The Significance of Tax Incentives in Attracting Foreign Investment: Lessons from the Canadian Oil Sands Project

By

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ABSTRACT

Tax incentives have been used by countries to stimulate foreign investment. Few countries doubt the effectiveness of tax incentives. Canada and Indonesia are among the many countries that offer tax incentives to attract investors. While Canada has a long history of using tax incentives to foster the development of the Alberta oil sands, Indonesia is just embarking on this strategy, especially in promoting foreign investment in remote areas.

Drawing on the Canadian development of the Alberta oil sands, this thesis asks what lessons Indonesia can learn from that experience in relying on tax incentives to develop the industry. This thesis acknowledges that there are many important differences between Canada and Indonesia. Since most countries speak of using tax incentive to finance their petroleum industries, it is worth examining at least one instance of that strategy and see whether Indonesia can extract any thing of value from this examination.

This thesis concludes that tax incentives have been largely insignificant in attracting foreign investors to the development of the Canadian oil sands. Tax incentives occurred as compensation to offset the extra cost involved in commencing oil sands projects. The Canadian case suggested that the Indonesian government should not rely on tax incentives only in promoting its petroleum industry.

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DEDICATION

This thesis is dedicated to those who still have faith in me when I lost mine:

My parents, M. Yusuf Adidana, and Mahogany Nahla Yusuf.

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LIST OF ABBREVIATIONS

ACCA	Accelerated Capital Cost Allowance
ARC	Alberta Research Council
CCA	Capital Cost Allowance
CDE	Canadian Development Expenses
CEE	Canadian Exploration Expenses
CPI	Corruption Perception Index
EIU	Economist Intelligence Unit
FDI	Foreign Direct Investment
FIRA	Foreign Investment Review Act
GCOS	Great Canadian Oil Sands
IOC	International Oil Company
ITA	Income Tax Act
ITR	Income Tax Regulation
LPWRE	Low Productivity Well Royalty Exemption
NEB	National Energy Board
NEP	National Energy Program
NOC	National Oil Company
OPEC	Organization of the Petroleum Exporting Countries
PGRT	Petroleum and Gas Revenue Tax
PIP	Petroleum Incentives Program
PSC	Production Sharing Contract
RWRE	Reactivated Well Royalty Exemption

INTRODUCTION

Attracting investment with generous tax incentives is a common government strategy. For years, tax incentives have been used to stimulate foreign investment. Developed and developing countries have been using this strategy in almost all sectors of their economies together with other financial incentives, such as grants, subsidized loans, or loan guarantees. In terms of government encouragement, of course, the well-known benefits of tax-related incentives is that whereas other financial incentives require the upfront investment of state resources, tax incentives do not require such an initial use of state funds.

Few countries doubt the effectiveness of tax incentives in fostering investment. In the oil sector in particular, reliance is repeatedly placed on the use of taxation as a tool to encourage the flow of foreign moneys. Tax benefits repeatedly form part of any discussion about encouraging investment in the development of the oil resources.

Neither Indonesia nor Canada appears to have any reservations about using tax incentives to attract investors. In the case of Canada, tax has long proved intensely relevant to enticing investment into the development of the Alberta oil sands, a practice which dates back to the early 1970s. Much more recently, on the other hand, Indonesia has sought to draw foreign investment dollars into her oil industry through highly attractive tax incentives. This is particularly so with respect to the promotion of investment in remote areas, far from Indonesia's commercial centers.

Drawing on the Canadian development of the Alberta oil sands, this thesis asks what lessons other countries, in particular Indonesia can learn from that experience in relying on tax incentives to develop the industry. While there are obvious many important differences between Canada and Indonesia, since most countries speak of using tax incentives to finance their petroleum industries, it is worth examining at least one instance of that strategy and see whether Indonesia can extract any thing of value from this examination.

Any attempt to isolate the effects of tax incentives on any economic activity is always a task mired in some complexity. It is difficult to know, with any degree of accuracy, what precisely influenced a particular, or many, investors. It is also difficult to separate taxes from other financial variables and determine exactly what influenced a particular course of action. Canada, however, offers some insight because it has a long history of offering tax incentives, a history which suggests that most agree that tax incentives work. There is also much that has been written on Canada's experience, as well as other developed countries experiences, in using tax benefits to solicit investment. Such a history and literature is very much lacking in the context of Indonesia. And while there are perhaps a number of strategies Indonesia might pursue in seeking to develop its own oil industry, it is currently very much intensely focused on tax incentives. Thus it is worth asking whether Indonesia can learn anything from the Canadian use of tax incentives to develop this industry.

This thesis begins by discussing why countries need foreign investment, discussing the increased competition to attain that investment and outlining the factors that appear to be most influential in the decision to invest. Next it speaks briefly about the central features of the Indonesian petroleum industry, why Indonesia seeks foreign direct investment (FDI), and underscoring Indonesia's determination to solicit that investment principally through the offering of generous tax incentives. The next part describes the Canadian petroleum industry and how the oil sands industry has developed into a major contributor to Canada's energy sector. This chapter outlines the relevant tax incentives used by the Canadian government to promote its oil sands. The analysis is divided into three periods of time: the 1970s, the 1980s, and the 1990s. This chapter presents the evolution of tax incentives as a part of the Canadian strategy to attract foreign investment. Chapter Four portrays the domestic and international situation which prevailed in the 1970s, 1980s and 1990s respectively, and compares the tax incentives against the development of the oil sands.

Putting the parts together, this research suggests that the role of tax incentives in attracting foreign investment can only be significant if other investment determinants are favourable. Although Indonesia is intent upon heavy reliance on incentives, the Canada development indicates that the governments of oil-producing countries should be aware that tax incentives are not the main driving force for foreign investment. Tax incentives occur as compensation to counterweigh the additional operational costs incurred. Despite being touted as a major force in driving foreign investment in the oil industry, it would

appear that tax incentives are only a minor force. Based on the Canada model, Indonesia, and any other country beginning to embark on the development course, should be wary about placing too much emphasis on tax incentives as a principal tool for bringing investment dollars in the sector.

CHAPTER I
FOREIGN INVESTMENT: INFLUENTIAL FACTORS

Foreign investment, in any sector not merely oil, is effected by a number of determinants, including taxation. The investment factors described in this chapter are limited to those that can be applied to most businesses and in particular, to oil industry. One of the factors often cited as the most effective inducement is tax incentives.

1.1 The Need for Foreign Investment

Often oil-rich countries, particularly developing countries, do not have the requisite capital or technology to explore their own oil resources. Domestic oil companies in developed countries such as the US and Canada have sufficient capital, technology, and expertise (or the means to attract those resources) to complete the "upstream activity" – the exploration, extraction and production activities. However domestic or national oil companies in most developing countries lack these abilities. In a situation where a country has abundant oil reserves but the domestic or national oil companies do not have sufficient resources for extraction, the government of the host country needs to invite international oil company (IOC) to assist them with the upstream activity. [1] For example, Kazakhstan, which ranks in the top ten oil and gas reserves, could not benefit from its resources without capital from foreign investors.[2]

[1] Host country refers to a country that seeks foreign investment.

[2] Mark J Kaiser & Allan G Pulsipher, "A Review of the Oil and Gas Sector in Kazakhstan" (2007) 35 Energy Policy 1300.

The foreign investment needed for oil development often takes the form of portfolio investment and foreign direct investment (FDI).[3] Foreign investment discussed in this thesis refers to FDI. FDI can be defined as "investment abroad involving the creation of new businesses, and the capital transfers to underwrite them".[4] This investment is more active compared to portfolio investment because in FDI investors actively manage the new company abroad. In portfolio investment, the investors only assist by providing sufficient capital. FDI provides capital, technology, expertise, and any other resource needed to commence upstream operations.

Many countries, both developed and developing, devote time, effort, and resources to developing and implementing policies that are attractive to investors.[5] The high competition in attracting foreign investment forces oil-producing countries to offer very favourable terms. Several factors—geological potential, the political situation, the legal structure, legal certainty, and fiscal regimes—are influential in the investor decision-making process.[6] The most important factor is the potential of a large oil reserve in one

[3] Generally, portfolio investment relates to stocks and bonds. This type of investment provides financial assistance for oil companies that commence upstream activity. Portfolio investment helps oil companies with limited capital but who have the technology and expertise to start oil extraction. See M Kabir Hassan, "Portfolio Investment of the OIC Countries and Their Implications on Trade" (2003) 29 Managerial Finance 122; Nigel Pain, "Financial Liberalization and Foreign Portfolio Investment in the United Kingdom" (1993) 45 Oxford Economic Papers 83.

[4] Ralph H Folsom, Michael Wallace Gordon & John A Spagnole, Jr, *International Business Transactions* 2d ed (St Paul: West Group, 2001) at 756.

[5] Sherif H Seid, *Global Regulation of Foreign Direct Investment* (Hampshire: Ashgate, 2002) at 3; Maria Claret M Ruane, "Attracting Foreign Direct Investments: Challenges and Opportunities for Smaller Host Economies" (2008) 7 Journal of International Business Research 65; Zahir Shah & Qazi Masood Ahmed, "Measurement of Cost of Capital for Foreign Direct Investment in Pakistan: A Neoclassical Approach" (2002) 41 The Pakistan Development Review 807 at 3.

[6] Harry G Broadman, "Incentives and Constraints on Exploratory Drilling for Petroleum in Developing Countries" (1985) 10 Ann Rev Energy 217 at 225; Raymond F Mikesell, *Petroleum Company Operations & Agreements in the Developing Countries* (Washington DC: Resources for the Future, Inc, 1984).

specific geographical area although fiscal regimes, legal certainty, and political stability, must also be favourable to maintain investor interest.

Due to the combination of the costly extraction process and the increase in competition between countries in need of funds, the governments of oil-producing countries cannot depend solely on the existence of their vast oil reserves to attract investment; they must find additional means for attracting foreign investment. Tax incentives are regularly recommended as the best or preferred method of attracting investment to the upstream aspect of the development enterprise. Drawing on the development of the Canadian oil sands, the subject of this research is whether this is entirely true.

1.2 Factors that Influence Foreign Investment

Potential oil reserves in a specific country is, of course, the main factor for foreign investment in the petroleum industry.[7] New reserves are important because oil is non-renewable. The imbalance between supply and demand, and the potential of oil scarcity made oil a valuable resource. As in any business, potential profit is the driving force. Potential increases in world oil prices is then the main reason for IOCs to seek new oil reserves around the globe. While acknowledging the importance of oil reserves and world oil price, this thesis draws attention to other influential factors, factors which co-exist with the tax dimension.[8]

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[7] Juan Carlos Echeverry, *et al*, "Oil in Colombia: History, Regulation and Macroeconomic Impact" (2008) online:IESA website < http://servicios.iesa.edu.ve/portal/CIEA/colombia_echeverry_d1.pdf> at 3.

[8] The 2008 economic decline that may have some effects on foreign investment decisions is not included in this research. Because of its peculiar condition, the unpredictable economic fall and how it affected the petroleum industry is subject to another thesis.

In examining the viability of an endeavour, multinational companies are concerned with numerous factors. They attempt to minimize any risks and consider any issues in a host country that may impact upon their investment. Some issues of host countries cross sectoral boundaries, arising regardless of the nature of the business activity. Most studies agree that legal certainty, political situation, and fiscal regime are the three main factors that influence foreign investment.[9] The correlations between these three factors are so interconnected that foreign investors tend to look at all three as a package.[10] Other investment factors are viewed as branches of these three main categories. In the Canadian context, two of these – legal certainty and political certain – are not particularly problematic. For developing countries such as Indonesia, they may, quite apart from any heavily reliance on tax incentives, prove influential disincentives to foreign investment.

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[9] Wolf stated that economic, political, legal and security issues are influential in foreign investment. In this thesis, security is included as a part of the political situation in the country because many physical security issues are caused by the political situation within host countries. Charles Jr Wolf, "Global Competition for Long-Term Capital: Who Will Win?" (1996) 31 Business Economics 7; Pancras J Nagy, Country *Risk: How to Assess, Quantify, and Monitor It* (London: Euromoney Publications, 1979); Erman Rajagukguk, "The Role of Law in Indonesian Economic Development: Survival Under Two Global Economic Crisis" (Presented at the 6th Asian Law Institute (ASLI) Conference, University of Hong Kong, Hong Kong 29-30 May 2009) online: <http://ermanhukum.com/Makalah%20ER%20pdf/Artikel%2020090528.pdf> ;BT Partnership Law Firm, "Foreign Investment" (2006) International Financial Law Review 1; OECD, *OECD Tax Policy Studies: Corporate Tax Incentives for Foreign Direct Investment* (Paris: OECD, 2001).

[10] Though scholars might prefer to look at each aspect separately, investors would look at these three aspects as one package, and would not consider one aspect only in choosing between two countries. They often use a perceived weakness as a bargaining point to negotiate for host government assistance (i.e. elimination of export-import duties, reduction in tax rate, etc.). Interview with Iceu Cahyati & Yerry P Silitonga (Analyst Investment & Financial Upstream Risk Management Pertamina), Fachmi Syuaib (Pertamina) and Madjedi Hasan (Petroleum Consultant).

1.2.1 Legal Certainty

Many developing countries experience a lack of legal certainty. This issue has inhibited them from gaining foreign investment because multinational companies are wary that their business will receive inadequate legal protection for their assets. The credibility of legal institutions within the host country is an important factor to consider in attracting foreign investment.[11] Sub-Saharan Africa, for example, has problems attracting potential foreign investors because its legal structure has made the resolution of legal problems expensive.[12]

Indonesia has similar problems in attaining foreign investment. The lack of legal certainty in Indonesia is one of the main factors inhibiting foreign investment.[13] Indonesia's second president had made Indonesia notorious as a country of corruption, collusion, and nepotism and, despite a series of presidents, these concerns remain.[14]

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[11] Darlington C Richards & Sonny Nwakwo, "Reforming the Legal Environment of Business in Sub-Saharan Africa: Moderating Effects on Foreign Direct Investment" (2005) 47 Managerial Law 154 at 156.

[12] *Ibid*.

[13] Berni K Moestafa, "RI Judiciary Worse Than First Thought: UN Rapporteur", *The Jakarta Post* (22 July 2002) online: The Jakarta Post < http://www.thejakartapost.com/news/2002/07/22/ri-judiciary-worse-first-thought-un-rapporteur.html>.

[14] The 2010 Corruption Perceptions Index showed that Indonesia scored 2.8 (ranked 110th out of 178 countries), whereas Canada scored 8.9 (ranked 6th), on a scale from 10 (highly clean) to 0 (highly corrupt). This study indicates that the level of corruption in Indonesia is perceived as beingmuch worse compared with Canada. Transparency International, *Corruption Perceptions Index 2010* (Berlin: Transparency International, 2010), online: Transparency International <http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results>.

