43085

MINISTER BRIEFING NOTE

Natural Gas and Liquids Value-Add Initiative

PURPOSE:
☒ INFORMATION/BACKGROUNDER
☐ DECISION REQUIRED
☐ RECOMMENDATION TO MEET

ISSUE:
- The Ministries of Energy, and Innovation and Advanced Education are proposing an incentive program in which the Government of Alberta would be providing grants or royalty credits in return for new investment in Alberta's petrochemical sector.
- Given the current challenging fiscal situation and the lack of economic merit to support the program, there are significant risks and costs associated with this proposal.

CURRENT STATUS:
- Energy and Economic Development and Trade are planning to formally submit their proposal via a Cabinet Report.
- Treasury Board has not approved funding for this initiative, and Energy does not have funding approved in its existing business plans to implement the proposal.

KEY MESSAGES:
- Given the current fiscal situation and the financial pressures facing the Government, it would be questionable to introduce subsidies to the petrochemical industry at this point.
- The proposed incentive program cannot be justified on economic merit alone, as the program costs are expected to be higher than the added revenues.
- Alberta's tax system is focused on keeping taxes low for all industries. The proposed incentive program means Government is selecting certain stakeholders to receive direct support.
- In addition, there is no guarantee that the incentive program will actually lead to additional investment and could benefit projects that would have gone ahead regardless of the incentives.
- The proposed program could induce other companies or industries to demand tailored support programs from Government in the future.

BACKGROUND:
- The proposed Hydrocarbon Value-Add Program (HVAP) entails the provision of direct subsidies to certain petrochemical companies in the form of either grants or royalty credits. HVAP would be administered by Energy. The objective is to influence the location decision of petrochemical corporations and compete with other jurisdictions offering incentive programs.
- The total amount of subsidies that would be available under HVAP is $500 million, with payouts starting as early as 2017-18, spread out over three to ten years. The amount of

subsidies provided would be based on the amount of feedstock used as input at the selected petrochemical plants.

- Given the challenging fiscal situation due to the recent collapse in oil prices, the proposed $500 million in incentives must withstand a very high standard of rigour and scrutiny.
- If approved, companies would be required to submit applications during a specific time window, after which the projects would be evaluated by Energy. The Minister of Energy would then approve the projects that are deemed best suited to meet HVAP's objectives.

ANALYSIS:

- In general, we disagree with using input-output models to estimate the impacts, which, as we understand, is being done in the Cabinet Report. Extreme caution should be used in cautioning the economic impacts provided.
- Some of the major limitations of the I-O model include:
  - Prices are fixed, meaning that no matter the size of the project, the costs of labour, capital and materials will not change either during the construction phase or the operations phase;
  - Assumes unlimited supply of inputs, including labour.
  - Assumes the economy is permanently set in 2010, the latest year available at the time IAE did their analysis (so the model assumes that the structure of AB's economy in 2010 would be exactly the same, say, 30 years from now).
- Because of these limitations, it is not recommend to use I-O models to estimate long-term impacts (it should instead be used to estimate relatively small, temporary changes, e.g., the unplanned maintenance of a manufacturing plant).
- HVAP is expected to come at a net cost to Government. The benefit of additional Government revenue from an additional petrochemical facility is well below the Government cost of the program, according to analysis by Treasury Board and Finance (TBF) using the Alberta macro-economic model. This model is used for budget and fiscal planning purposes and accounts for capacity constraints in Alberta's tight labour market. It is the most appropriate method to evaluate the macroeconomic and fiscal impacts of large projects for the Government.
- The impacts presented in the C2D2 are based on a static input-output approach not recommended by TBF. Nonetheless, these much larger impacts still show that the corporate tax revenue generated is below the program cost.
- Also misleading about the I-O estimates is that they don't account for the impacts that could have occurred if GoA used the $500 million (or whatever financial support) for other uses. For example, if the GoA decided to allocate the $500 million to, say, health care services, there'll be significant economic impacts associated with that industry. These opportunity costs should be accounted for in I-O estimates, such that only the net impacts are considered in the discussions.
- There is no guarantee that the incentives will lead to additional activity, and it is possible these investments could proceed regardless of Government support. Lower oil prices are expected to help alleviate capital cost pressures, which may improve the economics of certain capital projects.
- Given the current fiscal situation and financial pressures the Government is facing, it is questionable to introduce subsidies for industry at this point.
- Introducing this program could create significant public opposition if it occurs at the same time the Government is making difficult decisions related to revenues and expenditures.
- The Government's general approach has been to limit Government intervention in the marketplace. This general policy is reflected in Alberta's tax system, which has focused on keeping taxes low for all industries and allowing the market to make the investment decisions and determine the best allocation of resources.

- The rapid implementation of the program, coupled with the narrow time window for companies to apply, could be seen as bias toward projects that are already in advanced planning/development stages. Providing incentive to certain proponents could result in a dampening effect on other potential projects.
- Coupled with the recent Incremental Ethane Extraction Program, HVAP will strengthen the signal to industry that the Government is willing to consider tailored Government incentives.
- Local jurisdictions, such as Medicine Hat, where Methanex has proposed a brownfield methanol facility, may see themselves as excluded from Government's plans.
- While increased investment in Alberta's petrochemical sector could expand the provincial industrial base, it is still questionable that these additional value-added plants will help moderate the ups and downs of the oil and gas sector.

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