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Natural Resources Canada | Ressources naturelles Canada

Deputy Minister | Sous-ministre

Ottawa, Canada
K1A 0E4

MAY 29 2017

MEMORANDUM TO THE MINISTER

AUDITOR GENERAL'S AUDIT OF FOSSIL FUEL SUBSIDIES IN CANADA

(For Information)

SUMMARY

- This memo highlights the findings of the Office of the Auditor General (OAG)'s fossil fuel subsidy audit released on May 16, 2017 (Attachment 1), and NRCan's role in the related Government of Canada's commitment to phase out fossil fuel subsidies.

- Key findings of the report include:

  1. The departments of Finance (FIN) and Environment and Climate Change Canada (ECCC) did not clearly define what the 2009 G20 commitment to "rationalize and phase out in the medium term inefficient fossil fuel subsides" means in the Canadian context.
  2. FIN failed to consider all tax measures to determine whether they were inefficient fossil fuel subsidies under the commitment and did not develop an implementation plan with timelines to support the phase-out and rationalization by 2025 of remaining inefficient subsidies.
  3. ECCC developed a plan to support Canada's G20 commitment, however it has yet to implement its plan.

- While NRCan provides funding to the fossil fuel industry for various research, demonstration and development (RD&D) activities, [redacted]

- Given NRCan expertise related to the fossil fuel industry, officials will continue to support FIN and ECCC in responding to the audit recommendations, which will include a follow-up review conducted by FIN and ECCC. Officials will also continue to monitor and evaluate any proposed future changes that could impact industry and other stakeholders.

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BACKGROUND

In 2009, the G20 committed to "rationalize and phase out over the medium-term inefficient fossil fuel subsidies." This commitment was reaffirmed by G20 members in 2015 and the Government pledged to fulfill the G20 commitment in its election platform.

There is no generally agreed-upon definition of what constitutes an inefficient fossil fuel subsidy and the OAG commented directly on this in its report. Different organizations have used different definitions and methodologies to identify measures that may be considered fossil fuel subsidies. The OAG noted this deficiency in the Canadian context and the subsequent inability to measure progress against an ill-defined commitment.

CONSIDERATIONS

NRCan provides funding to the fossil fuel industry for various RD&D purposes [redacted]

Given the nature of NRCan's direct spending (i.e. innovation and environmental performance), the Department does not provide any inefficient fossil fuel subsidies that encourage wasteful production or consumption of fossil fuels. Scaling back NRCan programming to achieve further fossil fuel subsidy reform would simultaneously decrease support for important RD&D work that supports the Government's objective of transitioning to a lower-carbon economy.

Moreover, most of the existing measures that might be considered subsidies to fossil fuels at the federal level are tax expenditures that achieve important policy objectives.

For example:

- Canadian Exploration Expense facilitates resource exploration (e.g. oil and gas, mining) and removing it could lead to less future resource development;
- Flow-Through Share Deductions help small resource companies access the capital they need to pursue exploration and resource development;

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- Accelerated Capital Costs Allowance for Liquefied Natural Gas Facilities (which will be phased out by 2025) encourages investment in the nascent industry and could help Canada diversify its export markets; and
- Deductibility of Contributions to a Qualifying Environmental Trust helps ensure energy projects have put enough money aside to reclaim or restore the productivity of their land at the end of a project's life.

Public finance (e.g. Export Development Canada), which provides Canadian exporters with trade financing, export credit insurance and bonding services, is another category of federal measures; however, with no definition, it is not clear if this constitutes an inefficient fossil fuel subsidy. There is also a wide array of provincial fossil fuel measures, the majority providing fuel tax exemptions, reductions, rebates and refunds, which are not under the purview of the federal government.

NEXT STEPS

[redacted]

Christyne Tremblay
Deputy Minister

Philip Jennings
Associate Deputy Minister

Attachments: (2)

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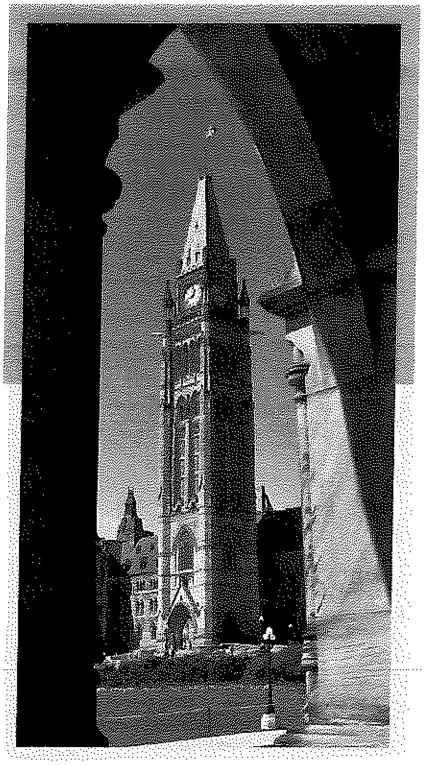

2017 Spring Reports of the Auditor General of Canada to the Parliament of Canada

Independent Audit Report

Report 7—Fossil Fuel Subsidies

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Introduction

Background

Fossil fuel subsidies

7.1 Fossil fuels are a non-renewable source of energy, including coal, oil, and natural gas. While playing an important role in Canada's economy, they have a negative impact on the environment, because when burned, they produce carbon dioxide, a significant greenhouse gas that contributes to climate change.