1.2.2 Political Situation

Another factor inhibiting foreign investment is related to the political situation within the host country. Political situation refers to a host government's policies towards foreign investors, as well as the political stability of the country. Political risk analysis is used in the petroleum industry to reduce uncertainty.[15] Any risk associated with political or sovereign uncertainty is called political risk.[16] Political risk can be defined as an exposure to potential actions by a host government that would threaten the value of an investment.[17] Political risk would also include any potential damaging actions from particular social groups in any host country.[18]

One of the most common examples of political risk is expropriation and nationalization. Expropriation refers to government seizures of foreign investment, in which the particular

[15] There is often a misconception between political uncertainty and political risk. The distinction is essential to understand political risk analysis in investor's decision-making. Political risk analysis identifies risks and, thus, reduces uncertainty. The identification of political risk, however, does not mean a 'go-no-go' decision. The investor can use the identified risks as part of their bargaining points in negotiations. By estimating potential cost caused by the political risk, investors can negotiate for special treatment in other aspects such as an elimination of certain tax obligation. Political risk is the older terminology and in the 1970s, much of modern research began using the term 'country risk' as opposed to political risk. Country risk includes natural risk, country-specific economic risk, and socio-political risk. Some risks, however, are difficult to be exclusively indentified within a single category. Natural risk refers to the natural phenomena that negatively affect business conditions. Country-specific economic risk consists of macro risk (directed at all foreign companies) and micro risk (directed toward specific sectors of activity or selected firms). Often, economic risk is caused by "political mismanagement", and therefore, in discussing country risk, this thesis focuses mainly on the political risk. Socio-political risk refers to all possible damaging actions or factors for the business of foreign firms that emanate from any social group, political authority, or governmental body in the host country. See Ronald L Solberg, *Country-Risk Analysis: A Handbook* (London: Routledge, 1992); Michel Henry Bouchet, Ephraim Clark & Bertrand Groslambert, *Country Risk Assessment: A Guide to Global Investment Strategy* (West Sussex: John Wiley & Sons Ltd, 2003).

[16] Jae K Shim & Joel G Siegel, *Dictionary of International Investment Terms* (New York: Barron's Educational Series, Inc., 2001) at 242 & 279.

[17] *Ibid.*

[18] Michel Henry Bouchet, Ephraim Clark & Bertrand Groslambert, *supra* note 15 at 17.

company and/or its property are expressly mentioned in an expropriation decree.[19] In contrast, no particular foreign company is mentioned in a nationalization decree. Instead, nationalization decrees mention a general class of property or a whole sector of the economy. Expropriation and nationalization are considered lawful actions and are recognized by international law.[20]

Both developed and developing countries make use of expropriation and nationalization. Indonesia engaged in nationalization by taking over Dutch assets in 1957, British and Malaysian assets in 1963, and some American, Canadian, and other foreign assets in 1965.[21] In the 1980s, US companies felt "threatened" by Canadian laws mandating an increase in Canadian ownership of foreign companies.[22]

Though foreign investment may increase value and create indirect benefits for the local economy, such as employment and tax revenue for the host country, many believe that the existence of multinational enterprises in their countries is a political threat. It has been noted that host countries perceive a multinational company as a political institution that has the ability "to exercise decision-making power over key segments of the national economy from a headquarters located outside the national territory and beyond the

[19] J Frederick Truitt, "Expropriation of Foreign Investment: Summary of the Post World War II Experience of American and British Investors in the Less Developed Countries" (1970) 1 Journal of International Business Studies 21 at 23.

[20] *Charter of Economic Rights and Duties of States*, GA Res 3281 (XXIX), UNGAOR, 29th Sess, Supp No 31, UN Doc A/RES/29/3281, (1974) 50 at 52.

[21] Mohammad Reza Vaghefi, Steven K Paulson, & William H Tomlinson, *International Business: Theory and Practice*, (New York: Taylor & Francis, 1991) at 320.

[22] Further discussion on how Canada increased its ownership of US companies is presented in Chapter Four.

jurisdictional reach of their government."[23] To minimize the political cost, host governments secure ownership through expropriation and nationalization.[24] While this enhances local ownership, it discourages foreign investment since it presents real risk to foreign investors. For instance, there is the possibility for a foreign parent of a multinational company to lose ownership of its affiliates.[25] The type of industries that are most susceptible to expropriation and nationalization are extractive industries (such as the petroleum industry) and other industries related to utilities, transportation, and financial services.[26]

[23] Franklin R Root, *International Trade and Investment*, 7h ed. (Cincinnati: South-Western Publishing Co, 1994) at 640.

[24] *Ibid* at 645.

[25] *Ibid*.

[26] Extractive industries are considered as fundamentally important to a host country's economy, therefore the risk of being expropriated or nationalized is high. The nationalization for the utilities, transportation and financial services, is rationalized because the host country believed that it was insufficient to leave the regulation of production of goods essential to the community to private management. An example of this is the UK which nationalized public utilities, electricity and transportation for efficiency. In 1982, the French also nationalized all banks. The purpose for such nationalization was to "to enable the government to consolidate the most powerful industrial groups so that they could compete with large foreign firms; and to lift France out of the crisis that had been hampering the global economy since the 1970s". See Mohammad Reza Vaghefi, Steven K Paulson, & William H Tomlinson, *supra* note 21 at 197; Isi Foighel, *Nationalization: A Study in the Protection f Alien Property in International Law*, (Copenhagen: Nyt Nordisk Forlag Arnold Busck, 1957); Robert L Heilbroner, "Labor Unrest in the British Nationalized Sector" (1952) 19 Social Research 61; Raymond Vernon, ed, *How Latin America Views the US Investor*, (New York: Frederick A Praeger, 1966); Pascal Dumontier & Claude Laurin, "The Financial Impact of the French Government's Nationalization/Privatization Strategy" (A paper delivered at the EFMA 2003 Helsinki Meetings, 10 January 2003), online: <http://ssrn.com/abstract=393484 or doi:10.2139/ssrn.393484>.

1.2.3 Fiscal Regime

Clearly another factor influencing foreign investment decisions is the fiscal regime of the host country. Because of competition to attain foreign investment, host countries are forced to offer fiscal regimes that are highly favourable to investors. In the petroleum industry, tax incentives are often cited as a preferred method of attracting investment to upstream development.[27] Fiscal or tax incentives can be defined as "policies that are designed to reduce the tax burden of a firm".[28] The North Sea is an ideal example where an incentive in the form of low tax rates has proven to be an effective strategy for attracting foreign investment.[29] During the oil price shock in the mid-1970s, IOCs decided to commence exploration and production in high-cost oil regions such as the United Kingdom's North Sea, Canada, and Mexico. The oil development in the North Sea was considered the most dramatic because it contributed to the increase of (Western) European oil production from 0.5 million barrels a day (Mb/d) in 1974 to 3.8 Mb/d in 1985.[30] The increase in world oil prices and favourable upstream tax incentives in the area have contributed to increased oil production in the North Sea.[31]

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[27] Avi Nov, "The "Bidding War" to Attract Foreign Direct Investment: The Need for a Global Solution" (2006) 25 Va Tax Rev 835.

[28] World Bank, *Global Economic Prospects and the Developing Countries 2003* (Washington DC: The World Bank, 2003) at 81.

[29] Mark Thomas Hill, *The British North Sea: The Importance of and Factors Affecting Tax Revenue from Oil Production?* (Master of Arts Thesis, Brigham Young University, 2003) online: <contentdm.lib.byu.edu/ETD/image/etd336.pdf>.

[30] Bright Erakpoweri Okogu, *The Middle East and North Africa in a Changing Oil Market* (Washington DC: International Monetary Fund, 2003) online: <http://www.imf.org/external/pubs/ft/med/2003/eng/okogu/okogu.htm>.

[31] *Ibid*.

1.3 The Petroleum Industry

The landscape of energy resources is rapidly changing, with new exploration struggling to meet demand. Currently, oil and natural gas are the cornerstones of the petroleum market. World oil demand in 2010 was 85.5 million barrels per day and the Organization of the Petroleum Exporting Countries (OPEC) predicted that demand for oil would continue to grow, reaching 105.5 million barrels per day by 2030.[32] The product of natural evolutionary phenomenon, oil and natural gas resources will not be replenished for less than twenty million years. Effectively, they are non-renewable resources.

Two main processes are involved in the petroleum industry: upstream and downstream operations. Exploration, extraction, and production are the start-up stages, known as upstream activity. Downstream activity mainly consists of processing, refining, storage, and distribution, as well as marketing the final product. The risks involved with upstream operations are very high, particularly in early exploration. Oil exploration requires technological and engineering expertise which comes at great expense. Exploratory aerial and geophysical surveys, geological studies, core testing, and the drilling of test wells are all required.[33] There is no guarantee that these massive initial capital investments will produce revenues. In terms of economic risk, exploration activity is the highest risk in oil production. Oil exploration can cost anywhere from tens to hundreds of billions of dollars, depending on various factors, including the location and size of the oil field.[34]

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[32] Organization of the Petroleum Exporting Countries, *World Oil Outlook 2010* (Vienna: OPEC Secretariat, 2010), online: Organization of the Petroleum Exporting Countries <http://www.opec.org/opec_web/static_files_project/media/downloads/publications/WOO_2010.pdf > at 63.

[33] Williams & Meyers, *Manual of Oil and Gas Terms*, 5h ed (San Francisco: Matthew Bender, 1981).

Often the project is halted at this stage of upstream activity because the exploration shows that there is no commercially viable amount of oil. The extraordinary amount of capital invested in the upstream activity is lost.

In discussing investment decisions in the oil and gas sectors, there must be a distinction between national oil company (NOC) and international oil company (IOC).[35] These two entities have different goals which influence decision-making. As state-owned enterprises, NOCs have the obligation to secure their country's oil supply.[36] NOCs' responsibilities "go beyond maximization of returns for the shareholders, as they have to meet important national goals".[37] In making investment decisions, NOCs have to pay attention to the foreign and strategic policies of their governments.[38] Their ultimate goal is to find oil reserves even if other investment factors are not appealing.[39] On the other hand, IOCs' ultimate goal is, of course, maximum profit. In order to gain maximum profit, any risk regarding investment is subject to thorough consideration. IOCs calculate

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[34] Organization of the Petroleum Exporting Countries, *The oil industry*, online: Organization of the Petroleum Exporting Countries <http://www.opec.org/opec_web/en/press_room/179.htm >.

[35] Interview with Fachmi Syuaib (Pertamina).

[36] There is also a domestic oil company which operates within its country. Often, domestic oil companies in developing countries are small oil companies with limited capital to explore outside the country. Interview with Madjedi Hasan (Petroleum Consultant) and Lukman Umar (Pertamina).

[37] Primila Edward, "NOCs and IOCs at the Crossroads" (2010) Malaysian Business 26.

[38] *Ibid*.

[39] Major oil consuming countries such as China and India needed to meet their country's oil demand. China has three well known NOCs: China National Petroleum Corp. (CNPC), China Petroleum Corp. (Sinopec) and China National Oil Corp. (CNOOC). The rapid growth of oil demand forces these NOCs to aggressively compete with the IOCs to access new reserves. CNOOC's $2.3 billion investment in Nigeria in 2006 has changed the composition of the oil industry in Africa. Before, African oil industries was dominated by the US, British and European IOCs only. See Primila Edward, *ibid*; Paula Dittrick, "Chinese NOCs Go Shopping" (2006) 104 Oil & Gas Journal 15; "China, India Boost African Status" (2006) 317 African Business 30.

the risk in relation to legal certainty, political condition, and fiscal regime before choosing to invest in a country.

Recognizing the difference between NOCs and IOCs show that foreign investment in petroleum industry is a vast and complex discussion. It touches many aspects including general investment factors such as legal certainty, political situation and fiscal regime; and also the world situation such as world oil price, national energy security, the notion of foreign oil dependency and environmental regulations.

CHAPTER II
TAXATION IN THE PETROLEUM INDUSTRY

Generally, the world's fiscal arrangements in regards to petroleum are divided into two basic systems: concessionary and contractual.[40]. The difference between concessionary and contractual systems rests in the ownership of the natural resources. Canada operates chiefly under the concessionary model; Indonesia under the contractual model. Lessons related to tax incentives and the development of the Canadian oil sands should take this difference into account, particularly as it pertains to the natural resource ownership concept. Since it is always difficult to isolate particular influences on development in order to determine their effects, this chapter outlines the frameworks of fiscal arrangements within the petroleum industry.

2.1 Overview of the Fiscal Arrangement Systems

Under the concessionary system, "governments decide whether resources are privately owned or whether they are state property".[41] This ownership concept comes from the common law. The concessionary system allows the government or landowner to transfer title of the resource to a company. The oil company is then subject to the payment of

[40] Daniel Johnston, *International Petroleum Fiscal Systems And Production Sharing Contracts* (Tulsa: PennWell, 1994) at 25.

[41] Mark J Kaiser & Allan G Pulsipher, *Fiscal System Analysis: Concessionary and Contractual System Used in Offshore Petroleum Arrangements* (New Orleans, La: U.S. Department of the Interior Minerals Management Service, Gulf of Mexico OCS Region, 2004) online: Louisiana State University Center for Energy Studies <http://www.enrg.lsu.edu/files/images/publications/online/2004/2004-016_Final_Report.pdf>.

royalties and taxes. Countries such as Canada, the United States, and the UK use this fiscal arrangement system.[42]

Under the contractual system, "oil companies have the right to receive a share of production or revenues from the sale of oil and gas in accordance with a production sharing contract (PSC) or a service contract".[43] The production sharing concept comes from the civil law concept of mineral ownership where ownership resides and remains with the state.[44] This system dictates that individuals not own the mineral wealth. Instead, the state owns it for the public good.

In the purest contractual arrangement systems any facilities built by the contractor within the host country's territory ultimately become the property of the state. This system consists of service contracts and a PSC. In a service contract, the contractor receives a share of the revenue in cash rather than a share of the production *in kind* (crude oil).[45] On the other hand, in a PSC the contractor gets a share of production and takes title of the crude oil reserve. Indonesia was one of the earliest countries to introduce the concept of

[42] Daniel Johnston, *supra* note 41; Mark J Kaiser & Allan G Pulsipher, *ibid.*

[43] Daniel Johnston, *ibid* at 22.

[44] Concessionary system is used in common law, whereas PSC is used in civil law.

[45] Service contracts are often called as risk service contracts. The idea is that the contractors has an obligation to provide all capital associated with exploration and development of petroleum resources. If exploration effort is successful, the government allows the contractor to recover the initial cost and pays the contractor a service fee. All production, however, belongs to the government. See Daniel Johston, *supra* note 40 at 87.

PSC, a concept soon adopted by other oil-producing countries such as Malaysia, Nigeria, and Equatorial Guinea.[46]

From a practical and financial point of view, the difference between the fiscal arrangement systems is predominantly terminological.[47] The main difference is related to the amount of tax imposed.[48] Consequently, investors are more concerned with the taxation levied rather than the particular underlying fiscal arrangement system.

