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Federal Government Response to the Recommendations of the Petrochemical Industry Task Force

Canada

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FEDERAL GOVERNMENT RESPONSE

to the

RECOMMENDATIONS

of the

PETROCHEMICAL INDUSTRY

TASK FORCE

JUNE 1984

SUMMARY

1. The Petrochemical Industry Task Force was established in March, 1983 by the Ministers of Energy, Mines and Resources and Regional Industrial Expansion. Its terms of reference were to provide advice to Government on the future of the industry and on industry and government measures which would allow the industry to increase its contribution to the national economy. After extensive consultations with interested provinces, other industries and labour representatives, the Task Force submitted a concensus report to Ministers which sets out conclusions and recommendations on a long-term outlook for the Canadian petrochemical industry.

2. The Task Force concluded that the industry can be viable and internationally competitive over the long-term based on advantages existing in Canada, provided the industry is able to obtain feedstocks at market related prices. The Task Force considered that if no appropriate government action were taken, the natural gas-based segment would most likely not undertake any further developments, and might possibly decline. With respect to the oil-based segment of the industry, it was concluded capable of re-establishing competitiveness by increasing its ability to use a wider range of feedstocks, in particular, two of the natural gas liquids, propane and butane. It was also noted that feedstocks based on crude oil will not likely be competitive in the intermediate term and that in the absence of government action, the oil-based sector will face shutdowns.

3. The 15 recommendations made by the Task Force relate to energy, fiscal and tariff policies, transportation regulations, international trade issues and the regulatory approval process associated with major projects. In support of its recommendations, the Task Force commissioned studies on the macroeconomic impact of its recommendations, if adopted. The Government wishes to acknowledge these studies but, nevertheless, must view their results as only broadly indicative and directional. These reservations and others have been made known to the Task Force.

4. Throughout the Report, the Task Force clearly emphasizes its principal concern as being the availability and costs of raw materials or feedstocks used in the production of primary petrochemicals and, in this regard, has grouped seven feedstock related recommendations directed toward improving the industry's competitive position. The Government recognizes that in developing these recommendations, the Task Force has acknowledged the need to provide equitable treatment for both the natural gas and oil-based segments of the industry.

5. The Government acknowledges the important contribution made by the petrochemical sector to the national economy and to the provinces in which the industry is located. The Government agrees with the Task Force that while the Canadian industry is, for the most part, world scale in size, it is nonetheless, highly dependent upon exports which must be marketed in an increasingly competitive international environment. The Task Force concluded and the Government concurs that since feedstocks represent up to 70 percent of production costs, they must be recognized as the critical element determining the Canadian industry's competitive position. Due to the abundance and cost of natural gas in Canada, it appears reasonable to conclude that if there is further growth in the petrochemical industry, it will, in the intermediate term, be based on natural gas.

6. The petrochemical industry is undergoing worldwide restructuring. Over the remaining half of this decade, a substantial part of the production of commodity petrochemicals is expected to be located in energy-rich countries, with reduction in capacity occuring in the U.S., Europe and Japan. The Task Force has concluded that, on the basis of Canada's resource and industrial advantages, it is reasonable to assume that this country could benefit if a new round of international investment were to take place, provided that government and industry work together to attract such investment. The Government recognizes the need to provide an attractive investment environment in Canada which will encourage new growth across a range of economic activities. While the Government clearly recognizes the value to the economy of a viable and expanding petrochemical industry it must be recognized that energy pricing and revenue sharing policies are set in the larger context of federal/provincial agreements which seek to balance the interests of producers and consumers and to provide government with the financial resources to meet its responsibilities to all Canadians. Even within these constraints the Government has undertaken measures which will benefit gas consumers including the petrochemical industry. These include: reducing the Natural Gas and Gas Liquids Tax to zero; subsidizing the cost of transporting gas to eastern Canada; and assisting with the extension of gas distribution and transmission facilities across Canada. Most recently, the Government has negotiated with Alberta an incentive plan to reduce the cost of gas to industrial customers.