7.2 In general, a subsidy is a financial benefit given by government to support taxpayers. Subsidies can take the form of non-tax measures, such as government grants and contributions, government loans or loan guarantees at favourable rates, resources sold by government at below-market rates, research and development funding, and government intervention in markets to lower prices.

7.3 Subsidies can also take the form of tax measures, such as tax expenditures. Tax expenditures reduce taxes payable by certain taxpayers and thus reduce the amount of revenue that governments would otherwise collect. These types of subsidies may involve a cash payment to the taxpayer.

G20 commitment

7.4 As a member of the **Group of 20 (G20)**, Canada officially recognizes that inefficient subsidies for fossil fuels undermine efforts to deal with climate change, encourage wasteful energy consumption, reduce energy security, and impede investment in clean energy sources.

Group of 20 (G20)—Twenty partners with advanced or emerging economies whose leaders meet every year to discuss the global economy and promote economic cooperation. The G20 members are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, the Republic of Korea, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States of America, and the European Union.

7.5 At the September 2009 G20 summit in Pittsburgh, the G20 leaders committed "to phase out and rationalize over the medium term inefficient fossil fuel subsidies while providing targeted support for the poorest." They have reaffirmed this commitment every year since then, including at the September 2016 G20 summit in Hangzhou, China.

7.6 In addition, the sustainable development goals adopted in September 2015 by members of the United Nations, including Canada, included a target to rationalize inefficient fossil fuel subsidies that encourage wasteful consumption and to phase out harmful subsidies in a manner that protects the poor and the affected communities.

7.7 At the June 2016 North American Leaders' Summit, Canada, the United States, and Mexico committed to phase out inefficient fossil fuel subsidies by 2025.

Roles and responsibilities

7.8 **Department of Finance Canada.** Since the 2009 G20 summit, the Department has been responsible for analyzing and advising the Minister of Finance on tax measures relevant to Canada's 2009 G20 commitment.

7.9 **Environment and Climate Change Canada.** In November 2015, the Prime Minister mandated the Minister of Environment and Climate Change and the Minister of Finance to work together to fulfill Canada's 2009 G20 commitment. Environment and Climate Change Canada is responsible for coordinating the identification and analysis of federal non-tax measures provided to the fossil fuel sector that could be inefficient subsidies in the context of Canada's G20 commitment.

Focus of the audit

7.10 This audit focused on whether the Department of Finance Canada and Environment and Climate Change Canada, in a manner consistent with their respective roles and responsibilities, supported Canada's 2009 G20 commitment to phase out and rationalize inefficient fossil fuel subsidies while providing targeted support for the poorest.

7.11 This audit is important because while fossil fuels play an important role in Canada's economy, their consumption is the main source of greenhouse gas emissions. Fossil fuels also have a negative impact on the health of Canadians. Furthermore, inefficient subsidies to the fossil fuel sector encourage wasteful consumption, undermine efforts to address climate change, and discourage investment in clean energy sources.

7.12 More details about the audit objective, scope, approach, and criteria are in **About the Audit** at the end of this report.

Findings, Recommendations, and Responses

Supporting the phase-out of inefficient fossil fuel subsidies

Overall message

7.13 Overall, we found that the Department of Finance Canada and Environment and Climate Change Canada did not define what the 2009 G20 commitment to phase out and rationalize inefficient fossil fuel subsidies means in the context of Canada's national circumstances.

7.14 We found that since 2009, six subsidies to the fossil fuel sector were reformed by legislation. Other tax measures for this sector were not reformed. We also found that the Department of Finance Canada did not consider all tax measures to determine whether they were inefficient fossil fuel subsidies under the commitment. The Department also did not develop an implementation plan with timelines to support the phase-out and rationalization by 2025 of remaining tax measures that are inefficient fossil fuel subsidies.

7.15 In addition, the Department of Finance Canada refused to provide all the analyses that we requested for tax measures that focus on the fossil fuel sector. As a result, we could not provide assurance that the Department analyzed the social, economic, and environmental aspects of all these tax measures to support informed decision making relating to Canada's 2009 G20 commitment.

7.16 We also found that while Environment and Climate Change Canada developed a plan to guide the initial stages of its work, it did not yet know the extent of federal non-tax measures that could be inefficient fossil fuel subsidies.

7.17 These findings matter because without a clear understanding of the fossil fuel subsidies covered by the G20 commitment and without an implementation plan with timelines, the departments cannot ensure that they are providing the support needed for Canada to meet the commitment by 2025. Meeting this commitment will have a positive impact on the health of Canadians and the environment by reducing greenhouse gas emissions and wasteful consumption of fossil fuels, and by encouraging investments in clean energy.

The Department of Finance Canada and Environment and Climate Change Canada did not define how they interpret the commitment

What we found

7.18 We found that the Department of Finance Canada and Environment and Climate Change Canada did not define what the 2009 G20 commitment means in the context of Canada's national circumstances.

7.19 Our analysis supporting this finding presents what we examined and discusses the following topic:

- Terms in the G20 commitment

Why this finding matters

7.20 This finding matters because without a clear interpretation of the 2009 G20 commitment, the departments cannot identify the inefficient fossil fuel subsidies that should be considered for phase-out or rationalization to meet the commitment.