2.2 Taxation in the Petroleum Industry

Taxation in extractive industries, particularly the petroleum industry, is related to economic rent. Understanding the economic rent concept is vital in petroleum taxation because it is the main reason a host country taxes the oil companies on their natural resources. In all oil-producing countries, the host government tries to seize as much economic rent as possible.[49] Imposing taxes is one way for the host government to capture this rent.[50]

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[46] Tengku Nathan Machmud, *The Indonesian Production Sharing Contract: an Investor's Perspective* (The Hague: Kluwer Law International, 2000); J G Frynas, "The Oil Boom in Equatorial Guinea" (2004) 103 Afr Aff 527; Lawrence Atsegbua, "The development and acquisition of oil licences and leases in Nigeria" (1999) 23OPEC Rev 55.

[47] Daniel Johnston, *supra* note 41 at 26.

[48] *Ibid.*

[49] Dale Gray, "Energy Tax Reform in Russia and Other Former Soviet Union Countries" (1998) 35 Finance & Development 31, online: <http://www.imf.org/external/pubs/ft/fandd/1998/09/pdf/gray.pdf>; Mark Thomas Hill, *supra* note 26 at 28; AS Brink, *Foreign Investment in the Petroleum Industry* (Masters of Arts Thesis, University of Calgary, 1983) [unpublished] at 66.

[50] Daniel Johnston, *supra* note 41 at 6.

Economists have been defining economic rent since the eighteenth century, with some definitions being vague, and others contradictory.[51] In the petroleum industry, the concept of economic rent began with David Ricardo's theory of land rent. He defined economic rent of a land as "the value of the difference in productivity between a given piece of land and the poorest, most costly piece of land producing the same goods under the same condition".[52] Another definition of economic rent is "the difference between the value of production and the costs to extract it".[53] Economic rent for oil occurs because this resource is valuable. The potential of scarcity in the future increases the value of oil. The difference between the value of oil and the cost of production is economic rent. This economic rent is a surplus; often called excess profit. Economic rent can be defined as:[54]

> Economic rent is the financial gain which remains after a firm has deducted all its production costs and a normal level of profit from the value of the product it manufactures. In Indonesia, a proportion of the rent is collected by the government as taxes and levies, while the remainder is retained by the concessionaire as large excess profits. When discussing economic rent, it is important to draw the distinction between normal and excess profit. Normal profit is defined as the minimum profit required to attract entrepreneurs to a certain activity and induce them to remain in that activity over the long term, while excess profit is any profit above and beyond that deemed to be a normal level of profit.

In economic theory, there are two types of profit: normal and excess. Any profit over that minimum amount is called excess profit, or "economic rent". The attempt to capture

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[51] Albert M Church, *Conflicts over Resources Ownership* (Toronto: Lexington Books, 1982) at 106.

[52] David Ricardo, *On the Principles of Political Economy and Taxation* (London: John Murray, 1817) as cited in LC Stilwell & RCA Minnitt, "Is Platinum Paying Its Rent?" (A paper delivered at the International Platinum Conference 'Platinum Surges Ahead', The Southern African Institute of Mining and Metallurgy, 8-12 October 2006) online: <http://basemetals.org/Pt2006/Papers/285-294_Stilwell.pdf>.

[53] Daniel Johnston, *supra* note 41 at 6.

[54] DFID (UK Department for International Development), *Final Report of the Senior Management Advisory Team and the Provincial Level Forest Management Project Vol. 2* (Jakarta: Department of Forestry, 1999) at 175.

this excess profit is the primary reason why the host country imposes taxes on their mineral or petroleum resources.

The concept of economic rent stems from the host government's ownership of its natural resources. Therefore, in discussing taxation in the petroleum industry, the concept of natural resources ownership must first be understood. Originally, ownership was regulated by the rule of capture.[55] If, for example, when most game animals or birds migrated from one area to another, the owner of the land where they resided was free to treat them as his own possessions. In the petroleum industry, the same rule was initially applied, where the owner of the land had the right to extract the oil or gas beneath it.[56] The original concept of resource ownership has now changed to the point where certain oil-producing countries no longer acknowledge private ownership.[57] As previously explained, resource ownership is related to fiscal arrangements. The difference between the two types of fiscal arrangements in terms of direct impact on business is taxation.[58] In relation to economic rent, the governments of oil-producing countries are eager to capture maximum economic rent regardless of the resource ownership rules they follow. By imposing taxes on resources contained underneath their land, oil-producing countries can capture not only the normal profit but also the excess profit.[59]

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[55] Daniel Yergin, *The Prize*: *the Epic Quest for Oil, Money, and Power* (New York: Simon & Schuster, 1991) at 32.

[56] *Ibid.*

[57] *Ibid.*

[58] Daniel Johnston, *supra* note 41 at 26.

[59] The host government can capture economic rent by imposing taxes, royalties, land rents, and license fees. Emerson explained that imposing taxes (such as corporate income taxes or property taxes) was an effective

Over the course of the development of their natural resources, the host governments' use of taxation systems to influence investment decisions has altered. Currently, they are less concerned with using taxation devices to capture high rent. Host governments use tax instruments as devices to draw oil companies' attention to the extraction of their resources. Increased competition between the oil-producing countries is the main driving force for such change. The IOCs now have more options with respect to the exploration and extraction of oil.

2.3 Tax Incentives for Attracting Foreign Investment

The question of whether tax incentives are highly effective in attracting foreign investment has long been discussed. Proponents of tax incentives claim that the incentives are cost-effective.[60] It is impossible for the host government to levy taxes if a foreign company does not invest and operate in the country. The incentives, then, appear effective and profitable because they must be compared to the possibility of not having any foreign investment at all, and therefore either no development or slow development. Another reason to use tax incentives to attract foreign investment is merely to remain competitive with other countries offering similar incentives.[61] Proponents view tax

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way to capture economic rent without creating distortions. See Repetto, Robert and Malcom Gillis (eds.) *Public Policies and the Misuse of Forest Resources* (Washington, DC: World Resources Institute, 1988) as cited in David Walter Brown, *Why Governments Fail to Capture Economic Rent: The Unofficial Appropriation of Rain Forest Rent by Rulers in Insular Southeast Asia Between 1970 and 1999* (Doctoral Dissertation, Centre For Policy Initiatives)[Unpublished]; Craig Emerson, "Taxing Natural Resources Projects" (1980) 4 Natural Resources Forum 123 as cited in Albert M Church, *supra* note 47 at 216.

[60] James K Smith, "Use of Business Tax Incentives: Part 1" (1998-1999) 17 J St Tax'n 1 at 3.

[61] *Ibid*.

incentives as "simply the healthy workings" of competition in a free market.[62] Specific to the petroleum industry, Johnston argued that "fiscal terms make a huge difference" in calculating a contractor's take.[63] Australia, for example, is less attractive than Malaysia or Indonesia in terms of volume of oil reserves. However, it is still considered a profitable option for IOCs because Australia's fiscal regime is not as tough as neighbouring countries such as Indonesia and Malaysia.[64]

Opponents of tax incentives argue that in deciding which country to invest in, foreign companies consider other business factors, such as legal certainty, political situation, security environment and non-tax incentives, to be far more important than tax incentives.[65] Wells and Allen also argued that in the Indonesian case, tax incentives

[62] A study conducted by Devereux and Griffith in 1998 shows that taxation has a significant impact on the choice of location of subsidiaries within Europe. A subsequent study conducted by Buettner and Ruf in 2007 examined the effect of taxation on the decision of German multinational corporations (MNCs) to establish subsidiaries in 18 countries. Buettner and Ruf's research indicated that host governments should be lowering their tax rates on corporate profits in an attempt to attract MNCs. They indicate that tax incentives are vital to foreign investors' decision-making processes. See James K Smith *Ibid*; Michael P Devereux & Rachel Griffith, "Taxes and the location of production: Evidence from a panel of US multinationals" (1998) 68 Journal of Public Economics 335; Thiess Buettner & Martin Ruf, "Tax incentives and the location of FDI: Evidence from a panel of German multinationals" (2007) 14 International Tax Public Finance 151.

[63] Contractor's take refers to the percentage of profits going to the contractor or oil company. Daniel Johnston, "Global Petroleum Fiscal Systems Compared by Contractor Take", (1994) 92 Oil & Gas Journal 47.

[64] Another study in 2002 compared fiscal regimes in Australia, Indonesia, Malaysia, China, and India, and showed that Australia's fiscal regime is the most favourable. Temmy Dharmadji & Tumbur Parlindungan, "Fiscal Regimes Competitiveness Comparison of Oil and Gas Producing Countries in the Asia Pacific Region: Australia, China, India, Indonesia and Malaysia" (A paper prepared for presentation at the SPE Asia Pacific Oil and Gas Conference and Exhibition held in Melbourne, Australia, 8–10 October 2002).

[65] Louis T Wells, Jr *et al*, *Using Tax Incentives to Complete for Foreign Investment: Are They Worth the Costs?* (Washington, DC: The International Finance Corporation and The World Bank, 2001); Chang Woon Nam & Doina Maria Radulescu, "Do Corporate Tax Concessions Really Matter for the Success of Free Economic Zones?" (2004) 37 Economics of Planning 99; Jacques P Morisset & Nede Pirnia, "How Tax Policy and Incentives Affect Foreign Direct Investment: A Review," World Bank Policy Research Working Paper, no. WPS 2509 (31 December 2000), online:

employed in order to attract FDI failed to deliver net gains to the country.[66] They argued that the net costs of tax incentives to the Indonesian treasury exceeded the total additional investment Indonesia received. They indicated that even though there was no "hard evidence" to support the Indonesian belief, the country accepted that tax incentives were influential for foreign investors.[67]

Earlier research also suggested that a "…relationship between tax incentives and investment decisions did not exist".[68] Similar to Wells and Allen's research, Aharoni also noted that while most investors did not find tax incentives attractive, host government officials believed that it was a powerful stimulus to FDI.[69] It appears that though there is no definitive view on the influence of tax incentives in cultivating foreign investment, host countries perceive tax incentives as a crucial factor.

Another study that specifically analyzed the importance of tax incentives to attract foreign investment in the petroleum industry was conducted by Phina.[70] Phina used the

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<http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469382&piPK=64165421&menuPK=64166093&entityID=000094946_01010905342188>; Sian Sandeman & Heather Self, "Keeping the UK competitive" (2001) 12 International Tax Review 66; James K Smith, *Ibid*; Charles Jr Wolf, *supra* note 20; Darlington C Richards & Sonny Nwakwo, *supra* note 9; Yair Aharoni, *The Foreign Investment Decision Process* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1966).

[66] Louis T Wells, Jr *et al*, *ibid*.

[67] *Ibid* at x.

[68] Aharoni conducted a study on the way foreign investment decisions were made by U.S. manufacturing firms. The conclusion was that income tax exemption was a weak stimulant and the investment decision was incorporated with a wide range of other influential factors. Yair Aharoni, *supra* note 66 at viii.

[69] Jacques P Morisset & Nede Pirnia, *supra* note 66 at 6.

[70] Anaghara O Phina, "Are There Economic Limits to Efficient Taxation in Mineral and Petroleum Fiscal Regimes?" 8 Dundee Yearbook of International Natural Resources & Energy Law & Policy (Dundee,

British North Sea and the Indonesian petroleum industry as case studies. He found that, in the case of British North Sea, the elimination of royalties had encouraged new investment. However, for the Indonesian case Phina concluded that even with an unattractive tax regime "investors are still eager to develop the industry". Phina argued that "Indonesia is favorably situated in terms of geology and proximity to the market".

In analyzing the significance of tax incentives in attracting foreign investment, this thesis uses a different approach than previous studies. Rather than focusing only on tax incentives; this research draws attention to three main foreign investment factors: legal certainty, political situation and fiscal regime. This approach brings the discussion to a broader framework. The changes in the tax regime from the 1970s to the 1990s will be compared against the prevailing situations. This approach illustrates the main driving forces for foreign investment at the early stage of oil sands development.

Despite the fact that there is still uncertainty as to what extent tax incentives can effectively encourage foreign investment, both developed and developing countries use such instruments. The incentives offered by the host government include tax holidays, a deduction in income taxes, low income tax rates, tax refunds, investment allowance, accelerated depreciation, and subsidies on factory buildings and land development, in

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Scotland: University of Dundee, Centre for Energy, Petroleum and Mineral Law and Policy, 2004) online: <http://www.dundee.ac.uk/cepmlp/car/html/car8_article16.pdf >.

order to reduce investment costs.[71] The decision as to which tax incentive will be used to attract foreign investors depends entirely on the host country itself.

2.4 Foreign Investment in Indonesia

With an area of 1.9 million square miles, Indonesia consists of more than seventeen thousand islands and has various natural resources. Natural resources such as oil, natural gas, gold, timber, coal, and fisheries have benefited the Indonesian economy. In the past, the richness of its natural resources caused several countries to invade and colonize in Indonesia. Indonesia acquired its independence on 17 August, 1945, after having been controlled by the Netherlands and Japan.

FDI in Indonesia began when Indonesia was still a Dutch colony. Prior to World War I FDI in Indonesia was done mostly by the Netherlands and focused mainly on the natural resources and plantation agriculture sectors.[72] After more than three decades of Dutch colonization, the Japanese invaded in the 1940s. In 1945, after Indonesia achieved its independence, foreign assets that were taken over by the Japanese were returned to Indonesia. There was no FDI in Indonesia from this period until 1966.[73]

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[71] Kui Hua Wang, "Some Legal Issues of Investing in Asia: An Australian Perspective" (1998-2000) 7 Canterbury L Rev 215 at 223.

[72] John H Dunning & Rajneesh Narula, eds, *Foreign Direct Investment and Governments: Catalyst for Economic Restructuring* (Oxon: Routledge, 1996) at 318.

[73] *Ibid*.

As a newly independent country after World War II, Indonesia was one of the lowest income countries in the world.[74] In order to improve the economic condition the first Indonesian president sought rapid industrialization. The country proved ideologically nationalistic thus FDI significantly decreased. Indonesia nationalized Dutch assets in 1957, British and Malaysian assets in 1963, and some American, Canadian, and other foreign assets in 1965.[75] During this period, many other developing countries pursued nationalization and expropriation strategies.[76] The expropriation, or nationalization, is often a consequence of independence: foreign investment was viewed as a symbol of Western industrialization and Western colonialism.[77] In Indonesia, nationalization discouraged foreign investment in almost all industries during this period.[78]

In the 1960s, Indonesia became more open to foreign investment. Previous economic policies lead to severe economic crisis, with inflation hampering Indonesia's economy

[74] *Ibid*. at 317.

[75] *Ibid*. at 320.

[76] Stephen J Kobrin, "Expropriation as an Attempt to Control Foreign Firms in LDCs: Trends from 1960-1979" (1984) 28 Int'l Stud Q 329 at 331.

[77] *Ibid.* at 337 - 340.

