NAVIGATING TO A SUSTAINABLE ENERGY FUTURE: "INEFFICIENT" FOSSIL FUEL SUBSIDIES

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This bulletin is part of our "Navigating to a Sustainable Energy Future" series which looks at legal and business issues relating to the rapidly-changing energy sector in Canada, including with respect to emissions reductions, transitioning to renewable energy, attracting investment, energy security and geopolitics, and job creation and economic growth.

On July 24, 2023, the Government of Canada released the *Inefficient Fossil Fuel Subsidies Government of Canada Guidelines*[1] and the associated *Inefficient Fossil Fuel Subsidies Government of Canada Self-Review Assessment Framework*[2] (collectively, the Guidelines), which form part of the Canadian Government's climate plan and targets to achieve the commitments set forth in the Paris Agreement, including building Canada's net-zero economy by 2050.

The Guidelines represent the Government of Canada's strategy to satisfy the commitment to "phase out and rationalize over the medium-term inefficient fossil fuel subsidies while providing targeted support for the poorest" made by the G20 countries in 2009 as part of the G20's commitment to launch a framework to "generate strong, sustainable and balanced global growth" to the transition from crisis to recovery in 2009.[3][4] Canada is the first of the G20 countries to adopt a strategy to satisfy the commitment to phase out government support in the fossil fuel sector. [5] The Guidelines came into effect on July 24, 2023.

As stated by the Canadian Government: "Inefficient fossil fuel subsidies encourage wasteful consumption, reduce our energy security, impede investment in clean energy sources and undermine efforts to deal with the threat of climate change." In sum, any subsidy supporting the fossil fuel industry will be characterized as inefficient, subject to limited exceptions, including subsidies that support clean technology, clean growth and accelerate efforts to decarbonize Canadian industries.

Scope of the Guidelines

The Guidelines apply to federal tax and non-tax measures in the fossil fuel sector, defined as federal programs and expenditure consisting of: (i) expenditure programs (such as grants, contributions and transfers), (ii) intramural R&D, (iii) tariff and duty reliefs (excluding those tariffs and duty where the Government has a standard way that it treats all businesses and industries), and (iv) tax expenditure that supports fossil fuel consumption or that can be claimed by the fossil fuel sector and that represent alternatives to expenditure programs (i.e., tax credits, accelerated capital cost allowances, flow-through shares). It is important to recognize that the Guidelines do not apply to provincial or territorial tax or non-tax measures.

The "fossil fuel sector" is broadly defined in the Guidelines to include those firms whose business primarily involves activities related to fossil fuel production (i.e., exploration, extraction, and processing including refining) and fossil fuel use (i.e., storage, transportation, sale), in addition to those firms that produce electricity and/or heat from fossil fuel. The Guidelines define "fossil fuels" as non-renewable resources formed from biomass in the geological past (e.g., coal, natural gas, crude oil, bitumen), and any secondary product manufactured from those natural resources (e.g., pentanes, butane, propane, gasoline, diesel fuel).

Process to Identify and Avoid Inefficient Fossil Fuel Subsidies

- The Guidelines establish the process by which the Federal Government seeks to:
- Avoid creating new measures that would be considered to be "inefficient fuel subsidies", by establishing a process by which federal ministers are to assess whether a new initiative to be considered by Cabinet would constitute an "inefficient fossil fuel subsidy", subject to the identified exceptions (and should undertake efforts to refine such initiative to avoid the creation of an "inefficient fossil fuel subsidy").

Ensure existing fossil fuel support from federal departments and agencies no longer supports measures in the fossil fuel sector, unless the measures align with the identified exceptions. Fossil fuel support is defined to include transfers (e.g., grants, contributions) to another party or expenditures on intramural R&D that occurs within a measure and confers a benefit to the fossil fuel sector, or supports fossil fuel consumption.

What is an "Inefficient" Fossil Fuel Subsidy?

All federal tax and non-tax measures are to be considered under the Guidelines, which provides that a measure will be an "inefficient fossil fuel subsidy" if such measure is a subsidy[6] that supports the fossil fuel sector by:

- supporting fossil fuel consumption, which refers to industrial, commercial, public sector, and individual consumers of fossil fuel, being those subsidies that reduce the price paid by final consumers in the purchase of a fossil fuel; or
- solely supporting a fossil fuel activity, being those activities directly related to fossil fuel production (i.e., exploration, extraction and processing), or fossil fuel use (i.e., storage, transportation, sale and production of electricity and/or heat); or
- providing a disproportionate benefit to the fossil fuel sector, which is broadly defined to include businesses primarily involved in activities related to fossil fuels production (i.e., exploration, extraction,

and processing including refining) and fossil fuels use (i.e., storage, transportation, sale), and those firms that produce electricity and/or heat from fossil fuels.