Recommendations

7.21 Our recommendations in this area of examination appear at paragraphs 7.29 and 7.30.

Analysis to support this finding

7.22 **What we examined.** We examined whether the Department of Finance Canada and Environment and Climate Change Canada interpreted the terms of the commitment according to Canada's national circumstances.

7.23 **Terms in the G20 commitment.** We asked the Department of Finance Canada for its interpretation of the commitment in the context of Canada's national circumstances, including what is meant by "inefficient fossil fuel subsidies," "rationalize," and "support for the poorest."

7.24 The Leaders' Statement of the 2009 G20 summit did not define the terms of the commitment but left it to each member country to do so. In particular, identifying the inefficiency of fossil fuel subsidies requires understanding the circumstances in each country and the impact of different subsidies. If a particular energy subsidy affects the production or consumption of a fossil fuel, the subsidy is not automatically inefficient or wasteful. Well-implemented subsidies can help address market failures or respond to social needs.

7.25 We found that the Department of Finance Canada did not define what an inefficient fossil fuel subsidy is in the context of Canada's national circumstances. The Department's approach to the G20 commitment focused on identifying tax measures specific to the production or consumption of fossil fuels that provided a preference or benefit to taxpayers.

7.26 The Department of Finance Canada informed us that with respect to tax measures, the term "rationalize" refers to a reform that removes the subsidy element of the tax measure. For example, rationalization would include the reduction of a tax deduction rate to what is considered a normal or neutral taxation rate for particular types of expenses.

7.27 According to the Department of Finance Canada, "targeted support for the poorest" in the G20 commitment was intended to address circumstances where fossil fuel subsidies are provided to consumers as an anti-poverty measure, and when these subsidies are phased out or rationalized, they should be replaced by alternative means of supporting the poor that do not involve subsidizing fuel use. Department officials stated that this part of the G20 commitment was not directly relevant to current federal tax measures, which are aimed at supporting the production of fossil fuels. In our view, however, this part of the commitment is not limited to consumer subsidies, and adverse impacts on the poorest are important considerations when phasing out all types of fossil fuel subsidies.

7.28 We also found that while Environment and Climate Change Canada's role with respect to the G20 commitment began in 2015, it did not define what the commitment means for non-tax measures in the context of Canada's national circumstances. Environment and Climate Change Canada planned to collaborate with other departments and agencies to develop a proposal on how to interpret the commitment. The Department planned to provide this proposal to ministers by fall 2017 for their consideration.

7.29 **Recommendation.** To support Canada's G20 commitment to phase out and rationalize inefficient subsidies to the fossil fuel sector, the Department of Finance Canada and Environment and Climate Change Canada should clearly define how the commitment will be interpreted in the context of Canada's national circumstances.

The departments' response. Agreed. The Department of Finance Canada, in supporting government decision making regarding the G20 commitment, has taken a broad and systematic approach. It has clearly defined the scope of potential fossil fuel subsidies in the tax system by consistently identifying and analyzing all federal tax expenditures (tax measures deviating from Canada's baseline tax treatment) that are

specific to the production or consumption of fossil fuels (as contrasted with provisions of general application), and that provide preferential treatment to those affected relative to other taxpayers.

The Department then analyzed these measures in terms of their efficiency and other relevant aspects, consistent with its usual analytical framework, in order to support government decision making.

Environment and Climate Change Canada has developed a plan to examine federal non-tax measures, in collaboration with central agencies and relevant departments and agencies. Part of this work will involve working with departments to interpret the commitment in the context of Canada's national circumstances.

7.30 **Recommendation.** The Department of Finance Canada and Environment and Climate Change Canada should ensure that adverse impacts on the poorest are considered when supporting decisions to phase out and rationalize inefficient fossil fuel subsidies.

The departments' response. Agreed. The reference in the G20 commitment to "providing targeted support for the poorest" and similar references in G20 statements to "the importance of providing those in need with essential energy services" express the intent that where fossil fuel subsidies are provided with the objective of alleviating the impacts of poverty, they should ideally be replaced by alternative means of support that do not involve subsidizing the use of fossil fuels.

Federal tax expenditures that potentially could be considered fossil fuel subsidies are aimed at producers development of fossil fuels, to a considerable extent to serve export markets. These tax expenditures have no material impact on fossil fuel prices, which are set in international markets. These expenditures are aimed at supporting production rather than alleviating poverty.

To the extent it is relevant to federal measures, the Department of Finance Canada and Environment and Climate Change Canada will ensure that adverse impacts on the poorest are considered when supporting government decision making with respect to the G20 commitment.

The Department of Finance Canada did not provide all of its analyses for tax measures

What we found

7.31 The Department of Finance Canada refused to provide all of its analyses for tax measures that focus on the fossil fuel sector. As a result, we could not provide assurance that the Department analyzed the social, economic, and environmental aspects of all these tax measures to support informed decision making relating to Canada's 2009 G20 commitment.

7.32 Our analysis supporting this finding presents what we examined and discusses the following topic:

- Analyses that supported decisions

Why this finding matters

7.33 This finding matters because our audit reports provide Parliament with information on government programs and activities. Without complete information from the Department on the social, economic, and environmental aspects of tax measures, we cannot provide assurance that decision makers received the information they need to make effective decisions that will enable Canada to meet its G20 commitment.