[78] In relation to the Indonesian petroleum industry, ownership was constructed in article 33 of the 1945 Constitution (*Undang-Undang Dasar 1945*). Article 33 (2) stated that production sectors that were vital to the state and that affected the livelihood of a considerable part of the population were to be controlled by the state; therefore the Indonesian petroleum industry has been under control of the state since Indonesia's independence. However, the laws and regulations implementing the 1945 Constitution regarding oil and gas were not drafted and passed by legislation until 1960. Between the independence period and the enactment of Law Number 44 of the Year 1960 on Oil and Gas Mining, exploration and production in the petroleum industry in Indonesia sank to their lowest levels, and were administered under the transitional regulations of *Undang-Undang Dasar 1945*. Mirza A Karim & Karen Mills, "Indonesian Legal Framework in the Oil, Gas, Energy and Mining Sectors; Including Dispute Resolution" (2003) KarimSyah Law Firm at 8.

since the early 1950s, and hyperinflation by the mid 1960s.[79] Government objectives were to restore macroeconomic stability.[80] This included changing the Indonesian economy's orientation from state-owned enterprises and direct government regulation to privately-owned enterprises that would be more dependent on market forces.[81]

New laws in the petroleum industry[82] "clarified the organizational and financial relationship between the government and Pertamina (the government owned oil company), and established a clearly defined chain of command, enhancing governmental control over Pertamina's operations".[83] During this period oil sector contributions increased significantly to where "in 1972 oil revenues accounted for thirty-three percent of total tax revenues" compared to 1966 when oil revenues only constituted five percent

[79] Anne Booth & Peter McCawley,eds, *The Indonesian Economy During the Soeharto Era* (Kuala Lumpur: Oxford University Press, 1981) at 102–125.

[80] John H Dunning & Rajneesh Narula, eds, s*upra* note 73 at 322.

[81] Soeharto's strategy succeeded in building Indonesia (which in 1966 had a negative net foreign exchange reserve, and whose economic leaders were forced to plead for rescheduling of debts) to a foreign exchange reserve of $1.492 billion, and established the rupiah as a hard currency. Hyperinflation was then reduced to tolerable levels in three years. See John H Dunning & Rajneesh Narula, eds; *Nota Keuangan 1975-76*, and *International Financial Statistics*, July as cited in Bruce Glassburner, "In the Wake of General Ibnu: Crisis in the Indonesian Oil Industry" (1976) 16 Asian Surv 1099 at 1101; Bruce Glassburner, *ibid.*.

[82] Pertamina is the Indonesian NOC. Prior to Law Number 8 of the Year 1971, there were three NOCs in Indonesia with different missions. Permina was established by the Army to operate Shell's oil fields in North Sumatra before the World War. Pertamin was established to take over the NIAM's (Nederlands Indische Aardolie Maatschappij) oil fields in Jambi and Bunyu. Permigan was dominated by the communist group to operate Shell's oil fields in Central Java. On January 4, 1966 Permigan was liquidated following the revolt of PKI (*Partai Komunis Indonesia*/Indonesian Communist Party). Assets of Permigan were handed over to Pertamin and Permina. On 1968, Pertamin and Permina merged into Pertamina. The position, mission and organization of this single NOC were later strengthened by the enactment of Law Number 8 of the Year 1971. See Pertamina, *Company's History,* online: Pertamina <http://www.pertamina.com/index.php/detail/read/company_history>; Madjedi Hasan, *Pacta Sunt Servanda: The Principles and Its Application in Petroleum Production Sharing Contract* (Jakarta: Penerbit PT.Fikahati Aneska, 2005).

[83] Robert Fabrikant, "Pertamina: A Legal and Financial Analysis of a National Oil Company in a Developing Country" (1975) 10 Tex Int'l L J 495 at 501.

of total tax revenues.[84] In relation to foreign investors, "besides conducting its own exploration of production, Pertamina oversees production sharing contractors and is constantly attempting to sign up new contractors…".[85] Such attempts to find new investment brought a positive effect to Indonesian tax revenues, where oil activities conducted by IOCs have resulted in "substantial exploration and development expenditures".[86]

Since, any success of Indonesian petroleum industry in finding foreign investment has declined. From 1999 to 2003, investment in the Indonesian petroleum industry attracted only a small percentage of global upstream oil and gas exploration and development investment.[87] Lack of legal certainty, security issues, problems surrounding the transfer of authority from the central government to regional governments (decentralization), a high probability of natural disaster, and tax issues have made Indonesia less attractive to foreign investment.[88] A recent study has placed Indonesia in the bottom four of a country risk survey of 12 Asian countries.[89] Indonesia's poor position was mainly caused

[84] *Ibid.* at 508.

[85] *Ibid.*

[86] Explorations and development expenditures amounted to US$ 412 million for the period of 1968-1971. It dramatically increased in 1972 by US$ 271 million as cited in Robert Fabrikant, *ibid.*

[87] PriceWaterhouseCoopers, *The Urgency of Building Competitiveness to Attract Oil and Gas Investment in Indonesia: An Industry Survey on Investment Issues and Opportunities to Enhance Upstream Investment* (Jakarta: KAP Haryanto Sahari & Rekan, 2005) at 29.

[88] American Embassy Information Resource Centre, *Indonesia: Investment Climate 2003*, online: U.S. Embassy <www.usembassyjakarta.org>; AT Kearney, *Global Business Policy Council Volume 7* (Virginia: A.T. Kearney, Inc., 2004) at 39, online: <www.atkearney.com>; "Getting Sunnier: Indonesia's Improving Investment Climate" *INA Magazine* (2006) 7 INA Magazine 6.

[89] Although there has been an improvement compared to the 2008 survey, which put Indonesia in last place, generally Indonesia is still considered as one of the riskiest places to invest. Political and Economic Risk

by its poor legal system and lack of law enforcement.[90] A recent survey on Indonesia's inward investment indicated that 95 per cent of respondents rate legal/regulatory risk as the most significant factor to a successful investment in Indonesia.[91]

2.4.1 Legal Certainty

Legal certainty, reflected in serious criticism of the independence of Indonesia's judiciary inhibits foreign investment.[92] Some cases regarding the problem with Indonesia's legal system received both domestic and international attention. For example the controversial case of PT Asuransi Jiwa Manulife Indonesia (AJMI),[93] where a joint venture insurance company which was perfectly solvent declared bankruptcy in spite of its solvency. There was also a similar case in 2004 that involved another insurance company, PT Prudential Life Assurance[94]In the energy industry the lack of legal certainty

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Consultancy, Asian *Risk Prospects 2010*, online: <www.asiarisk.com>; Lilian Budianto,"Indonesia's judicial system rated the worst in Asia: Survey", The Jakarta Post, 15 September 2008.

[90] Hikmahanto Juwana, "Reform of Economic Laws and Its Effects on the Post-Crisis Indonesian Economy" (2005) 43 The Developing Economies 72; Alan Sipress, "Flawed Legal System Impending Indonesia" *Washington Post* (29 October 2002) as cited in Delissa A Ridgway & Mariya A Talib, "Globalization and Development-Free Trade, Foreign Aid, Investment and the Rule of Law" (2002-2003) 33 Cal W Int'l LJ 325 at 337-338; "Indonesia Economy: Ten-Year Growth Outlook" *EIU ViewsWire* (23September 2005).

[91] The Norton Rose Group Indonesia inward investment survey 2011 took the view of 109 respondents, all of whom had invested in Indonesia or expect to make an investment. See Norton Rose, *Indonesia Inward Investment: An Industry Survey* (np: Norton Rose, 2011) online: <http://www.nortonrose.com/files/indonesia-inward-investment-june-2011-pdf-52492.pdf>.

[92] Berni K Moestafa, *supra* note 13.

[93] For further discussion on the case see Hikmahanto Juwana, *supra* note 90 at 86; "Controversial Manulife Judges Exonerated", *The Jakarta Post* (21 January 2003); "Controversial Manulife Judges Moved", *The Jakarta Post* (8 August 2003).

[94] Some analysis has suggested that both the Manulife and Prudential cases were caused by a problem in the bankruptcy law and the Indonesia's judiciary independency. "Prudential's Indonesian Directors Face Jail Threat Over Bankruptcy Charge" *Reuters* (11 May 2004) online: The Financial Express <http://www.financialexpress.com/news/prudentials-indonesian-directors-face-jail-threat-over-bankruptcy-charge/59761/>; "Indonesia Supreme Court overturns bankruptcy ruling on Prudential Life-Update 2" *AFX*

also played a role in the dispute between Karaha Bodas Company (a Cayman Islands company primarily owned by Florida Power and Light and Caithness Energy[95]) and Pertamina (Indonesia's national oil company).[96] These three cases demonstrate that legal uncertainties in Indonesia are multifaceted; not only are there problems surrounding Indonesia's judiciary, but also the laws and regulations are vague and create ambiguity.

The corruption level in Indonesia can also be used as an indicator of legal uncertainty. Indonesia's investment condition has deteriorated due to corruption problems, where, based on the corruption perception index (CPI), Indonesia scores 2.8 on a scale of 10 (highly clean) to 0 (highly corrupt).[97] While lack of legal certainty, combined with

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Asia (6 August 2004) online: Interactive Investor <http://www.iii.co.uk/investment/detail/?display=news&code=cotn:PRU.L&action=article&articleid=4993642>.

[95] The actual owners were Caithness Enegy, LLC (40.5%), Florida Power and Lights Energy (40.5%), a subsidiary of Florida Power and Light Group, Inc., Tomen (9%), and the local partner (10%). Both Florida Power and Light and Caithness Energy are two of America's most important energy producers and distributors.

[96] In November 1994, Karaha Bodas Company (KBC) and Pertamina entered into a joint operation contract (JOC) which granted KBC geothermal development rights in West Java, Indonesia. KBC and Pertamina then signed an energy sales contract (ESC) with PLN (*Perusahaan Listrik Negara*/ State Owned Electricity Company) in which PLN agreed to purchase from Pertamina the electrical energy produced at the Karaha Bodas geothermal facility. In September 1997, as a response to the Asian financial crisis, President Soeharto issued a decree to postpone the Karaha Bodas project. In November 1997, President Soeharto reversed his decision and reinstated the Karaha Bodas Project after protests by KBC. In January 1998 a third decree postponed the project for good. KBC then notified both Pertamina and PLN that the government's actions "constituted an event of *Force Majeure*" under both contracts, ceased operations, and served the parties with notice of its intent to initiate arbitration. Based on clauses in each contract, in the event of dispute, the three parties were agreed to arbitrate in Geneva, Switzerland, under the United Nations Commission on International Trade Law Arbitration Rules (UNCITRAL). In 18 December 2000, the Arbitrators held that both Pertamina and PLN breached their contracts with KBC and awarded KBC $261 million in damages, including $ 111 million in sunk costs and $ 150 million in lost profits, plus 4% post-judgment interest. Though the amount awarded by the Arbitrators was considered excessive by economists; the Indonesian court received many critics with the rulings to annul the foreign arbitration awards. See Noah Rubins, "The Enforcement and Annulment of International Arbitration Awards in Indonesia", (2004-2005) 20 Am U Int'l L Rev 359; Louis T Wells, "Double Dipping in Arbitration Awards? An Economist Questions Damages Awarded Karaha Bodas Company in Indonesia" (2003) 19 Arb Int'l 471.

[97] Transparency International, *supra* note 14.

corruption problems, is cited as one of the ultimate challenges hampering Indonesia from obtaining foreign investment, Canada is not facing a similar problem. There has been no report or study on problems with legal certainty in Canada. The CPI indicates that Canada is perceived as relatively clean of corruption, with a score of 8.9.[98]

2.4.2 Political Situation

Another factor inhibiting foreign investment in Indonesia is related to country risk.[99] In the case of Indonesia, the high probability of earthquake and tsunami discourages investment.[100] While there is little discussion on country-specific economic risk in Indonesia, the country faces real risks with respect to socio-political matters, such as terrorism, insurrection, and the possibility of expropriation or nationalization. Although there is no specific value placed on the impact of terrorism and insurrection to the foreign investment rate, these security issues may increase the country risk. Repeat terrorist bombings in Indonesia causing death to Indonesians and foreigners have discouraged investment.[101]

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[98] *Ibid.*

[99] As described in Chapter One, country risk can be broken down into three main risks: natural disasters, country-specific economic risk, and socio-political risk. This thesis, however, focuses on the political risk. Michel Henry Bouchet, Ephraim Clark & Bertrand Groslambert, *supra* note 15.

[100] 26 December 2004: Tsunami in Aceh; 2 March 2005: Earthquake in Banda Sea; 28 March 2005: Earthquake in Nias; 27 May 2006: Eartquake in Yogyakarta; 17 July 2006: Tsunami in Pangandaran; 6 March 2007: Earthquake in West Sumatra: 12 September 2007: Earthquake in Bengkulu; 3 January 2009: Earthquake in Manokwari.

[101] In July 2009, bombs exploded in two international hotels in Jakarta (the capital). Many foreigners became the victims and one of them was the President Director of PT Holcim Indonesia (one of the major cement company in Indonesia). See Stephen Sherlock, *The Bali Bombing: What it Means for Indonesia* (Australia: Department of the Parliamentary Library, 2002), online: Parliament of Australia <http://www.aph.gov.au/library/pubs/cib/2002-03/03cib04.pdf >.

With the experience of having almost all foreign assets in Indonesia nationalized in the 1950s, there is always the possibility that similar action could occur in the future. In the case of extractive industries, the ways in which the concept mineral ownership was constructed in the 1945 constitution indicates that the Indonesian government would prefer if such assets remained under state control. Given the historical experience of foreign' invasion, many Indonesians perceive foreign investment as another form of foreign penetration into the country. This historical background could lead to extreme government action, such as expropriation or nationalization.

While Indonesia's country risk is quite high with respect to natural disasters; Canada, particularly Alberta, does not have a problem with natural phenomena. In terms of expropriation/nationalization, Canada has had similar experiences as Indonesia. In the 1980s Canada's political view began to be more nationalistic. The introduction of the National Energy Program on 28 October, 1980[102] was perceived by foreign investors as a political threat to their business within the country. Further discussion will be conducted in Chapter Four.

[102] Ian Wilson, "NEP: 25 Years Later, Boom to Bust" *Calgary Sun* (29 October 2005), online: <http://www.calgarysun.com>.

2.4.3 Fiscal Regime

Specific to the petroleum industry, another barrier for investment is related to tax issues. According to the 2005 and 2008 PricewaterhouseCoopers survey of foreign investors in Indonesia, taxation is one of the critical challenges facing the petroleum industry.[103] Taxation is one barrier the government can readily control.

The shift in the Indonesian political structure from a centralized government to decentralization has resulted in Indonesia's tax regime becoming less attractive to foreign investors.[104] Legal changes in 2004 [105] had given the provincial and regional governments more authority in many aspects including taxing authority.[106] Those changes, which resulted in a decentralization of the political structure caused "disastrous consequences for business and foreign investment dn Indonesia" because of the increased probability of excessive and illegal new levies and charges.[107] Without control from a central

[103] Based on the 2008 survey, there are five challenges hampering foreign investment in the Indonesian petroleum industry: taxation; contract sanctity; security of people, assets, and ownership rights; uncertainty over cost recovery and BP Migas/BPKP audit findings; and interference form other government agencies. Taxation, contract sanctity and security were included as the top five challenges in the 2005 survey. PriceWaterhouseCoopers, *Exploring the Black Gold: Investor Survey of the Indonesian Oil and Gas Industry* (Jakarta: PricewaterhouseCoopers, 2008), online: <http://www.pwc.com/id/en/publications/assets/pricewaterhousecoopers_indonesia_oilandgas_2008.pdf> at 3.