Notwithstanding this classification, the Canadian Government recognizes the benefits of fossil fuel subsidies that support (i) clean technology, clean growth and accelerated efforts to decarbonize processes and projects, (ii) Indigenous economic participation in fossil fuel activities, and also (iii) energy security. In particular, fossil fuel subsidiary are not characterized as "inefficient" fossil fuel subsidies under the Guidelines if they satisfy any one or more of the following six criteria:

1. enable significant net greenhouse gas (GHG) emission reductions in Canada or internationally in alignment with Article 6 of the Paris Agreement;
2. support clean energy[7], clean technology[8] or renewable energy;[9]
3. provide an essential energy service[10] to a remote community;[11]
4. provide short-term support for emergency response;[12]
5. support Indigenous economic participation[13] in fossil fuel activities; and
6. support abated[14] production processes, or projects that have a credible plan to achieve net-zero emissions by 2030, such as carbon capture and storage (CCS)/carbon capture, utilization and storage (CCUS) or equivalent technologies (but does not include carbon capture for the purposes of enhanced oil recovery).

While the Government of Canada has defined what it considers an "inefficient fossil fuel subsidy", being a fossil fuel subsidy that does not satisfy any of the six above-noted criteria, implementing the Guidelines presents many challenges, including challenges to the specific identification of such subsidies.

It is important to recognize that there is no consistent definition or approach as to what constitutes a subsidy, what makes a subsidy inefficient, and what is a considered wasteful subsidy; not even among the G20, the World Trade Organization (WTO), the Organisation for Economic Co-operation and Development (OECD), the International Energy Agency (IEA) or the International Monetary Fund (IMF). [15] [16] For example, Canada's neighbor and largest trading partner, the United States, has not adopted a uniform policy, but rather by Executive Order, President Biden has mandated the reduction of oil and gas subsidies (which are not defined), which mandate is being implemented on a piecemeal basis, and which was arguably undermined by the call by President Biden in 2022 for increased gas production to meet consumer demand in response to the energy crisis triggered in part by Russia's invasion of Ukraine. [17]

General Observations: The Need for a Transparent and Effective Regulatory Framework

Policies regarding subsidies to the fossil fuel sector, including those that relate simply to the production of any fossil fuel, are complex, for many reasons, including: the need for energy security, especially in light of forecast demand significantly outstripping supply of energy from renewable sources and also geopolitical challenges (including Russia's invasion of Ukraine); ESG considerations in respect of the supply of energy; the impact of emissions from and waste related to fossil fuels on the environment; challenges to quantify and define subsidies; and the need to spur technological innovation to transition to a green economy, among others.[18]

Leadership by Canadian Oil and Gas Industry

Oil and gas companies headquartered or operating in Canada have independently undertaken significant initiatives for many years to reduce GHG emissions from production to achieve net-zero emissions by 2050. This leadership has been recognized by the Canadian Government, which stated: "The oil and gas sector is one of the leading investors in clean technology and innovation in Canada, making an estimated 58% of all energy research and development investments (averaging about $1B/year) over the decade to 2019. Oil and gas companies such as Shell Canada, Whitecap Resources, Wolf Midstream, Enhance Energy, and Northwest Redwater Partnership are leaders in carbon capture, utilization and storage (CCUS)", and recognizing that "Many Canadian oil and gas companies have already set net-zero-emissions targets and have developed decarbonization plans. This includes the Pathways Alliance, comprised of Canadian Natural Resources, Cenovus Conoco Phillips Canada, Imperial Oil, MEG Energy and Suncor Energy - which collectively account for 95% of Canada's oil sands production. To achieve net-zero by 2050, this Initiative proposes a $75 billion investment to deploy a combination of clean electrification, operational efficiencies, emerging technologies such as low-emission hydrogen and carbon capture, small modular nuclear reactors), and offsets to eliminate 68 Metric tonnes (Mt) from oil sands operations."[19]

Predictable and Competitive Framework Needed

Such oil and gas and other green initiatives are expected to require greater investment to reach full potential – including in the form of subsidies – in order to reach policy goals, support a low carbon economy and develop new sub-sectors and job growth. Accordingly, a predictable and competitive regulatory framework with a clear purpose, developed through an understanding of the oil and gas industry and with a degree of cooperation with oil and gas participants and other governments, is necessary to spur investment in decarbonisation technologies and enable the Canadian oil and gas industry to achieve Canada's net zero emissions commitments. The lack of international consistency and coordination and overall approach between governments will create uncertainty, impact the flow of investments to finance projects and technology (to both the fossil fuel sector but also the renewable energy sector), impact the competitiveness of projects, and distort various markets, all of which may be detrimental to both Canadian fossil fuel producers (many of whom are driving clean energy technological advances) and consumers if the Guidelines are not implemented in recognition of such international pressures.