7. The Task Force concluded that there is little justification to keep the price of crude oil in Canada artificially low for petrochemical purposes, given the current and foreseen supply/demand balance for crude oil. Furthermore, it was recommended that the oil-based industry, in order to become viable, must further develop the flexibility to use a variety of feedstocks, particularly propane and butane. The Government agrees with these conclusions and is prepared to work with and to assist the industry to achieve this objective. The investments

required for the industry to adapt facilities to become more feedstock flexible are substantial and while the Government perceives that the responsibility for these investments lies within the industry, it is prepared to contribute to the costs, in co-operation with the governments of concerned provinces, provided the companies can demonstrate long-term viability.

8. The Government recognizes that the petrochemical industry is highly dependent upon exports and that trade policy and market development considerations will continue to play an important role in helping these products compete successfully in increasingly, competitive international markets. It remains committed, therefore, to its efforts to reduce barriers to trade in petrochemicals with our major trading partners, and, in particular, with the U.S.A. The Government is pleased to confirm that discussions are currently underway with the U.S.A. with a view to ensuring reciprocity in multi-modal transportation regulations governing the movement of dangerous goods.

9. Responses to each Task Force recommendation are set out in the following section.

10. Recommendation (1): that a market responsive policy environment be developed for natural gas in Canada, encompassing both supply and pricing.

11. Response: In response to the Task Force recommendations, the Minister of Energy, Mines and Resources, will be prepared to address with Alberta, in the context of future discussions that will be necessary this year or early next year, options for a more market responsive domestic natural gas pricing regime, than that which currently exists.

12. The federal government has taken action to facilitate the transportation of gas not owned by a transmission pipeline company. An amendment to the National Energy Board Act in 1982, provided the Board with the authority to require a company operating a pipeline to transport gas offered for transmission.

13. With regard to the taxes and royalties on natural gas, the federal government reduced the Natural Gas and Gas Liquids tax to zero on February 1, 1984 in order to offset the increase in the Alberta border price and maintain stable gas prices for consumers.

14. Within the province of Alberta, petrochemical companies may negotiate directly with gas producers. In British Columbia, the provincial government is in the process of implementing a pricing and royalty system which will allow petrochemical companies to negotiate the price of gas directly with gas producers. In all provinces, including Manitoba, Ontario and Québec, distribution utility rates for gas are determined by the provinces.

15. **Recommendation (2): that immediate action be taken within the present regulated system to provide natural gas at a lower cost to industrial users in Canada. The Task Force also recommends that the reduction in cost be an amount equal to a reduction in the order of 15% of the price at the Toronto City Gate (which currently would be approximately 60¢ per MCF).**

16. Response: Existing Canada-Alberta arrangements for the pricing of gas in interprovincial trade continue through January 31, 1985. Pursuant to these agreements, the federal government has worked vigorously to secure an incentive for industrial consumers. This incentive was announced on April 26, 1984 and became effective on May 1. The incentive has a three year term, subject to revision of the Canada/Alberta Memorandum of Agreement. The incentive provides a discount of $0.35/gigajoule for incremental gas sales and a further $0.35/gigajoule for one-quarter of a customer's base volume. In order to be eligible for this plan, a gas customer must consume more than 100,000 gigajoule.

17. While this incentive is less than that recommended by the Task Force, it, nevertheless, represents a significant adjustment to gas prices and a signal to industrial gas consumers that gas will be priced competitively.

18. **Recommendation (3): that government develop a monitoring system to track the average acquisition costs of crude oil in Canada and on the U.S. Gulf Coast to ensure, to the maximum extent possible, that Canadian crude oil pricing policy does not place Canadian consumers and industry at a competitive disadvantage. Any adjustments required should be implemented on the most current basis possible.**

19. Response: Relative Canadian and U.S. Gulf Coast refinery crude oil acquisition costs have been examined from time to time. Studies done recently show approximate cost parity between the two countries, after taking into consideration such factors as spot prices, freight rates, domestic/imported crude ratios, quality and currency exchange rates. As these results differ from those reported by the petrochemical industry, a more systematic study is indicated. However, in order to be able to implement an effective cost monitoring system, the present methodology would need to be more fully developed. Consultation with industry is being undertaken to improve the tracking system to be able to extend the monitoring of Canadian and U.S. crude oil costs to include the U.S. Gulf Coast.