[104] Indonesia has been cited as an unattractive tax system because of the high rate of government take. See Daniel Johnston, *supra* note 64; Anaghara O Phina, *supra* note 71; PriceWaterhouseCoopers, *ibid*.

[105] *Undang-Undang No. 32 Tahun 2004 tentang Pemerintah Daerah*.

[106] Decentralization can be defined as "a shift of authority towards local governments and away from central governments". Jonathan Rodden, "Comparative Federalism and Decentralization: On meaning and Measurement" (2004) 36 Comp Pol 481 at 482.

[107] Hans W Vriens & Dharmawan Ronodipuro, "Indonesia's messy decentralization" (2001) Asian Wall Street Journal; Wayne Arnold, "Indonesia Takes a Tortuous Path to Oil" ,The New York Times (19 February 2004) online: The New York Times <http://www.nytimes.com/2004/02/19/business/indonesia-takes-a-tortuous-path-to-oil.html>; Bambang Brodjonegoro, "Three Years of Fiscal Decentralization in Indonesia: Its Impact on Regional Economic Development and Fiscal Sustainability" (A paper presented at

government, or a harmonization strategy across the country, taxing powers can lead to unpredictable fiscal regimes.[108] Here, Canada, like Indonesia, has some decentralization difficulties. Canada, too, has taxing powers distributed amongst diverse levels of government and there is the distinct possibility of disharmonized regulations and policies. These are discussed in chapter Three.

2.5 The Indonesian Petroleum Industry

The petroleum industry is a major industry in Indonesia that contributes to the country's development. The first discovery of Indonesian oil reserves in a commercially viable quantity was in 1885, sixty years before independence. Since then petroleum, especially in the form of oil, has been an important factor in the Indonesian economy.[109] Oil and natural gas have continued to be important contributors to the Indonesian economy.[110]

The International Symposium on Decentralization in Asian Countries, Hitotshubashi University, Tokyo, Japan, February 2004) online: <http://www.econ.hitu.ac.jp/~kokyo/APPPsympo04/Indonesia%28Bambang%29.pdf> at 8; Ari Perdana & Deni Friawan, *Economic Crisis, Institutional Changes and the Effectiveness of Government: the Case of Indonesia* (Jakarta: Centre for Strategic and International Studies, 2007) at 18, online: <http://www.csis.or.id/CMS/workingpaperfile/76/wpe102.pdf>.

[108] Hans W Vriens & Dharmawan Ronodipuro, *ibid*; Wayne Arnold, *ibid*; Bambang Brodjonegoro, *ibid*; Ari Perdana & Deni Friawan, *ibid.*

[109] The increase of oil prices in 1973 brought windfall gains both to the petroleum industry and the Indonesian economy as a whole. The quadrupling price increase generated a 29 percent increase in government revenue from corporate taxation of foreign oil companies (20 percent in the fiscal year 1971-72, to 49 percent in 1974-75) and a 36 percent increase in total export revenue (46 percent in 1971, to 70 percent in 1974). See Syahril Sabirin, *The Impact of the 1973-1974 Oil Price Increase on the Traded and Non Traded Sectors in Indonesia* (PhD Dissertation, Vanderbilt University, Nashville, 1979) at 8; Bank Indonesia, *Indonesian Financal Statistics April 78* as stated in Syahril Sabirin, *ibid* at 102; International Monetary Fund, *International Financial Statistics July 1978 & March 1979* as stated in Syahril Sabirin, *ibid* at 103.

[110] The contribution of the oil and gas industry to total state revenue averaged 28 percent for the period 2004 to 2008, and it reached 30 percent in 2008. David Braithwaite, *et al*, *Fossil Fuels – At What Cost? Government Support for Upstream Oil and Gas Activities in Indonesia* (Geneva: The Global Subsidies Initiative of the International Institute for Sustainable Development, 2010).

Though the contribution of the petroleum industry to the Indonesian budget is quite significant, Indonesia has limited capital and resources to extract its own oil and natural gas. Indonesia is one of the developing countries that need foreign investment to realize their oil resource potential. In the early 1980s, when abundant oil reserves and fewer competitors meant that Indonesian oil was still considered profitable, inviting IOCs was relatively easy. However, over more than three decades of exploitation, the oil supply has been declining because of the decline in the reserves.[111] In late 2004, Indonesia became a net oil importer and soon after that, the country decided to suspend its membership from OPEC.[112]

Currently, the Indonesian government has started to concentrate on promoting upstream activities in more difficult and remote areas. To maintain foreign investors' interest, the Indonesian government provides tax incentives as compensation for the additional costs arising from starting projects in difficult areas.

[111] Indonesian oil reserves declined from 14 billion barrels in 1998 to around 12 billion barrels in 2008. Oil production declined from 557million barrels in 1995 to 357 million barrels in 2008. Braithwaite *et al*, *ibid*.

[112] OPEC, *Annual Report 2008* (Vienna: Organization of the Petroleum Exporting Countries, 2009), online: <http://www.opec.org/opec_web/static_files_project/media/downloads/publications/AR2008.pdf>; PriceWaterhouseCoopers, *Oil and Gas in Indonesia: Investment and Taxation Guide*, online: <http://www.pwc.com/id/en/publications/assets/OilAndGas-InvestmentAndTaxationGuide-2010.pdf>.

CHAPTER III

THE DEVELOPMENT OF THE CANADIAN OIL SANDS INDUSTRY

Chapter Three presents the development of the Canadian oil sands industry and discusses the particular tax incentives used to foster that development. . It considers the role of tax incentives provided by the Federal and the Provincial governments in the initial periods of oil sands development, breaking the discussion into three periods of time: the 1970s, 1980s and 1990s.

3.1 The Canadian Petroleum Industry

With an area of 9,984,670 square kilometres, or around 3,855,102 square miles, Canada is the second largest country in the world.[113] The country is rich in natural resources such as coal, diamonds, timber, uranium, oil, and gas.[114] The oil sands are one such resource. Compared to conventional oil, the development of the oil sands requires more sophisticated technology, expertise, and expense. The Canadian petroleum industry consists of three stages: upstream, midstream, and downstream.[115] The upstream activities generated over $100 billion of revenue in 2005.[116]

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[113] Natural Resources Canada, *Significant Canadian Facts*, online: Natural Resources Canada <http://atlas.nrcan.gc.ca>.

[114] Natural Resources Canada, *Coal*, online: Natural Resources Canada <http://www.nrcan.gc.ca>; Natural Resources Canada, *Canada's Clean Coal Technology Roadmap*, online: Natural Resources Canada <www.cleancoaltrm.gc.ca>; Natural Resources Canada, *Canada Forest Service*, online: Natural Resources Canada <http://cfs.nrcan.gc.ca>; Natural Resources Canada, *Geological Survey of Canada*, online: Natural Resources Canada <http://gsc.nrcan.gc.ca>; Industry Canada, *Industry Canada*, online: Industry Canada <http://www.ic.gc.ca>.

[115] Robert Bott, *Our Petroleum Challenge: Sustainability into the 21st Century* (Calgary: Canadian Centre for Energy Information, 2004) at 19.

While other oil-producing countries focus on conventional oil resources, Canada has become famous for its "oil sands" project. The oil sands, or tar sands as they are sometimes called, were initially considered a high risk investment. The growing demand for oil has changed the situation. As described by Bill Paul[117], an energy journalist, the new oil industry now consists of conventional oil[118], substitute liquid fuels[119], and efficiency[120]. The realization that alternative forms of energy could be a feasible substitute for conventional oil has had a positive impact on oil sands development. Recent technological advances have lessened the operational cost of separating oil from the oil sands.[121] Many reports and studies have been completed on how Canada has achieved great success[122] with its most recent energy resource.[123]

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[116] Peter Tertzakian & Kara Baynton,, *Canadian Upstream Oil and Gas Industry, Financial Performance Outlook 2006-2008, A study prepared for the Canadian Association of Petroleum Producers* (Calgary, Alberta: ARC Financial Corporation, 2006) at 6.

[117] Bill Paul, *Future Energy* (New Jersey: John Wiley & Sons, Inc, 2007) at 6 & 81.

[118] Oil sands differ from conventional oil. Conventional oil is crude oil that was produced by a well drilled into a geologic formation in which the reservoir and fluid characteristics permit the oil to readily flow to the well bore.

[119] Substitute liquid fuels are broken down into two categories: biofuel and unconventional fossil fuels. Biofuel is fuel acquired from plants such as corn, potato or soybeans. Unconventional fossil fuel includes oil sands, coal, natural gas and oil shale.

[120] Efficiency refers to the use of electricity as a "nonliquid alternative fuel".

[121] Department of Finance Canada, Oil Sands Tax Expenditures by Ken Ketchum, Robert Lavigne, & Reg Plummer (Ottawa: Department of Finance Working Paper, 2001), online: <http://dsp-psd.pwgsc.gc.ca/Collection/F21-8-2001-17E.pdf>.

[122] The Canadian oil sands have acquired billion of dollars in investment. For instance, ExxonMobil's Canadian unit is investing $10 billion US in the Kearl oilsands project; and China has invested $13 billion in the past 2 years. "Oil forecast favours Canada" *Edmonton Journal* (17 June 2011) at D2; Robert Sullivan, "China Eyes Alberta Oil Sands Investment", *Oil Investing News* (30 May 2011) online: Oil Investing News <http://oilinvestingnews.com/3812-china-eyes-alberta-oil-sands-investment.html>; Jeremy van Loon & Jim Polson, "Alberta to Win Chinese Oil-Sands Investment, Minister Says" *Bloomberg* (17

The largest Canadian oil sands reserves are located in the province of Alberta, with present proven reserves of 170.4 billion barrels.[124] In 2006, the Alberta oil sands reserves contained over 175 billion barrels of oil, placing Canada as second-largest in global reserves, after Saudi Arabia.[125] As of January 2008 proven reserves were estimated to exceede 170 billion barrels, and Canada, again, ranked second after Saudi Arabia.[126] It is easier now for Canada to invite IOCs for exploration of the oil sands due to its proven track record. However, it was very different initially, when the oil sands project first began. The Canadian government offered a variety of tax incentives to attract IOCs. In analyzing the importance of tax incentives in promoting the oil sands, this thesis focuses on three periods of time: the 1970s, 1980s, and 1990s. The reason for concentrating on such periods is because they were the time of early development of the oil sands and therefore should help identify (or isolate) which significant factors helped promote the industry.

May 2011) online: Bloomberg <http://www.bloomberg.com/news/2011-05-17/alberta-to-win-chinese-oil-sands-investment-minister-says-1-.html>.

[123] Paul Chastko, *Developing Alberta's Oil Sands: from Karl Clark to Kyoto* (Calgary: University of Calgary Press, 2004); Ministry of Alberta Employment, Immigration & Industry, *Alberta's Heavy Oil and Oil Sands*, online: Alberta Abundant Energy <http://www.abheavyoilguidebook.com>; Ibrahim Dincer & Sadik Dost, "On the energy resources of Canada", (1996) 20 International Journal of Energy Research 595; Paul Precht & Carmen Rokosh, "Alberta's Oil Sands: The New Paradigm", online: (1998) Alberta Energy <http://www.energy.gov.ab.ca>.

[124] Saskatchewan has oil sands reserves but the province remains focused on the production of conventional oil and the oil sands reserves have not yet been developed. The Global Subsidies Initiative (GSI) of the International Institute for Sustainable Development (IISD), *Tax and Royalty Related Subsidies to Oil Extraction from High-Cost Fields: A Study of Brazil, Canada, Mexico, United Kingdom and the Unites States* (2010) Research performed for Greenpeace International at 51, online: <http://www.globalsubsidies.org/files/assets/ffs_taxes_royalties.pdf>.

[125] Canadian Association of Petroleum Producer, "Alberta's Oil and Natural Gas Industry Contributing to a Strong Provincial Economy", online: Canadian Association of Petroleum Producer <http://www.capp.ca>.

[126] International Energy Agency, *World Energy Outlook 2008* (Paris: International Energy Agency, 2008) at 215.

3.2 The Canadian Oil Sands

The Canadian oil sands are located in three major deposits, Athabasca, Cold Lake and Peace River. [127] The first European to discover the Athabasca oil sands was Peter Pond, in 1778. The first engineer to begin to use the oil sands commercially was Sidney Ells, in 1915. He extracted samples from Athabasca and sent them to Edmonton for laboratory testing. The testing proved that bitumen, a substance contained in oil sands, could be used for road pavement. In 1915 Sidney Ells worked with Dr. Karl Clark, experimenting with a hot water flotation process which separated the bitumen from the sand. Dr. Clark then joined the Alberta Research Council (ARC), and in 1948 the hot-water extraction process for separating oil from bitumen was implemented on a large scale.

Oil sands are different than conventional oil. In general, crude oil is classified as light, medium, heavy, or extra heavy. [128] Conventional crude oil flows naturally or can be pumped from the ground without being heated or diluted. Oil sands, on the other hand, are a mixture of sand, clay, water and bitumen. Bitumen, the substance that ultimately gets used as fuel, does not flow naturally and cannot be pumped from the ground without being heated or diluted. This makes the upstream operations for oil sands more costly and time consuming than those employed for the extraction of conventional oil.

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[127] Syncrude, "Oil sands History" Unlocking the Potential of the Oil Sands, online: Syncrude <http://www.syncrude.ca>; Suncor Energy, Suncor's History 1917-1930, online: Suncor <http://www.suncor.com>; Canada's Petroleum Heritage, *Alberta Research Council (ARC)*, online: < http://www.albertasource.ca>.

[128] The classification refers to the gravity as measured on the American Petroleum Institute (API) Scale. Light crude oil is oil with the API gravity higher than 31.1°, medium oil is between 31.1° and 22.3°, heavy oil is 22.3° and 10°, and extra heavy oil (bitumen) is oil with gravity of less than 10°. See Canadian Centre for Energy Information, *What Are Oil Sands and Heavy Oil*, online: Centre of Energy Information < http://www.centreforenergy.com/AboutEnergy/ONG/OilsandsHeavyOil/Overview.asp>.

Oil sands can be extracted by two techniques; the surface mining technique and *in situ* recovery.[129] The surface mining technique can only be applied to bitumen deposits that lie less than 75 metres from the surface.[130] In the mining technique, the material lying over the oil sands is first removed and then the oil sands are removed by open-pit mining techniques. After that, the oil sands are sent to an extraction plant to separate the bitumen from the sand and other non-hydrocarbon materials. The bitumen is then delivered to an upgrader that lightens the bitumen into a synthetic light crude oil.[131]

In situ recovery is required for bitumen deposits which are more than 75 metres below the surface.[132] The oil sands must be recovered in place, or what is commonly called *in situ* recovery. The *in situ* extraction involves generating and applying sufficient heat to the oil sands to reduce the viscosity of the bitumen, allowing it to flow and be recovered.[133] The upgraded oil is known as synthetic oil. As opposed to conventional oil, the process of changing oil sands into synthetic oil is more expensive.