Recommendations

7.34 We made no recommendations in this area of examination.

Analysis to support this finding

7.35 **What we examined.** We examined the Department of Finance Canada's work on tax measures for the fossil fuel sector to determine whether the Department analyzed federal tax measures that could be considered inefficient fossil fuel subsidies.

7.36 **Analyses that supported decisions.** We asked the Department for the analyses that it conducted to support decisions regarding the G20 commitment.

7.37 We found that the Department conducted an analysis of the social, economic, and environmental aspects of a new fossil fuel subsidy, introduced in 2015, for liquefied natural gas facilities.

7.38 The Department refused to provide us with 243 pages from budget briefing notes that it said contained analyses relating to the G20 commitment prepared for the purpose of ministerial decision making between 2010 and 2016. According to the Department, these documents are Cabinet confidences that it could not provide to us.

7.39 According to an internal evaluation report published by the Department, budget briefing notes require a substantial amount of effort and resources, and are among the most complex outputs of its Tax Policy Branch. The Department's internal evaluation report also states that budget briefing notes encompass all the research and analysis undertaken on a particular issue, including economic, policy, and statistical analysis, simulations, and a review of the relevant literature. They also include **strategic environmental assessments.**

Strategic environmental assessment—An environmental assessment of proposed policies, plans, and programs, which seeks to incorporate environmental considerations into the development of public policies and strategic decisions. It also serves to strengthen accountability and provide greater public confidence that the federal government considers potential environmental impacts when making decisions.

7.40 We asked the Department for strategic environmental assessments conducted for fossil fuel subsidies that it considered in the context of the G20 commitment. The Department provided a few examples of these assessments, but redacted most of the information contained in them because, again, it considered the information to be a Cabinet confidence that it could not provide to us.

7.41 Since we did not receive all the analyses that we requested from the Department of Finance Canada, we could not provide assurance to Parliament that the Department analyzed the economic, social, and environmental aspects of all tax measures related to the fossil fuel sector to support informed decision making.

The Department of Finance Canada did not consider all tax measures and did not have a plan to support the G20 commitment

What we found

7.42 We found that since 2009, six subsidies to the fossil fuel sector were reformed by legislation. Other tax measures to the fossil fuel sector were not reformed.

7.43 We also found that the Department did not consider all tax measures to determine whether they were inefficient fossil fuel subsidies under the commitment. The Department thus could not provide assurance that it took a rigorous approach to supporting Canada's G20 commitment.

7.44 Though some fossil fuel subsidies were phased out and rationalized, we found that the Department of Finance Canada did not develop an implementation plan with timelines to support the phase-out and rationalization by 2025 of remaining tax measures that are inefficient fossil fuel subsidies.

7.45 Our analysis supporting this finding presents what we examined and discusses the following topics:

- Status of reforms to tax measures for the fossil fuel sector
- Benchmark income tax measures
- Implementation plan

Why this finding matters

7.46 This finding matters because until the Department conducts a thorough analysis of all tax measures for the fossil fuel sector, including benchmark income tax measures, the Department cannot provide assurance that it took a rigorous approach to supporting Canada's 2009 G20 commitment.

Recommendations

7.47 Our recommendations in these areas of examination appear at paragraphs 7.54 and 7.55.

Analysis to support this finding

7.48 **What we examined.** We examined the Department of Finance Canada's work on tax measures for the fossil fuel sector to determine whether the Department

- identified federal tax measures that could be considered inefficient fossil fuel subsidies, and
- developed an implementation plan to support the phase-out and rationalization of inefficient fossil fuel subsidies by 2025.

7.49 **Status of reforms to tax measures for the fossil fuel sector.** We found that since the government's commitment in 2009 to phase out and rationalize inefficient fossil fuel subsidies, six fossil fuel subsidies were reformed by legislation. The government either phased them out by eliminating them or rationalized them by, for example, reducing their deduction rates to what is conside particular type of expenses. We also found other tax measures that reduced taxes payable by the fossil fuel sector that were not reformed (Exhibit 7.1).

Exhibit 7.1—Some tax measures relating to the fossil fuel sector were phased out and rationalized

