221-257, *passim*.
10. *House of Commons Debates*, March 13, 1953, pp. 2927-2930.