With abundant oil sands reserves, the Canadian government tried to convince IOCs to commence oil sands projects. However, the very expensive oil sands extraction process

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[129] Government of Alberta, *What is Oil Sands*, online: Alberta Government <www.energy.gov.ab.ca>; Department of Finance Canada, *supra* note 121.

[130] Department of Finance Canada, *ibid.* at 3.

[131] The Pembina Institute, *Alberta's Oilsands*, online: <www.pembina.org>; Department of Finance Canada, *ibid*.

[132] Department of Finance Canada, *ibid*; The Global Subsidies Initiative (GSI) of the International Institute for Sustainable Development (IISD), *supra* note 124.

[133] The Pembina Institute, *ibid*; Department of Finance Canada, *ibid*.

inhibited this endeavour. In developing the oil sands industry, the Canadian government was facing a similar problem as the Indonesian government in developing its petroleum industry.[134] Even with scientific advances and the ability to process bitumen into crude oil, oil sands development was commercially challenged by high production costs and low productivity. To attract investment, federal and provincial governments granted tax incentives specific to oil sands development to help the IOCs reduce upstream activity costs.

3.3 Tax Framework

3.3.1 Federal and Provincial Taxing Powers

Individuals and companies in Canada are obliged to pay federal income tax on their business income, as governed by the *Income Tax Act* (ITA).[135] This act, which effectively governs all income taxation in Canada, consists of two general categories of tax provisions.[136] First, there are general tax provisions that apply to all sectors of the economy. Second, there are special provisions that apply only to specific sectors of the economy. Tax provisions for the energy sector are complicated because they are governed not only by the ITA but by provincial instruments as well.

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[134] Investing in the Canadian oil sands is expensive because it requires a more complicated process to produce. Investing in Indonesia is expensive because of the degree of uncertainty and the fiscal regime. These two countries have abundant oil reserves; however, the extraction and production processes require more capital than does merely investing in the Middle East.

[135] *Income Tax Act*, RSC 1985, c 1 (5th Supp).

[136] S Minto *et al*., "Government Support for Energy Investments" *2000 Report of the Commissioner of the Environment and Sustainable Development* (30 May 2000), online: Office of the Auditor General of Canada <http://www.oag-bvg.gc.ca>.

Under section 91(3) of the *Constitution Act* the federal government has power to make laws with the purpose of raising money by any mode or system of taxation.[137] The federal government can impose both direct and indirect taxes. The provincial government, on the other hand, has power to levy tax only for direct taxation. The definition of direct and indirect taxation is:[138]

> A direct tax is one which is demanded from the very person who is intended or desired, should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another.

Typically, direct taxes are taxes to be paid by the people who are taxed, and indirect taxes are taxes to be paid by someone else.[139] Income taxes, sales taxes, property taxes, and customs are classified as direct taxes. These direct taxes overlap between the federal and provincial government. In 1941, the federal and provincial governments signed the tax rental agreements.[140] The agreements gave the authority to levy tax on personal income taxes, corporate income taxes, and inheritance taxes to the federal government. In return, the provinces received compensation for the lost revenue from those taxes.[141] In 1962,

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[137] *Constitution Act*, 1867 (UK), 30 &31 Vict C 3, reprinted in RSC 1985, App II, No 5.

[138] John Stuart Mill's definition of direct and indirect taxation is often used in the court. *Bank of Toronto v Lambe* (1887) 12 AC 575; *Quebec (Attorney General) v Reed* (1884) 10 AC 141; *Severn v R* [1879] 2 SCR 70; *Barthe* v *Alleyn* (1920) 60 SCR 1; *New Brunswick (Workmen's Compensation Board) v Bathurst Lumber Co.* [1923] 4 DLR 84 (CA); *Halifax (City) v Fairbanks Estate* [1927] 4 DLR 945; *Atlantic Smoke Shops Ltd. v Conlon* [1943] 4 DLR 81 (Can PC). See John Stuart Mill, *Principles of Political Economy: and, Chapters on Socialism* (Oxford: Oxford University Press, 1994) at 190; Peter W Hogg, *Constitutional Law of Canada 2006*, student ed (Scarborough: Thomson Carswell, 2006) at 683.

[139] Peter W Hogg, *ibid*.

[140] Peter W Hogg, *Constitutional Law of Canada 2009*, student ed (Toronto: Thomson Reuters Canada Limited, 2009) at 162.

[141] *Ibid*.

the tax rental agreements were replaced by the tax collection agreements.[142] These agreements allow the provinces to impose their own income taxes at their own rates.[143] To share their taxing powers with the provinces the federal government also agreed to allow reductions of corporate and personal income taxes for taxpayers in all provinces. The provisions of corporate income tax are under the authority of both federal and provincial governments.

Similar to Canada, Indonesia also has two levels of government, and both have the authority to tax investors. This means that foreign investors who want to put their money in Indonesia have to deal with both central and provincial tax provisions. Often, tax provisions between these two levels of government overlap. This situation has discouraged foreign investors. Similar situations occurred in Canada when foreign investors were discouraged by the overlapping tax provisions between federal and provincial government.

3.3.2 Royal Commission on Taxation

While Canada's tax system remained relatively static for many years, in 1962 Royal Commission on Taxation was appointed to examine the federal tax laws of Canada and to make recommendations for improvement.[144] Its report, delivered in 1966, resulted in

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[142] *Ibid* at 163.

[143] *Ibid*.

[144] Neil Brooks ed., *The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later*, (Toronto: Carswell, 1988) at 3.

significant changes to the taxation system, including changes that touched on the Petroleum industry.[145]

The report recommended many changes to personal and corporate income taxes.[146] The Royal Commission's approach to the petroleum industry was consistent with its approach to overall tax reform.[147] Regarding income taxation, the Commission proposed an equal treatment for all businesses.[148] The Commission (known at the Carter report) argued that the possibilities of risks were as great in extractive industries as in any other industries and therefore, "any tax-based disincentives to risk-taking should be addressed in a way that is equally applicable to all industries and types of organization".[149] In 1969, in response to the Carter Report, the government proposed a White Paper on Tax Reform. The white paper was a moderate version of the Commission's report and was accepted by the Commons Finance Committee and tax reform finally appeared when Bill C-259 was introduced in June 1971.[150] Some of Carter Commission's became effective in 1972. Many touched on natural resource and the mining sector although the recommendations dealt with all aspects of taxation.[151]

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[145] The Commission was also known as the Carter Commission which was named after its chairman, Kenneth LeM. Carter.

[146] Department of Finance Canada, *supra* note 121 at 4.

[147] John F Helliwell, *et.al*, "Oil and Gas Taxation" (1988) 26 Osgoode Hall LJ 453 at 455.

[148] *Ibid*.

[149] *Ibid* at 456.

[150] Hon E. J Benson, Minister of Finance, *Budget Speech* (Ottawa: Department of Finance, 18 June 1971) as cited in John F Helliwell *et al*, *ibid* at 459.

[151] See John F Helliwell *et al*, *ibid*. The main elements of the tax reform were:
(1) to permit full expensing of all exploration and development expenditures;

3.4 The Equation

Foreign investment levels, in general, depend on legal certainty, political stability, and economic opportunity. [152] It is difficult to isolate any one factor. In the petroleum industry, the attractiveness of an oil-producing country depends on legal certainty (which includes the level of law enforcement, and corruption), country risk (which includes natural risk, country-specific economic risk, and socio-political risk), and economic opportunity (which consists of oil price and operational costs).

Tax incentives occur as part of economic opportunity. Economic opportunity in the oil industry is influenced by two variables: oil price and operational cost. The world oil price is very volatile whereas operational cost is a more predictable and controllable variable. In the case of the oil sands, where the estimated operational costs, especially in early development, are very high compared to conventional oil, the Canadian government offered tax incentives to compensate for those extra costs. By balancing the operational costs, the oil-producing country remains competitive, provided that other influential factors (i.e., legal certainty and country risk) are favourable.

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(2) to extend the percentage depletion until the end of 1976;
(3) to allow all expenditures from 1969 to 1976 to accumulate for the use of post-1976 earned depletion.

[152] OECD, Working Group on Trade and Investment, *Technical Assistance and Capacity Building Related to Foreign Direct Investment*, Doc. No. WT/WGTI/W/102 (2001); BT Partnership Law Firm, s*upra* note 9; Pancras J Nagy, s*upra* note 9.

3.5 Tax Incentives to Promote Oils Sands Projects

Tax incentives provided by both the federal and provincial governments in Canada in respect to oil sands development were used to promote oil sands projects. It is worth noting that there have been many changes in the Canadian tax regime so that often "specialists lose track of what provisions were in place during which years."[153] There have been rapid changes in energy taxation and regulation since the beginning of the 1970s, especially in 1973 when OPEC placed an embargo on crude oil going to Western countries. This research focuses on the main tax incentives only. This section provides a broad description of tax incentives involved in the initial development of the Canadian oil sands project. The discussion then continues to Chapter Four where the changes in the tax regime will be compared against the prevailing situations in the periods of the 1970s, 1980s, and 1990s.

This research focuses on these three periods of time because low commercial productivity and a lack of technological expertise made oils sands development more difficult and costly. In the new millennium, the oil sands began to be considered one of the most promising industries in Canada and the country became the largest supplier of crude oil to the United States, providing 1.4 million barrels of crude oil to the US per day in 2010.[154] Recent huge investment has been coming from China. After investing $13 billion in the

[153] John F Helliwell, *et al*, *supra* note 147.

[154] Canada provided 19 per cent of the US's total crude imports in 2008. See National Round Table on the Environment and the Economy and the Public Policy Forum, *Oil Sands: From Debate to Dialogue* (Ottawa: National Roundtable on the Environment and the Economy, 2010), online: <http://www.ppforum.ca/sites/default/files/Oil-Sands-From-Debate-to-Dialogue-eng_0.pdf> at 11.

past 2 years, China has planned to add investment in oil sands.[155] The need to secure a national energy source and rapid technological advances has influenced China's NOCs to expand their business to the Canadian oil sands.[156]

3.5.1 Period of the 1970s

3.5.1.1 Federal Government

3.5.1.1.1 Capital Cost Allowance

Shifting with capital cost allowance formulations is one way in Canadian authorities sough to encourage investment. Capital Cost Allowance (CCA) is an optional deduction related to tangible capital assets.[157] The concept behind a CCA is that a company is allowed to deduct its income by claiming depreciation of its tangible capital assets. These tangible assets are grouped into different classes. These classes determine the rate at which an asset may be depreciated or written-off over time. Pursuant to the *Income Tax Regulation*[158] (ITR), the oil sands processing plant fell under Class 10[159] and Class 28. Class 10 assets include capital assets for *in situ* oil sands projects. As for oil sands

[155] A trade mission to China led by Calgary Economic Development (CED) occurred on May 2011 between the mayor's office, industry representatives from the energy and financial services sector, and their counterparts in Beijing and Shanghai. While discussion on establishing tourism links have also been on the agenda, the focus of the talks has undoubtedly centered on Chinese investment in the Alberta oil sands. Robert Sullivan, *supra* note 123; Jeremy van Loon & Jim Polson, *supra* note 123.

[156] Alberta's energy minister Ronald Liepert said, "The advancement of technology has been so incredible that it's hard to predict even five years out". Jeremy van Loon & Jim Polson, *ibid*.

[157] E Nicolaas Holland, G Richard Schulli & Ronald M Kemp, *Canadian Taxation of Oil and Gas Income: an AnalyticalEevaluation* (Don Mills: CCH Canadian Limited, 1979) at 24.

[158] *Income Tax Regulation*, CRC, c945, s 1104(5)(b).

[159] Class 10 includes assets such as drilling rigs, oil well equipment, oil gathering lines leading to a transmission pipeline automotive equipment, mining buildings, and spur lines that are not included in Class 28, electronic data processing equipment, designated underground storage and property designated for the purposes of determining the existence, quality or location of oil or minerals that are acquired after 22 May 1979.

projects that use surface mining techniques, capital assets are categorized as Class 28. Class 10 is eligible to write off up to 30% declining balance.[160] The maximum write-off allowed for Class 28 is the middle value of the income from the mine before the write-off, the undepreciated capital cost of assets, and 30% of the undepreciated capital cost of the assets.

3.5.1.1.2 Resource Allowance

As a response to the increased price of oil in the beginning of 1970s, the Alberta government increased taxes and royalties on oil and natural gas.[161] Prior to 1974, in calculating federal taxable income, royalties with respect to production of natural resources had been deductible as a business expense.[162] The increase in provincial royalties was high enough that it significantly reduced the income for federal tax purposes.[163] To avoid losing revenue the Federal Government announced that provincial royalties were no longer treated as expenses under the federal income tax system.[164] This tax incentive was then replaced by a resource allowance.[165] The resource allowance was

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[160] Declining balance is an accelerated amortization method that computes annual amortization by multiplying the asset's decreasing book value by a constant percentage, which is two times the straight line rate. Walter T Harrison, Jr *et al*, *Financial accounting* (Toronto : Pearson Prentice Hall, 2004) at 326.

[161] John F Helliwell, *et al*, *supra* note 147.

[162] Department of Finance Canada, *Tax Expenditures 2000: Notes to the Estimates/Projections*, online: Department of Finance Canada < http://www.fin.gc.ca/taxexp-depfisc/2000/taxexpnot00_3-eng.asp>.

[163] JHG Roche, "Recent Developments in the Income Taxation of Oil and Gas Profits" (1979) Alta L Rev 14 at 17.

[164] Hon J N Turner, Minister of Finance, *Budget Speech* (Ottawa: Department of Finance, 18 November 1974) as cited in John F Helliwell, *et al*, *supra* note 147.

[165] SC 1974-75-76, c 71.

perceived as "a better way of recognizing that provinces impose mining taxes and/or royalties and to take that fact into account, within reasonable limits, in determining taxable income".[166] The resource allowance system allowed the Federal government to recognize the provincial taxing powers without the need to forgo its own revenue. As for the petroleum industries, the resource allowance provided relief to "the extractive industries for the various exactions of the provincial governments".[167] In 1976, oil sands producers could claim a resource allowance deduction equal to 25 percent[168] of their annual resource profits.[169]

3.5.1.1.3 Exploration & Development Expenses

The concept of exploration and development expenses is peculiar to the extractive industries.[170] The nature of exploration activities is uncertain since often the exploration operation has to stop because results indicate that there are not enough commercial oil reserves to produce. The concept of exploration and development expenses recognizes that exploration creates benefits for other businesses beyond the firm that incurred the original expenditure.[171] The incentive aims to assist the taxpayer in claiming deductions

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[166] Federal Budget Speech, *June 23, 1975* as cited in Department of Finance Canada, *supra* note 162.

[167] E Nicolaas Holland, G Richard Schulli & Ronald M Kemp, *supra* note 157 at 43.