20. Recommendation (4): that government retain the present market responsive policy framework for propane and butane in Canada.

21. Response: The Government does not plan any change in the policy framework for propane and butane in Canada. The current situation with respect to propane and butane is consistent with market responsive energy pricing.

22. Recommendation (5): that government ensure the domestic supply of butane and propane in applying the appropriate surplus test for exports.

23. Response: The application of appropriate surplus tests for exports of propane and butane is a matter for the National Energy Board (NEB). On the basis of the Board's record and of discussions subsequent to publication of the Task Force report, there is no reason to doubt that the surplus tests will continue to be appropriately applied. At present, propane exports are limited to 36 per cent of domestic production in order to ensure that all domestic requirements are met. While there is no designated export limit for butane, the mechanism can be put quickly in place should there be a danger that all domestic requirements will not be met.

24. Recommendation (6): that government reduce the upfront fiscal burden on propane and butane used for industrial purposes in Canada, in order to provide increased negotiating latitude for pricing between the suppliers and purchasers of these products.

25. Response: There are three federal taxes which could potentially affect the level of the "upfront fiscal burden" on propane and butane in Canada: the Natural Gas and Gas Liquids Tax (NGGLT), the Petroleum and Gas Revenue Tax (PGRT), and the Canadian Ownership Special Charge (COSC). It is not clear that reducing or removing these federal taxes is an effective way of assisting the petrochemical industry, for the tax reduction may not necessarily lead to reduced product prices to consumers, because it cannot be assured that the tax reductions will be passed on to consumers. Moreover, tax reductions for all users or industrial users is costly. The NGGLT rate has already been set at zero for natural gas and gas liquids, thus some fiscal relief has been provided by the federal government to consumers of these commodities.

26. The PGRT is levied on crude oil and natural gas at the wellhead and the tax content per unit of production varies among producers depending upon field prices and individual costs of production. It does not apply to propane and butane, because these products have no character separate from oil or raw natural gas at the wellhead, or when produced from crude oil at a refinery. For these reasons, it is very difficult to reduce the

PGRT for propane and butane only. The benefit of a reduction in the rate of PGRT would not necessarily be passed on by producers, or if it were, it might not accrue to petrochemical manufacturers. Thus a PGRT reduction is a very imprecise instrument for providing a benefit to the petrochemical industry, but could be very costly for the federal government.

27. A reduction or removal of the COSC does not involve any technical problems, as with the PGRT. However, the COSC is a significant source of government revenue, yielding almost $1 billion per year. The removal of the COSC from propane and butane would be inequitable relative to other commodities which bear this charge and could therefore lead to similar requests for COSC reductions by natural gas distributors and petroleum refiners. A limited or general reduction in the COSC would involve a significant reduction in federal revenues while there is, again, no assurance that the reduction would result in reduced product prices for consumers.

28. Recommendation (7): that government initiate a transition program for the oil-based segment, the objective of which is to increase feedstock flexibility and move off oil to the maximum extent practicable in the near term. This program would involve a study period of up to 12 months, followed by a period of up to 24 months to implement the required changes. During these periods of transition, financial assistance would be provided to the oil-based segment in order: that the segment can sustain itself during the transition periods; that the segment is not competitively disadvantaged with respect to the gas-based segment; and to provide assistance with the costs associated with the studies and subsequent modifications. Since circumstances, including refinery and transportation linkages, differ for each manufacturing centre, the Task Force recognizes that feedstock flexibility may require the application of different measures in each situation. Therefore, the details of the program, including commitments and amount of assistance, would be negotiated between government and the individual companies involved within the described framework.