This need for a supportive regulatory framework is becoming even more important in light of the long lead time needed to implement decarbonisation projects and also the recent U.S. and other governments' adoption of policies to facilitate the transition to a clean energy economy through funding, programs and incentives, including for example, the U.S. *Inflation Reduction Act* implemented in 2022 (IRA), which provides a "simple" structure that has lead to clear incentives for industry. As noted by Petronas CEO Tengku Muhammad Taufik: "The IRA will have the effect of really attracting capital back to the U.S. for the reasons and the results that it sort of needs." [20]

The adoption of the Guidelines is part of Canada's strategy to satisfy its 2009 G20 commitment to phase out "inefficient" fossil fuel subsidies. However, additional clarity and predictability are required to provide a more tangible understanding of the applicability of the Guidelines to current federal tax and non-tax measures – and other relevant government policies (such as caps on emissions and initiatives announced in recent federal budgets) – to allow businesses to make those investments necessary to decarbonize the Canadian fossil fuel sector and remain competitive. Failing to do so will jeopardize the potential leadership role of Canada in this new economy while ensuring energy security.

[1] See Inefficient Fossil Fuel Subsidies Government of Canada – Guidelines - Canada.ca.
[2] See Inefficient Fossil Fuel Subsidies Government of Canada – Self-Review Assessment Framework - Canada.ca.
[3] See: Online.
[4] The G20 commitment is part of an international trend targeting "inefficient fossil fuel subsidies encourage wasteful consumption, disadvantage renewable energy, and depress investment in energy efficiency, and that effectively addressing fossil fuel subsidies will deliver trade, economic, social and environmental benefits as well as release government funds to support a green and climate-resilient COVID-19 recovery" (See the World Trade Organization (WTO) Fossil Fuel Subsidies Ministerial Statement issued in December 2021 signed by 45 WTO members, at WTO | 2021 News items - New initiatives seek to put environment at heart of trade discussions).
[5] Note that the Guidelines do not apply to (i) direct public support for operations in the fossil fuel sector (which are assessed under Canada's Glasgow Statement Guidelines) or (ii) public financing support for operations within the fossil fuel sector, which the Government will assess under a separate process to be determined. Canada is also committed to phasing out public financing of the fossil fuel sector. This refers to financing beyond the scope of today's fossil fuel subsidies commitment. The Government's work will identify current public financing by 2024 and announce by fall 2024 the implementation plan to phase out public financing of the fossil fuel sector.
[6] The term "subsidiary" is defined by reference to accepted definition in the World Trade Organization's

(WTO) as set out in Article 1.1 of the Agreement on Subsidies and Countervailing Measures: *"[A] subsidy shall be deemed to exist if: a.(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where: a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees); ii. government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits; iii. a government provides goods or services other than general infrastructure, or purchases goods; iv. a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments; or b. (2) there is any form of income or price support in the sense of Article XVI of GATT 1994; and c. a benefit is thereby conferred*.

[7] Clean energy is energy produced without the release of GHG.

[8] Clean technology is any process, product or service that reduces negative environmental impacts relative to prevailing technology.

[9] Renewable energy is energy derived from natural processes that are replenished at a rate that is equal to or faster than the rate at which they are consumed.

[10] Essential energy services are those energy services used for electricity, transportation, or space or water heating.

[11] A remote community is a community that is a) not currently connected to the North American electrical grid nor to the piped natural gas network; and, b) a permanent or long-term (five years or more) settlement with at least 10 dwellings.

[12] An emergency response is a response to a public health, humanitarian, or economic crisis.

[13] Indigenous economic participation refers to measures that promote increased Indigenous economic participation in projects and firms, which should ensure that the main beneficiary of the funding or measure are Indigenous peoples.

[14] Abated refers to effective (leading to significant elimination of emissions), operational carbon capture and storage (CCS)/carbon capture, utilization and storage (CCUS) or equivalent technologies.

[15] See for example, Organisation for Economic Co-operation and Development & International Energy Agency (2021) "Update on recent progress in reform of inefficient fossil-fuel subsidies that encourage wasteful consumption 2021" available here; and International Energy Agency. (2021) "Net zero by 2050: A roadmap for the global energy sector." available here.

[16] See International Institute for Sustainable Development "Fossil Fuel Subsidies: Types, measurement, impacts and reform efforts", available here.

[17] See The Brookings Institution, "Reforming global fossil fuel subsidies: how the United States can restart

international cooperation" at: Reforming global fossil fuel subsidies: How the United States can restart international cooperation | Brookings.
[18] This is especially the case with the new Guidelines, as Canada is the first of the G20 countries to adopt the policy to phase out inefficient fossil fuel subsidies, meaning Canada will need to be prepared to respond to any unintended consequences of such these Guidelines.
[19] See the Government of Canada's "Option to cap and cut oil and gas sector greenhouse gas emissions to achieve 2030 goals and net-zero by 2050 – discussion document" dated August 3, 2022, available here.
[20] See Reuters, "CERAWEEK-Inflation Reduction Act will bring capital to the US – Petronas CEO on March 6, 2023", available here.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.