Tax measure	Budget announcement year	Status of reform	Projected impact on budgetary balance [1]
Expenses of oil sands and oil shale leases and property, previously treated as Canadian development expenses (deductible at 30% annually), are treated as Canadian oil and gas property expenses (deductible at 10% annually).	2011	Rationalization completed in March 2011	$75 million in the 2015–16 fiscal year
Expenses incurred to bring new oil sands and oil shale mines into production, previously treated as Canadian exploration expenses (deductible at 100% in the year incurred), are treated as Canadian development expenses (deductible at 30% annually).	2011	Rationalization completed in January 2016	$75 million in the 2015–16 fiscal year
The Atlantic Investment Tax Credit, a 10% credit for investments in buildings, machinery, and equipment for businesses in the Atlantic and Gaspé regions, was phased out for the oil and gas and mining sectors.	2012	Phase-out completed in January 2017	$85 million in the 2016–17 fiscal year
The accelerated capital cost allowance allows a deduction for the cost of tangible assets used in mines [2] (such as machinery) of up to 100% annually. The deduction will be gradually adjusted to the normal rate of 25% annually.	2013	Phase-out to be completed by January 2021	$40 million in the 2019–20 fiscal year [3]
Expenses incurred to bring all other mines (in addition to oil sands and oil shale) into production, previously treated as Canadian exploration expenses (deductible at 100% in the year incurred), will be gradually treated as Canadian development expenses (deductible at 30% annually).	2013	Rationalization to be completed by January 2018	$30 million in the 2019–20 fiscal year [3]
The accelerated capital cost allowance that effectively allows a 30% annual depreciation rate for equipment used in natural gas liquefaction instead of the normal rate of 8%, and a 10% rate for buildings at a facility that liquefies natural gas instead of the normal rate of 6%, will be eliminated.	2015	Phase-out to be completed by January 2025	−$10 million in the 2019–20 fiscal year
Accelerated deductibility of Canadian exploration expenses for successful exploration allows a deduction of 100% in the year costs are incurred.	Not applicable [4]	No reform legislated [4]	No data is available
Flow-through shares for exploration and development expenses in oil, gas, mining, and renewable energy are a tax shelter that allows a corporation to transfer tax deductions to investors.	Not applicable	No reform legislated	−$130 million in 2017 [5]
A reclassification of expenses under flow-through shares allows small corporations in the oil and gas sector to reclassify the first $1 million of Canadian development expenses passed on to shareholders (deductible at 30% annually) as Canadian exploration expenses (deductible at 100% in the year incurred).	Not applicable [4]	No reform legislated [4]	$5 million in 2017

1 A positive amount represents an improvement in the budgetary balance (higher revenues or lower spending). A negative amount represents a decline in the budgetary balance (lower revenues or higher spending).

2 An adjustment of the deduction rate of this subsidy for oil sands and oil shale mines was announced in Budget 2007 and completed in 2015.

3 This amount includes a projected increase in revenue from all mines. No projections were available from the Department of Finance Canada for the amount attributable specifically to the fossil fuel sector.

4 See **Subsequent Event** at the end of the report for additional information.

5 This amount includes costs for all mines and renewable energy. No estimates were available from the Department of Finance Canada for the amount attributable specifically to the fossil fuel sector.

Source: Based on Department of Finance Canada information

Benchmark income tax system—A tax system that represents what might be considered neutral taxation.

Canada's benchmark income tax system allows a tax deduction for expenses incurred to earn business income.

7.50 **Benchmark income tax measures.** We found that the Department of Finance Canada's approach to the G20 commitment focused on identifying tax measures specific to fossil fuels that provided a preference or benefit to taxpayers. However, we also found that its approach did not consider a number of tax measures that applied specifically to the oil, gas, and mining sectors. The Department told us that it considered these tax measures to be part of the **benchmark income tax system** and that they would not generally be considered subsidies covered by the commitment.

7.51 The Department identified certain benchmark income tax measures that applied specifically to the oil, gas, and mining sectors (Exhibit 7.2).

Exhibit 7.2—The Department of Finance Canada identified certain benchmark income tax measures specific to the oil, gas, and mining sectors

Benchmark income tax measure
The Canadian exploration expense allows corporations to deduct 100% of their expenses for unsuccessful exploration in the year incurred. This measure also includes the cost of environmental studies and community consultations related to exploration.
The Canadian development expense allows corporations to deduct 100% of the cost of development expenses, such as drilling a production well, at a rate of 30% annually.
The Canadian oil and gas property expense allows corporations to deduct 100% of the cost of oil and gas properties, such as drilling rights, at a rate of 10% annually.
The foreign resource expense allows corporations to deduct 100% of international exploration and development costs at a rate between 10 and 30% annually, depending on the circumstances.

Source: Based on Department of Finance Canada information

7.52 We asked the Department for its analyses on how it determined that these tax measures were part of the benchmark income tax system. We found that the Department did not conduct any analyses on whether the deduction rates for these benchmark income tax measures, which have been in place for decades, were still appropriate.

7.53 **Implementation plan.** Though some fossil fuel subsidies were phased out and rationalized, we found that the Department of Finance Canada did not develop an implementation plan with timelines to support the phase-out and rationalization of remaining tax measures that are inefficient fossil fuel subsidies.

7.54 **Recommendation.** The Department of Finance Canada should complete an analysis of all tax measures that apply to the fossil fuel sector, including benchmark income tax measures, to support the phase-out and rationalization of inefficient fossil fuel subsidies.

The Department's response. Agreed. As set out in the response to the recommendation at paragraph 7.29, the Department of Finance Canada has consistently taken a broad and systematic approach in identifying federal tax measures that could potentially be considered fossil fuel subsidies. The Department considers all tax measures and annually reviews each tax system change, in order to identify aspects of the tax system that deviate from Canada's baseline tax treatment and that should thus be considered tax expenditures. To identify potential inefficient fossil fuel subsidies, each tax expenditure was reviewed to isolate those that are specific to the production or consumption of fossil fuels and provide preferential treatment to those affected relative to other taxpayers. The Department then rigorously analyzed these tax expenditures in terms of their efficiency and other relevant aspects, such as relevance, effectiveness, equity, simplicity, fiscal implications, and environmental impact, consistent with its usual analytical framework, in order to support government decision making.

Going forward, the Department will continue to provide analysis and advice with respect to any remaining tax expenditures potentially relevant to the G20 commitment.