29. Response: The attainment of increased feedstock flexibility and reduced reliance on oil-derived feedstocks are viewed as desirable objectives which the Government supports. It is also recognized that oil-based petrochemical producers in Canada have already taken measures on their own initiative in the direction of these objectives. In support of these industry actions, the Government is prepared to negotiate with Pétromont and Petrosar, with a view to providing assistance for the modernization of such plants to give them greater feedstock flexibility. Such assistance would be conditional upon the provision of equivalent assistance by the governments of the provinces in which the facilities are located and a demonstration of long-term viability by the companies. As noted in the response

to Recommendation 2, the Government is not presently in a position to reduce further the price of natural gas to industrial users, beyond the reduction provided for by the industrial incentive plan which became effective May 1. Therefore, in keeping with the concern of the Task Force that government financial assistance should not alter the competitive relationship between the oil-based and gas-based sectors of the petrochemical industry, and in consideration of Canada's international trade obligations, the Government is not prepared to offer financial assistance to the oil based industry, beyond that in respect of the feedstock conversion of plant facilities.

30. Recommendation (8): that a concerted effort by industry and government be developed towards the reduction of trade barriers for petrochemical products with our major trading partners. In particular, efforts should focus on bilateral negotiations with the U.S., and the continued development of negotiations with Japan.

31. Response: The Government supports in principle the objective of reducing barriers to trade in petrochemical products with our major trading partners. It also notes the acknowledgement in the Task Force Report of the need to preserve and enhance the multilateral trading system embodied in the GATT. The Government is prepared to examine trade liberalization in the sector through whatever means would provide the maximum opportunity to improve access for Canadian petrochemical exports.

32. The Government notes that representatives of the Canadian industry have met with their U.S. counterparts for initial discussion of these issues and welcomes indications that further activity is in prospect. Canadian officials will consult further with the industry and provinces with a view to recommending to Ministers appropriate steps to enhance market opportunities for the petrochemical sector.

33. With regard to Japan, the Government will continue to seek agreement for expanded opportunities for both petrochemical exports to Japan and Japanese investment in the Canadian petrochemical industry, through government to government dialogue supportive of private sector initiatives.

34. Recommendation (9): that government assist with the development of a more market responsive transportation system in Canada to improve the country's competitiveness and ensure the long-term health of both the petrochemical and transportation industries. The development of such a system should include the active participation of the petrochemical industry.

35. Response: The Government, through its Western Transportation Initiative, is ensuring that adequate rail system

capacity will continue to be available in western Canada to meet the traffic demands of all commodities, including petrochemicals.

36. The CTC is currently investigating the effects of U.S.A. deregulation on the Canadian transportation system. It is consulting with several members of the Petrochemical Industry Task Force in the conduct of its investigation.

37. Recommendation (10): that government-industry efforts be increased to achieve regulatory reciprocity with the U.S.A. on cross-border transport of dangerous goods in the short term. The objective in the longer term is for uniformity as far as it is practicable and warranted by Canadian interests.

38. Response: The Government is fully aware of the need, for trade reasons, to maintain present mutual and reciprocal recognition of hazardous materials and dangerous goods regulations in respective Canadian and U.S.A. regulations for rail transport and to expand that recognition to include other modes of transport. Discussions are taking place to that end and, subject to the need to respect regulation making procedures in both countries, it is believed that the Recommendation will be met.

39. Recommendation (11): that government recognize the heavy expenditures required to bring new ideas and products from the laboratory to the marketplace and extend the application of current taxation incentives for R&D to work in these later, very important stages of the innovative process.

40. Response: Prior to April 1983, the Government undertook extensive consultations with Canadian industry to determine how to maximize the effectiveness of research and development incentives. While it was recognized that the existing research and development incentives were already more generous than those made available by Canada's major trading partners, two improvements were introduced. First the system was simplified by replacing incremental income tax deductions with increased investment tax credits. Second, tax incentives were made more readily available through a new flow-through mechanism called the Scientific Research Tax Credit.