[168] *Income Tax Regulations, amendment*, SOR/DORS76-188, s 5.

[169] A resource allowance is computed after operating costs and capital cost allowances, but before the deduction of exploration expenses, development expenses, earned depletion and interest expenses. See JHG Roche, *supra* note 162 at 16; Department of Finance Canada, s*upra* note 161.

[170] John V Krukowski, *Canadian Taxation of Oil and Gas Income* (Toronto: CCH Canadian Limited, 1987) at 71.

[171] EnviroEconomics Inc, Dave Sawyer & Seton Stiebert, *Fossil Fuels – at What Cost? Government Support for Upstream Oil Activities in Three Canadian Provinces: Alberta, Saskatchewan,and*

for the amortization of expenses incurred in exploring and developing minerals and petroleum in Canada. Similar to capital assets that become obsolete, natural resources are also depleted and need to be amortized for accounting purposes.

In 1974, the federal government divided exploration and development expenses into two groups: Canadian exploration expenses (CEE) and Canadian development expenses (CDE).[172] Essentially, the difference between CEE and CDE is the timeline between exploration and commercial production. CEE relates to the expenses incurred before reaching the production stage for commercial quantities, whereas CDE involves expenses incurred after the production stage. CEE allows deductions of up to 30% of cumulative CEE at the end of the year.[173] CDE also allows deduction of up to 30% of cumulative CDE.[174] CEE and CDE serve as incentives to oil companies because these costs are capital in nature (i.e. they have a benefit to the company extending over several years as the oil is produced) and they are not directly deductible. The ITA then provided a rule which allows a specific amount to be deducted each year.

Newfoundland and Labrador, (Geneva: The Global Subsidies Initiative of the International Institute for Sustainable Development, 2010) at 117.

[172] Commissioner of the Environment and Sustainable Development, *2000 May Report of the Commissioner of the Environment and Sustainable Development*, online: Office of the Auditor General of Canada < http://www.oag-bvg.gc.ca>.

[173] *Income Tax Act*, RSC 1970, c. I-5 as amended by SC 1970-71-72, c.1, 11, 30,48,63,64; SC 1972, c.9; SC 1973-74, c. 14, 29,30,44,45,49,51; 1974-75, c.26, 50,58,71, subsection 66.1 (3).

[174] *Income Tax Act*, *ibid* subsection 66.2 (1).

3.5.1.1.4 Earned Depletion Allowance

In 1974, the federal government replaced the "percentage" depletion allowance with the earned depletion allowance.[175] Class 10 and Class 28 assets—in respect of CCA assets—are also eligible for an additional resource income deduction called earned depletion.[176] The earned depletion allowance applies to most types of capital expenditures incurred for mining and oil and gas production.[177] The Canadian federal government allowed taxpayers to write off one-third of the cost of Class 10 and Class 28 assets. Effectively, for investors in upstream oil sands development, this increased the amount of expenses they could claim and thereby reduce their taxable income. By claiming earned depletion those qualified expenditures could be written off 4/3 times. First it would be written off as CCA, and then another one-third as earned depletion.[178] The qualified expenses exceed the actual costs. This significantly reduced the resulting tax payable by the company.

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[175] Commissioner of the Environment and Sustainable Development, *supra* note 178.

[176] Department of Finance Canada, *supra* note 162.

[177] Department of Finance Canada, *supra* note 122 at 4.

[178] John V Krukowski, *supra* note 170 at 279.

3.5.1.1.5 Deductibility of Provincial Royalties (Joint Venture Payments) for the Syncrude Consortium Project

The Syncrude consortium was a joint venture of four US controlled oil companies (Imperial and Gulf were Canadian subsidiaries of Exxon Corporation of New York and Gulf Oil Corporation of Pittsburgh respectively; and Atlantic Richfield and Canada-Cities Service were Canadian subsidiaries of two smaller US companies).[179] Syncrude was perceived as a major foreign investment because in 1973, these four US parent companies had combined assets of more than $ 40 billion.[180] After months of "long, hard and tough" negotiations between the Alberta government and the Syncrude consortium; Premier Peter Lougheed announced that the Syncrude Consortium project would go ahead.[181] The Syncrude Consortium project was started in the early 1970s, when all provincial Crown royalty charges were fully deductible in the computation of income taxes. Further discussion of the Syncrude Consortium Project is presented in Chapter Four.

The high initial capital required for commencing oil sands projects required the oil sands producer to seek government assistance. In order to promote the development of the oil sands, the federal government helped the oil sands producer (Syncrude Consortium Project) by treating the joint venture payments to the province as royalties. This treatment meant that in calculating taxable income, taxpaying participants in the

[179] Larry Pratt, *The Tar Sands: Syncrude and the Politics of Oil* (Edmonton: Hurtig Publishers, 1976).

[180] *Ibid* at 119.

[181] *Ibid* at 19.

Syncrude Consortium project were permitted to deduct both a resource allowance and "joint venture payments" made to the province of Alberta.[182]

3.5.1.2 Provincial Government

The Syncrude Consortium project was the second commercial oil sands project initiated in Canada; the first project, the Great Canadian Oil Sands project (GCOS), was initiated by another US oil company, Sun Oil). As the first commercial oil sands project, the GCOS project suffered several unsuccessful attempts at production. Between 1963 and 1970 Sun Oil of Philadelphia had invested more than $ 250 million in the GCOS project and the company was still losing money due to poor productivity.[183] The foreign investors negotiated with the provincial government to help them reduce the loss they suffered. On 26 May 1970, Alberta's provincial government reduced the crown royalty by fifty percent (from 16 percent to 8 percent) for the next three years to encourage the oil sands project.[184] A reduction in crown royalties was treated as compensation for the potential loss in continuing the project.

[182] In May 1976, the Government granted a remission order to taxpaying participants in Syncrude Project by Order in Council. The remission order permitted participants to deduct joint venture payments to the province of Alberta. See Department of Finance Canada, *supra* note 161.

[183] Further discussion on the GCOS project is presented in Chapter Four. See Paul Chastko, *supra* note 123; Doug Richardson & Tim Quigley, "The Resource Industry, Foreign Ownership, and Constitutional Methods of Control" (1974-1975) 39 Sask L Rev 92 at 103.

[184] Paul Chastko, *ibid* at 137.

3.5.2 Period of the 1980s

Though Helliwell[185] stated that there were many changes in the Canadian tax regime with respect to the petroleum industry, most of the changes were related to the change in taxation rate or the removal of certain deductions, such as the CCA rate for depreciable assets being reduced to 25% from 30%[186] or the earned depletion allowance being phased out in 1987.[187] One dramatic change in the 1980s was the introduction of the National Energy Program (NEP), an energy policy aimed at promoting oil self-sufficiency for Canada.

In analyzing tax incentives in the 1980s this thesis does not divide the two levels of governments as in the previous section. The reason for this is because during this period of time the enactment of the National Energy Program had changed the Canadian tax regime for the energy industry, therefore making it irrelevant to distinguish the tax incentives provided by federal and provincial governments. During this period there was a different perspective regarding energy policies between the federal government and western provincial governments, particularly Alberta. The energy dispute had adverse effects on the petroleum industry, including the oil sands industry.

During the mid 1970s the Canadian government, especially the federal and eastern provincial governments, started to fear for the continuity of their oil supply. This was due

[185] John F Helliwell, *supra* note 147 at 455.

[186] Department of Finance Canada, *supra* note 121 at 5.

[187] *Ibid.*

to the increasing price of oil imported for Eastern provinces and the National Energy Board (NEB) report claiming that western provinces' oil reserves had been declining.[188] At the same time there was also a change in Canada's political environment which shifted to a more nationalistic way of viewing of the country. This nationalist viewpoint, particularly in the federal government, "produce[d] a growing desire to reduce the level of economic dependence on the United States and to preserve Canada's resources for Canadians".[189] The federal government then designed the NEP to secure and increase Canadian ownership of oil reserves.

Following the introduction of NEP, the federal government imposed the petroleum and gas revenue tax (PGRT) to fund the new Petroleum Incentives Program (PIP).[190] The PIP was designed to increase Canadian ownership in the energy industry. A system of cash payments under the new PIP replaced earned depletion as an incentive to explore for oil and gas. The NEP generated negative responses from both provincial governments (western provinces) and oil sands producers. Alberta responded by announcing a series of phased cutbacks of allowed conventional oil production and halted the approval process for new oil sands plants.[191] The provincial government threatened that those measures would remain in effect until "the sharp differences in energy policy were

[188] The NEB report was published by the Federal Government in November 1974. See The National energy Board, *In the Matter of the Exportation of Oil, Report to the Honourable Minister of Energy, Mines and Resources* (Ottawa: Information Canada, October, 1974) as cited in Judith Maxwell, *Developing New Energy Sources: The Syncrude Case* (Montreal: C. D. Howe Research Institute, 1975).

[189] JC Hurewitz, *Oil, the Arab-Israel Dispute, and the Industrial World: Horizons of Crisis* (Boulder, Colorado: Westview Press, Inc, 1976) at 23.

[190] Commissioner of the Environment and Sustainable Development, *supra* note 178.

[191] John F Helliwell, *et al*, *supra* note 147 at 468.

resolved in a manner acceptable to Alberta".[192] To resolve the energy dispute a memorandum of agreement on oil and gas pricing and taxation was signed by the Prime Minister of Canada and the Premier of Alberta.[193] There were two main features of the agreement relevant to oil sands industry. First, the pattern of regulated world oil prices was to be linked more closely to world oil prices.[194] Second, specific to Alberta, the PIP was administered and paid for by the province for all eligible investment in that province.[195] The rate was dependent on the company's degree of Canadian ownership, and the federal government would continue to administer the rate schedule and the ownership and control rules, subject to agreement by Alberta.[196] Finally, after suffering much criticism[197], the federal government phased out PIP grants and the PGRT by signing the Western Accord in 1985.[198]

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[192] *Ibid.*

[193] Canada, *Memorandum of agreement between the Government of Canada and the Government of Alberta relating to energy pricing and taxation* (Ottawa: 1981) as cited in John F Helliwell, *et al*, *ibid* at 469.

[194] The pattern of regulated world oil prices was to be linked more closely to world oil prices with synthetic oil and new oil (crude oil produced from pools discovered after 1980) getting the world price, while a price schedule limited to 75 per cent of the cost of the world oil price would apply to old oil (oil produced from pools discovered before 1980). See John F Helliwell, *et al, ibid*.

[195] See John F Helliwell, *et al, ibid*; John F Helliwell & Robert N McRae, "Resolving the Energy Conflict: From the National Energy Program to the Energy Agreements" (1982) 8 Can Pub Pol'y 14 at 16.

[196] *Ibid.*

[197] Tammy Nemeth, "Pat Carney and the Dismantling of the National Energy Program" (1998) 7 Past Imperfect 87.

[198] Commissioner of the Environment and Sustainable Development, *supra* note 178.

3.5.3 Period of 1990s

3.5.3.1 Federal Government

Similar to the 1980s, most of the changes in tax incentives offered in the 1990s were related to tax rates or the removal of certain deductions. Tax provisions on resource allowance were clarified and tightened in 1996.[199] As for exploration and development expenses, there was also an increase in the deductible rate for CEE's. In the 1970s the deductible rate for CEE's was 30%, in the 1990s the deductible rate was 100 percent. These changes in the tax rate provisions, however, did not significantly affect the oil sands industry with respect to new foreign investment.

Accelerated Capital Cost Allowance (ACCA) is cited as "the most important federal tax break".[200] This tax incentive allowed groups of assets to be written off for tax purposes more rapidly than would be permitted under a neutral tax system.[201] It "allow[ed] the normal costs of capital to be deducted as fast as income from the project w[ould] allow rather than deferring the deductions over time".[202] Oil sands producers could recover their initial investments sooner, and "reduce the investment risk……thus improving the overall economics of the project". In the mid-1990s the federal government added to the

[199] The mechanism of new resource allowance is more vulnerable to misinterpretations by companies than before, and at the same time keeps intact the incentive provided by the resource allowance. Natural Resources Canada, *Mining-Specific Tax Provisions*, online: < http://www.nrcan.gc.ca>.

[200] John Dillon & Ian Thomson, *Pumped Up: How Canada Subsidizes Fossil Fuels at the Expense of Green Alternatives* (Ottawa: Kairos, Canadian Ecumenical Justice Initiatives, 2008) at 18.

[201] Amy Taylor, Matthew Bramley& Mark Winfield, *Government Spending on Canada's Oil and Gas Industry: Undermining Canada's Kyoto Commitment* (np: The Pembina Institute Report, 2005) , online: <http://pubs.pembina.org/reports/GovtSpendingOnOilAndGasFullReport.pdf > at 21.

[202] Edmonton Chamber of Commerce, "Applying the Accelerated Capital Cost Allowance for Oil Sands, Upgrading and Petrochemical Industries" (2010), online: <http://www.edmontonchamber.com/files/Policy_Applying_the_Accelerated_Capital_Cost_Allowance.pdf >.

ACCA by allowing tangible capital expenses for *in situ* oil sands projects to be written off in the same manner as expenses for projects that employed surface mining techniques. Prior to 1996, these expenses were written off using the tax rules for oil and gas. As a result of the change, the expenses incurred from *in situ* oil sands projects could be written off using the more generous tax rules for mining.[203]

3.5.3.2 Provincial Government

3.5.3.2.1 Reactivated Well Royalty Exemption and Low Productivity Well Royalty Exemption[204]

The objective of the reactivated well royalty exemption (RWRE) and low productivity well royalty exemption (LPWRE) was to encourage production of conventional oil and oil sands in existing wells. RWRE[205] took effect in January 1993 and is applicable to an oil well or an oil sands well that was reactivated on or after October 1, 1992, after the well did not produce during its qualifying period. This tax incentive was designed to address problems with the maturing conventional oil sector in the early 1990s, but it was also applicable to oil sands wells. It provides royalty holidays for a successful reactivation of matured wells. LPWRE[206] is another tax incentive provided by the government of Alberta to encourage additional production from low-productivity wells.

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[203] ACCA for mining allows taxpayers to fully deduct (subject to the half-year rule) the cost of depreciable assets incurred in a year on a mine in excess of 5% of gross revenue from the mine for the year, to the extent of the taxpayer's income from the mine. See Natural Resources Canada, *supra* note 205.

[204] EnviroEconomics Inc, Dave Sawyer & Seton Stiebert, *supra* note 172; Alberta Department of Energy, *Oil and Gas Fiscal Regimes: Western Canadian Provinces and Territories* (Edmonton: Alberta Department of Energy, 2006), online: <http://www.energy.alberta.ca/Tenure/pdfs/FISREG.pdf>.

[205] Alta Reg 352/1992.

[206] Alta Reg 350/1992.

It was designed to address the high marginal royalty rates on investment in oil well productivity enhancements, and it was also applicable to oil sands wells.[207] However, due to the timing of their introduction, it can be assumed that these generous tax incentives have had an insignificant effect on foreign investment in the oil sands industry. Commercial oil sands projects only began in the 1970s and therefore there were relatively few mature wells. These two incentives had a bigger impact on conventional oil projects.