7.55 **Recommendation.** The Department of Finance Canada should develop a plan with timelines that outlines the actions that the Department will take to support the phase-out and rationalization by 2025 of remaining tax measures that are inefficient fossil fuel subsidies.

The Department's response. Agreed. The Department of Finance Canada has, on a timely basis and in accordance with its role, consistently identified federal tax expenditures that support fossil fuels, analyzed them, and developed policy options for consideration by the government.

Dating back to before the G20 commitment, Canada has phased out most tax preferences for fossil fuel production, including provisions relating to the resource allowance (Budget 2003); accelerated capital cost allowance for oil sands (Budget 2007); intangible capital expenses for oil sands (Budget 2011); the Atlantic Investment Tax Credit for oil and gas mining (Budget 2012); accelerated capital cost allowance and pre-production development expenses for mines (Budget 2013); and accelerated capital cost allowance for liquefied natural gas facilities (Budget 2016). Most recently, Budget 2017 proposed the rationalization of Canadian exploration expense treatment for oil and gas and the phase-out of the ability of oil and gas producers to reclassify certain development expenses as more favourably treated exploration expenses. As a result of these actions, there is only one remaining federal tax expenditure potentially relevant to the G20 commitment.

Going forward, the Department will continue to provide ministers with timely analysis and advice with respect to the G20 commitment.

Environment and Climate Change Canada did not yet know the extent of federal non-tax measures that could be inefficient fossil fuel subsidies

What we found

7.56 We found that while Environment and Climate Change Canada developed a plan to guide the initial stages of its work related to non-tax measures, it did not yet know the extent of federal non-tax measures that could be inefficient fossil fuel subsidies.

7.57 Our analysis supporting this finding presents what we examined and discusses the following topic:

- Implementation plan

Why this finding matters

7.58 This finding matters because in November 2015, the Prime Minister mandated the Minister of Finance and the Minister of Environment and Climate Change to work together to fulfill the G20 commitment and phase out and rationalize subsidies to the fossil fuel sector. For Canada to fully meet its commitment by 2025, Environment and Climate Change Canada needs to develop an implementation plan with timelines to support the phase-out and rationalization of non-tax measures.

Recommendations

7.59 We made no recommendations in this area of examination.

Analysis to support this finding

7.60 **What we examined.** We examined whether Environment and Climate Change Canada developed an implementation plan with timelines to support the phase-out and rationalization of non-tax measures.

7.61 **Implementation plan.** We found that while Environment and Climate Change Canada's role with respect to the G20 commitment began in November 2015, it did not yet identify federal non-tax measures supporting the fossil fuel industry that could be considered to be inefficient fossil fuel subsidies.

7.62 In the 2012 Fall Report of the Commissioner of the Environment and Sustainable Development, Chapter 4—A Study of Federal Support to the Fossil Fuel Sector, we reported that federal funding to the fossil fuel sector for research and development and economic development was $508 million from the 2007–08 to 2011–12 fiscal years. This total does not include all non-tax measures that support the sector, such as government loans or loan guarantees at favourable rates.

7.63 In February 2017, the Minister of Environment and Climate Change approved a plan with timelines that included collaborating with other federal departments and agencies to identify non-tax measures and to interpret the G20 commitment. Any changes to particular non-tax measures that are identified will rest with the responsible ministers.

Conclusion

7.64 We could not conclude whether the Department of Finance Canada supported Canada's 2009 G20 commitment to phase out and rationalize inefficient fossil fuel subsidies while providing targeted support for the poorest. The Department refused to provide us with all documents that may contain analyses to support decision making. According to the Department, these documents are Cabinet confidences that it could not provide to us. As a result, we could not provide assurance to Parliament that the Department conducted the analyses required to support informed decision making.

7.65 We concluded that Environment and Climate Change Canada developed a plan to support Canada's 2009 G20 commitment. However, the Department did not yet implement its plan.

Subsequent Event

7.66 On 22 March 2017, the government released Budget 2017, which proposed the following reforms to two fossil fuel subsidies discussed in Exhibit 7.1:

- Modify the accelerated deductibility of expenses for successful oil and gas exploratory drilling (100-percent deduction in the year incurred) by treating them as Canadian development expenses, which are deductible at a rate of 30 percent annually.
- Remove the tax preference that allows small oil and gas companies to reclassify Canadian development expenses as immediately deductible Canadian exploration expenses when they are passed on to flow-through share investors.

About the Audit

This independent assurance report was prepared by the Office of the Auditor General of Canada on the phase-out and rationalization of inefficient fossil fuel subsidies. Our responsibility was to provide objective information, advice, and assurance to assist Parliament in its scrutiny of the government's management of resources and programs, and to conclude on whether the actions of the Department of Finance Canada and Environment and Climate Change Canada in support of Canada's 2009 G20 commitment comply in all significant respects with the applicable criteria.

All work in this audit was performed to a reasonable level of assurance in accordance with the Canadian Standard for Assurance Engagements (CSAE) 3001—Direct Engagements set out by the Chartered Professional Accountants of Canada (CPA Canada) in the CPA Canada Handbook—Assurance.

The Office applies Canadian Standard on Quality Control 1 and, accordingly, maintains a comprehensive system of quality control, including documented policies and procedures regarding compliance with ethical requirements, professional standards, and applicable legal and regulatory requirements.