41. These improvements added $100 million to the already substantial benefits flowing to companies engaged in research and development activities. Furthermore, these changes were determined to be the most effective in promoting research and development in Canada. The exact distinction between research and development activities and ordinary business operations will always be debatable. The Government is of the view that the current activities considered to be research and development reflect an appropriate balance, particularly in light of the recent increases in research and development incentives and the currently tight fiscal situation confronting the Government.

42. Recommendation (12): that government initiate a study of those aspects of taxation policy directly related to the capital costs associated with major projects, in order to determine ways in which Canada's capital cost disadvantages might be significantly reduced or eliminated.

43. Response: A study of the issues raised in this recommendation has already been initiated under the Government and the Export Trade Development Board. The study is being undertaken by the Conference Board. The group of industries selected for this study includes the petrochemical industry. It is worth noting, however, that at least one recent study has shown that in general, Canadian incentives for investment in manufacturing are more generous than those available, for example, in the U.S.A. Major incentives in the Canadian tax system include the 6 per cent Manufacturing and Processing deduction, the accelerated write-off for Manufacturing and Processing investment, and the Investment Tax Credit.

44. Recommendation (13): that government make process equipment not available from Canadian production eligible for duty remission under the Machinery Program administered by the Department of Regional Industrial Expansion.

45. Response: One of the recommendations in the 1978 Petrochemical Industry Task Force Report was the introduction of a duty remission program for process equipment used by the chemical industry. That recommendation was carefully reviewed and extensive consultations were held with industry. A report was sent to the Minister of Finance and it was decided that the Task Force recommendation should not be implemented, mainly for the following reasons:

a) there was no evidence that the duty on imported equipment contributed in any significant way to the higher capital costs faced by Canadian chemical producers compared with their U.S.A. competitors. It was estimated that, at post Tokyo Round tariff rates, duty would add only 0.5 per cent to 1978 capital costs. Since much of the imported equipment would not qualify for duty remission under a Machinery Program type arrangement because it is available from Canadian manufacturers, duty savings under a remission program would have amounted to only 0.14 per cent of capital costs.

b) similar equipment is used by other industries (e.g. pulp and paper) and it would be inequitable to give the chemical industry more favourable tariff treatment than those sectors, some of which faced deeper cuts in their tariff protection than the chemical industry, as a result of the Tokyo Round.

c) an expansion of the Machinery Program would become an "irritant" in our trade relations with the U.S.A. which during the Tokyo Round sought and obtained a contraction of the Program so as to provide U.S.A. exporters with greater certainty of the terms of access of the Canadian market.

46. The Government is not aware that the circumstances prevailing at the time of the 1978 review have changed to an extent that would warrant reconsideration of the earlier decision. The Government, therefore, cannot support the implementation of the current recommendation.

47. Recommendation (14): that the sales tax on material and equipment used in the construction of manufacturing facilities be remitted.

48. Response: The Government has already addressed the concern raised by the Task Force by levying a lower than average rate of sales tax, five per cent, on materials used to construct manufacturing facilities. Furthermore, the labour, machinery and equipment used to construct these facilities are already exempt from sales tax. A further reduction in the rate of tax on goods used for this purpose would create an important precedent that, in practice, would be difficult to administer, particularly in light of the difficulty in distinguishing among the various potential purposes of buildings.

49. Recommendation (15): that government in collaboration with industry, develop a framework and set of recommendations designed to clarify and streamline the regulatory approval process associated with major projects, and to identify areas for the possible harmonization of government standards.

50. Response: The Government recognizes the need to improve the regulatory approval process associated with major projects. Certain initiatives have already been taken which are intended to promote inter-agency coordination with the objective of streamlining the approval process. In view of the Task Force Report, increased emphasis will be placed on accelerated progress in this area as part of the Government's ongoing program of regulatory reform.