In conducting the audit work, we have complied with the independence and other ethical requirements of the Rules of Professional Conduct of Chartered Professional Accountants of Ontario and the Code of Values, Ethics and Professional Conduct of the Office of the Auditor General of Canada. Both the Rules of Professional Conduct and the Code are founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour.

In accordance with our regular audit process, we obtained the following from management:

- confirmation of management's responsibility for the subject under audit;
- acknowledgement of the suitability of the criteria used in the audit;
- confirmation that the findings in this report are factually based; and
- confirmation that all known information that has been requested, or that could affect the findings or audit conclusion, has been provided. Management's confirmation expressly excluded Cabinet confidences.

We asked the Department of Finance Canada for analyses that it conducted on tax measures related to the fossil fuel sector to support informed decision making regarding Canada's 2009 G20 commitment. The Department refused to provide us with its budget briefing notes that it said contained analyses relating to the G20 commitment, prepared for the purpose of ministerial decision making between 2010 and 2016. The Department also redacted information contained in strategic environmental assessments conducted for fossil fuel subsidies that it considered in the context of the G20 commitment. According to the Department, these documents are Cabinet confidences that it could not provide to us.

Audit objective

The objective of this audit was to determine whether the Department of Finance Canada and Environment and Climate Change Canada, in a manner consistent with their respective roles and responsibilities, supported Canada's 2009 G20 commitment to phase out and rationalize over the medium term inefficient fossil fuel subsidies while providing targeted support for the poorest.

Scope and approach

The audit examined whether the Department of Finance Canada identified and analyzed tax measures in the context of Canada's 2009 G20 commitment to phase out and rationalize over the medium term inefficient fossil fuel subsidies while providing targeted support for the poorest. It also examined whether the Department of Finance Canada and Environment and Climate Change Canada determined their respective roles and responsibilities since November 2015, and developed an implementation strategy and timeline to support the phase-out and rationalization over the medium term of inefficient fossil fuel subsidies while providing targeted support for the poorest.

The audit involved interviewing Department of Finance Canada and Environment and Climate Change Canada officials, as well as reviewing and analyzing documents provided by department officials.

Criteria

To determine whether the Department of Finance Canada and Environment and Climate Change Canada, in a manner consistent with their respective roles and responsibilities, supported Canada's G20 commitment to phase out and rationalize over the medium term inefficient fossil fuel subsidies while providing targeted support for the poorest, we used the following criteria:

Criteria	Sources
The Department of Finance Canada identifies and analyzes federal government tax measures that can be considered inefficient fossil fuel subsidies in the context of Canada's 2009 G20 commitment to phase out and rationalize over the medium term inefficient fossil fuel subsidies while providing targeted support for the poorest.	• Leaders' Statement: The Pittsburgh Summit, 2009 • G20 Leaders' Communiqué—Hangzhou Summit, 2016 • Minister of Finance Mandate Letter, 2015 • 2015 Spring Reports of the Office of the Auditor General of Canada, Report 3—Tax-Based Expenditures • 2013–14 Report on Plans and Priorities, Department of Finance Canada • 2014–15 Report on Plans and Priorities, Department of Finance Canada
The Department of Finance Canada assesses Canada's progress in meeting its 2009 G20 commitment through federal tax reforms in relation to the fossil fuel sector.	• Leaders' Statement: The Pittsburgh Summit, 2009 • G20 Leaders' Communiqué—Hangzhou Summit, 2016 • Minister of Finance Mandate Letter, 2015 • 2015 Spring Reports of the Office of the Auditor General of Canada, Report 3—Tax-Based Expenditures • 2013–14 Report on Plans and Priorities, Department of Finance Canada • 2014–15 Report on Plans and Priorities, Department of Finance Canada
The Department of Finance Canada and Environment and Climate Change Canada define their respective roles and responsibilities in relation to Canada's 2009 G20 commitment to phase out and rationalize over the medium term inefficient fossil fuel subsidies while providing targeted support for the poorest.	• Leaders' Statement: The Pittsburgh Summit, 2009 • G20 Leaders' Communiqué—Hangzhou Summit, 2016 • Minister of Finance Mandate Letter, 2015 • Minister of Environment and Climate Change Canada Mandate Letter, 2015 • 2013–14 Report on Plans and Priorities, Department of Finance Canada • 2014–15 Report on Plans and Priorities, Department of Finance Canada • Policy on Management, Resources and Results Structures, Treasury Board, 2010 • Policy on Results, Treasury Board, 2016
The Department of Finance Canada and Environment and Climate Change Canada develop implementation strategies and timelines to support the phase-out and rationalization over the medium term of inefficient fossil fuel subsidies while providing targeted support for the poorest.	• Leaders' Statement: The Pittsburgh Summit, 2009 • G20 Leaders' Communiqué—Hangzhou Summit, 2016 • Minister of Finance Mandate Letter, 2015 • Minister of Environment and Climate Change Canada Mandate Letter, 2015 • 2013–14 Report on Plans and Priorities, Department of Finance Canada • 2014–15 Report on Plans and Priorities, Department of Finance Canada • Policy on Management, Resources and Results Structures, Treasury Board, 2010 • Policy on Results, Treasury Board, 2016

Period covered by the audit

The audit covered the period between September 2009 and February 2017. This is the period to which the audit conclusion applies. However, to gain a more complete understanding of the subject matter of the audit, we also examined certain matters that preceded the starting date of the audit. We al understanding of the subject matter of the audit, we also examined certain matters that preceded the starting date of the audit. We also noted a subsequent event that occurred on 22 March 2017.

Date of the report

We obtained sufficient and appropriate audit evidence on which to base our conclusion on 28 February 2017, in Ottawa, Ontario.

Audit team

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List of Recommendations

The following table lists the recommendations and responses found in this report. The paragraph number preceding the recommendation indicates the location of the recommendation in the report, and the numbers in parentheses indicate the location of the related discussion.

Supporting the phase-out of inefficient fossil fuel subsidies

Recommendation	Response
7.29 To support Canada's G20 commitment to phase out and rationalize inefficient subsidies to the fossil fuel sector, the Department of Finance Canada and Environment and Climate Change Canada should clearly define how the commitment will be interpreted in the context of Canada's national circumstances. **(7.23–7.28)**	**The departments' response.** Agreed. The Department of Finance Canada, in supporting government decision making regarding the G20 commitment, has taken a broad and systematic approach. It has clearly defined the scope of potential fossil fuel subsidies in the tax system by consistently identifying and analyzing all federal tax expenditures (tax measures deviating from Canada's baseline tax treatment) that are specific to the production or consumption of fossil fuels (as contrasted with provisions of general application), and that provide preferential treatment to those affected relative to other taxpayers. The Department then analyzed these measures in terms of their efficiency and other relevant aspects, consistent with its usual analytical framework, in order to support government decision making. Environment and Climate Change Canada has developed a plan to examine federal non-tax measures, in collaboration with central agencies and relevant departments and agencies. Part of this work will involve working with departments to interpret the commitment in the context of Canada's national circumstances.

Recommendation	Response
7.30 The Department of Finance Canada and Environment and Climate Change Canada should ensure that adverse impacts on the poorest are considered when supporting decisions to phase out and rationalize inefficient fossil fuel subsidies. **(7.23–7.28)**	**The departments' response.** Agreed. The reference in the G20 commitment to "providing targeted support for the poorest" and similar references in G20 statements to "the importance of providing those in need with essential energy services" express the intent that where fossil fuel subsidies are provided with the objective of alleviating the impacts of poverty, they should ideally be replaced by alternative means of support that do not involve subsidizing the use of fossil fuels. Federal tax expenditures that potentially could be considered fossil fuel subsidies are aimed at producers and support the exploration and development of fossil fuels, to a considerable extent to serve export markets. These tax expenditures have no material impact on fossil fuel prices, which are set in international markets. These expenditures are aimed at supporting production rather than alleviating poverty. To the extent it is relevant to federal measures, the Department of Finance Canada and Environment and Climate Change Canada will ensure that adverse impacts on the poorest are considered when supporting government decision making with respect to the G20 commitment.
7.54 The Department of Finance Canada should complete an analysis of all tax measures that apply to the fossil fuel sector, including benchmark income tax measures, to support the phase-out and rationalization of inefficient fossil fuel subsidies. **(7.49–7.53)**	**The Department's response.** Agreed. As set out in the response to the recommendation at paragraph 7.29, the Department of Finance Canada has consistently taken a broad and systematic approach in identifying federal tax measures that could potentially be considered fossil fuel subsidies. The Department considers all tax measures and annually reviews each tax system change, in order to identify aspects of the tax system that deviate from Canada's baseline tax treatment and that should thus be considered tax expenditures. To identify potential inefficient fossil fuel subsidies, each tax expenditure was reviewed to isolate those that are specific to the production or consumption of fossil fuels and provide preferential treatment to those affected relative to other taxpayers. The Department then rigorously analyzed these tax expenditures in terms of their efficiency and other relevant aspects, such as relevance, effectiveness, equity, simplicity, fiscal implications, and environmental impact, consistent with its usual analytical framework, in order to support government decision making. Going forward, the Department will continue to provide analysis and advice with respect to any remaining tax expenditures potentially relevant to the G20 commitment.
7.55 The Department of Finance Canada should develop a plan with timelines that outlines the actions that the Department will take to support the phase-out and rationalization by 2025 of remaining tax measures that are inefficient fossil fuel subsidies. **(7.49–7.53)**	**The Department's response.** Agreed. The Department of Finance Canada has, on a timely basis and in accordance with its role, consistently identified federal tax expenditures that support fossil fuels, analyzed them, and developed policy options for consideration by the government. Dating back to before the G20 commitment, Canada has phased out most tax preferences for fossil fuel production, including provisions relating to the resource allowance (Budget 2003); accelerated capital cost allowance for oil sands (Budget 2007); intangible capital expenses for oil sands (Budget 2011); the Atlantic Investment Tax Credit for oil and gas mining (Budget 2012); accelerated capital cost allowance and pre-production development expenses for mines (Budget 2013); and accelerated capital cost allowance for liquefied natural gas facilities (Budget 2016). Most recently, Budget 2017 proposed the rationalization of Canadian exploration expense treatment for oil and gas and the phase-out of the ability of oil and gas producers to reclassify certain development expenses as more favourably treated exploration expenses. As a result of these actions, there is only one remaining federal tax expenditure potentially relevant to the G20 commitment. Going forward, the Department will continue to provide ministers with timely analysis and advice with respect to the G20 commitment.

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