3.5.3.2.2 Generic Oil Sands Royalty Regime

In the 1990s the dispute between the federal and provincial governments and the oil sands industries was coming to an end. The Alberta Chamber of Resources established the National Task Force on Oil Sands Strategies (Task Force hereinafter).[208] This Task Force provided a report consisting of several recommendations to encourage oil sands development. One of the recommendations was related to fiscal regime. The Task Force suggested that royalties should be established through legislation rather than individual Crown agreements.[209] The Task Force recommended that the royalty regime should be a generic one where the same rules applied in the same situations and the same clear, standardized royalty terms applied to all new oil sands projects.[210] The standard royalty

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[207] EnviroEconomics Inc, Dave Sawyer & Seton Stiebert, *supra* note 172 at 85.

[208] The Alberta Chamber of Resources was established in 1935. It was originally called the Alberta and North West Chamber of Mines and Resources and was established to provide a liaison between the hard-rock mining industry in the north and those firms that served it. In 1977 the name was changed to the Alberta Chamber of Resources (ACR) and the scope of the Chamber increased to include oil sands mining. Alberta Chamber of Resources, *74 Years in the Making - The History of ACR*, online: Alberta Chamber of Resources <http://www.acr-alberta.com/ABOUTTHEACR/History/tabid/104/Default.aspx>.

[209] This Task Force consisted of representatives from both federal and provincial governments, the oil sands producers and supporting industries. See Robert Mitchell, *et al,* "Alberta Oil Sands: Update on the Generic Royalty Regime" (1998) Alberta Department of Energy; Alberta Department of Energy, *supra* note 203.

[210] Alberta Department of Energy, *ibid.*

terms would create fiscal certainty and stability and encourage investment for oil sands projects. The Alberta government accepted the recommendation and enacted two pieces of legislation.[211]

The generic royalty regime benefited the oil sands producers because it provided a smaller royalty share for the government at the beginning of a development.[212] The generic royalty regime was designed with three main purposes:[213]

(1) to encourage the development of the oil sands while ensuring a fair return to Albertans;
(2) to create a stable fiscal and regulatory framework that facilitates oil sands development, because the government of Alberta does not provide other incentives such as grants, loans, or loan guarantees to encourage oil sands investment.
(3) to ensure that investment in the oil sands provides developers a rate of return that is competitive with other petroleum development opportunities around the globe; and

It is noteworthy that the objective of the provincial government's tax incentive was to create "a stable fiscal and regulatory framework" that could lead to a better investment climate for oil sands development. When the provincial government structured the generic oil sands royalty regime, it recognized that potential investors expect stable and predictable fiscal and legal conditions. This provincial government policy, with the

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[211] The *Mines and Minerals Act*, RSA 1980, c M-15 was amended by The *Mines and Minerals Act*, 1997, SA 1997, c 17 in May 1997 to insert the generic oil sands royalty formulas and core rates in legislation. Alta Reg 185/1997.

[212] The government receives a larger royalty share after the oil sands producers had recovered their costs. See EnviroEconomics Inc, Dave Sawyer & Seton Stiebert, *supra* note 172 at 41.

[213] Alberta Department of Energy, *supra* note 203at 19.

support of the federal government,[214] was in accordance with the hypothesis that legal certainty, political stability, and economic opportunity are significantly influential to foreign investment decisions. Even when the provincial government used the general royalty regime as a tax incentive to foster oil sands development, the government understood that the tax incentive's role was only to create better investment conditions instead of automatically attracting investors.

3.5.3.2.3 Provincial Accelerated Capital Cost Allowance

The provincial government's commitment to promoting oil sands development was shown again in 1999 when the Oil Sands Generic Royalty Regime established the provincial accelerated capital cost allowance **(**ACCA), which mirrored the Federal ACCA.[215] There is no report on the impact of the provincial ACCA on foreign investment. It could be because the provincial ACCA generates little effect on the development of Alberta oil sands. The first and second oil sands projects indicated there was a good relationship between the Alberta government and the foreign investors. For instance, when the federal government introduced the NEP in 1980s, the Alberta government reacted in favor of the foreign investors. The Alberta government's commitment to support oil sands development, which will be discussed in the next chapter, was more influential than the provincial ACCA in attracting the investors from the United States.

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[214] In designing the generic oil sands royalty, the Government of Alberta received National Task Forces on Oil Sands which consisted of representatives from the Federal Government.

[215] EnviroEconomics Inc, Dave Sawyer & Seton Stiebert, *supra* note 172 at 41; Government of Alberta-Energy, *Alberta's Royalty History*, online: <http://www.energy.alberta.ca>.

CHAPTER IV

THE SIGNIFICANCE OF TAX INCENTIVES

This section considers the significance of tax incentives in attracting foreign investors by comparing incentives and development of the industry over particular periods of time. As noted earlier, the study of tax incentives and development of industries is a project shrouded in uncertainty. The analysis looks at both international and domestic situations as they impact on the oil sands. The purpose of this chapter is to examine whether tax incentives offered by the Canadian government have had a significant impact on attracting foreign investment.

4.1 Oil Sands Development in 1970s

4.1.1 International Situation

At the beginning of the 1970s it was predicted that synthetic oil development would soon be an important part of the Canadian oil industry. The oil embargo of the countries that supported Israel in the Yom Kippur War and OPEC's control of oil pricing caused an increase in the price of oil worldwide.[216] OPEC announced that the Arab countries were reducing production and placing an embargo on crude oil going to Western countries, particularly the US and the Netherlands.[217] The embargo was put in place as part of the

[216] The Yom Kippur War was a war between Israel and Egypt and Syria during Yom Kippur (a Jewish holiday). It started on 16 October, 1973.

[217] Raymond Vernon ed, *The Oil Crisis* (New York: WW Norton & Company, 1976) at 60.

political strategy and caused the world oil price to triple. The cost of crude oil increased from $3.00 per barrel in 1972 to $10.50 in early 1974.[218]

Until late the 1960s, the United States was still confident about its oil supply. Given that operational costs for conventional oil were low and supplies abundant, the country considered that "it did not need to fear interruption or manipulation of supply or prices by OPEC for economic reasons".[219] It also believed that there was no need for protection against embargo because "it imported very little oil from Arab countries".[220] Such assumptions were later challenged. The oil demand continued to increase, the domestic oil supply had been declining, and, for the most part, foreign sources of supply on which the United States had relied failed meet expectations.[221] Under these conditions the exploration and extraction of unconventional crude oil began to be feasible to the United States and the IOCs.[222]

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[218] Paul Chastko, *supra* note 123 at 147.

[219] Raymond Vernon ed, *supra* note 217.

[220] *Ibid*.

[221] A revolution in Libya replaced the pro-western government with a "hostile and erratic nationalistic one". The Trans-Arabian pipeline was shut down which causing problem on transportation capacity and prices. Raymond Vernon ed, *ibid*.

[222] Ray Dafter, "World Oil Production and Security of Supplies" (1979) 4 International Security 154 at 176.

4.1.2 Domestic Situation

4.1.2.1 The Great Canadian Oil Sands Project

Within Canada, the development of the oil sands in the 1970s started with productivity challenges with the first oil sands plants. In 1963, Sun Oil Companies announced the investment of almost $250 million to build its oil sands facility.[223] The project was known as the Great Canadian Oil Sands[224] project (GCOS), the first commercial oil sands project. The first commercial oil sands production plant started in 1968 and it was designed to produce 45,000 barrels per day.[225] However, it produced only about 24,000 barrels because of technical difficulties.[226] The production shortfalls continued into the following year.[227] To avoid suffering more losses from the poor productivity, Sun Oil asked for assistance from the government of Alberta.[228] The series of negotiations between Sun Oil and the provincial government resulted in the reduction of the GCOS's crown royalty (from 16 percent to 8 percent) for the next three years.[229]

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[223] Brad Bellows, "Suncor Energy Reaches Billionth Barrel Oil Sands Milestone" *Newsroom* (5 January 2006), online: Suncor <http://www.suncor.com>.

[224] Great Canadian Oil Sands Ltd. is controlled by Sun Oil of Philadelphia. See Doug Richardson & Tim Quigley, *supra* note 183 at 103.

[225] Paul Chastko, *supra* note 123 at 135.

[226] *Ibid* at 135.

[227] GCOS estimated that production in its second year could reach 37,000 barrels per day. The actual production was only 27,000 barrels per day which was 10,000 less than the anticipated target. See Paul Chastko, *ibid* at 137.

[228] *Ibid.*

[229] *Ibid.*

This GCOS project indicated that the tax incentive (in the form of crown royalty reduction) was used as compensation for the additional cost that Sun Oil suffered. It seems that Sun Oil, as the foreign investor, did not fund the GCOS project because of the tax incentives offered by the Canadian government. The IOC had already invested its money in the project before the provincial government provided preferential treatment to the project. Still, the nature of the oil sands project, which required large sums of capital, forced Sun Oil to seek government assistance to reduce the initial cost. It can be assumed that tax incentives were important to the continuation of the project; however, they were not the main driving force for the initiation of the first commercial oil sands project.

4.1.2.2 The Syncrude Consortium Project

Following the GCOS project, the Syncrude Consortium[230] agreed to construct the second commercial oil sands plant. Based on the Great Canadian Oil Sands experience, Syncrude officials lobbied the Canadian government for tax incentives, which finally resulted in the federal government assuring the investors that the joint venture payments to the province would be treated as royalties. On 18 September 1973 Premier Peter Lougheed announced that the Syncrude Consortium Project would be commenced. The Syncrude Consortium project began when Canada's national energy security was being questioned.[231] The first official recognition of oil security problem in Canada was presented in a NEB report on oil supplies in November 1974.[232]

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[230] Syncrude was owned by four Canadian subsidiaries of United States firms. See Doug Richardson & Tim Quigley, "The Resource Industry, Foreign Ownership, and Constitutional Methods of Control" (1974-1975) 39 Sask L Rev 92 at 103.

[231] At the end of 1974 Canada found out that the country would have problems with oil supply. Conventional oil production in Western provinces had reached capacity, and the industry had not been able to find sufficient new reserves. Judith Maxwell, *supra* note 188 at 1.

Soon after the NEB report was released, the Syncrude Consortium project encountered "substantial and unanticipated difficulties".[233] The revised cost estimation indicated that the operational cost would be $ 2.3 billion; whereas the initial estimation was as low as $ 500 million.[234] The increased cost caused Atlantic Richfield (one of the US controlled oil companies) to withdraw from the project which endangered its continuation.[235] The remaining three oil companies wanted to avoid a shut down of the project. They had been committing money and management effort to the oil sands since 1950s.[236] Given that they had already committed $550 million, and stood to lose that money in the event that the project was shut down, the only option was to find a new partner.[237]

The problem with finding a new partner was the low rate of return that the project offered. A nine percent rate of return was "obviously not an attractive proposition" for other oil companies. Imperial, Gulf and City Services then lobbied the Canadian government to become their partner.[238] Beside the financial assistance to continue the project, the reason for asking the government to replace Atlantic Richfield was to reduce

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[232] The NEB report was published by the Federal Government. See The National energy Board, *In the Matter of the Exportation of Oil, Report to the Honourable Minister of Energy, Mines and Resources* (Ottawa: Information Canada, October, 1974) as cited in Judith Maxwell, *ibid*.

[233] *Ibid* at 3.

[234] *Ibid* at 5-6.

[235] Larry Pratt, *supra* note 179 at 162; Judith Maxwell, *ibid.*

[236] Judith Maxwell, *ibid* at 10.

[237] *Ibid*, at 11.

[238] *Ibid*, at 12.

political risk. One executive of the consortium said that "getting governments in means that we have taken the political risk out of this for the next five years".[239]

Syncrude's persistent lobbying revealed that tax incentives were crucial in securing their investment dollars. However, there was no indication that the Syncrude Consortium would have cancelled the oil sands project if the government did not grant any tax incentive.[240] It is clear that Syncrude intended to keep its investment in Canada, and simply lobbied for tax cuts in order to recoup some of the startup costs they had already expended. These two cases (GCOS and Syncrude) show that tax incentives appear as part of negotiations to offset the large capital required to start an oils sands project.[241]

4.1.2.3 The Canadian Government Commitment

The GCOS and Syncrude cases emphasize foreign investors' attempts at gaining government assistance in the oil sands project. This section illustrates the Canadian government's willingness to participate in oil sands development. The Syncrude project problem was resolved with an agreement between the three companies with three Canadian governments (the Alberta Government, the federal Government and the Ontario

[239] *Ibid,* at 11.

[240] Similar to the GCOS project, there was no indication that the IOCs would cancel the project if they did not acquire any special tax treatment. However, the IOCs might have expected to get tax incentives. There was no record or discussion on this matter.

[241] These two projects showed that the investors had invested a large sum of money. There might be some small chance that they would give up or stop the project because of the lack of special tax treatment. However, often the IOCs have calculated their cost estimate to start the project within the existing fiscal regime. It can therefore be assumed that if they decided to start the project, then they would have accepted such an amount to be their initial cost.

Government).[242] The three governments agreed to put up 30 percent of the equity and provide both financial and market supports.[243] The Alberta Government also committed another $ 455 million to finance the ancillary facilities, such as utility plants, housing, pipeline and highways and bridges.[244] Together the three governments agreed to three general concessions [245]

a. Production from the plant will be marketed at the prevailing international price.
b. Production from the plant will not be curtailed in the event that production in the oil industry generally is shut down (weak demand or excess supply).
c. Profits from the project will be taxed according to the royalty-income tax system that existed in 1973.[246]

The reason for the federal government to replace the Atlantic Richfield as a partner in the Syncrude project was to secure the oil supply. The withdrawal of Atlantic Richfield was two weeks after the federal government published the NEB report which suggested that at least five oil sands plants were needed by 1985.[247] In the event of an increase in oil prices, Canada, as any other oil-producing country, was facing two facts: the increased world oil price was an opportunity to increase revenue from the oil industry, but it was also a warning about energy security. Energy Minister Macdonald said, "If we had allowed this project to die, it would have taken a long time to re-open the research

[242] The agreement often called the Winnipeg agreement because the negotiation took place in Winnipeg. See Judith Maxwell, *ibid*; Larry Pratt, *supra* note 179.

[243] The federal government agreed to invest $300 million. The Alberta government committed $200 million and the Ontario $100 million. Judith Maxwell, *ibid* at 7;

[244] *Ibid*.

[245] *Ibid*, at 9.

[246] In 1976, the Government granted a remission order to taxpaying participants in Syncrude Project by Order in Council. All provincial royalty charges were fully deductible in the computation of income taxes.

[247] Judith Maxwell, *ibid*.

and development activity".[248] The federal government believed that the Syncrude Consortium project, as the second commercial plant, was crucial to the "national energy policy".[249] If a project like Syncrude, supported by three strong IOCs, could not be successfully launched then there was small possibility for other oil companies to invest in the industry - a clear threat to the future of Canada's energy supplies.

The Alberta government, as the producing province, was very committed to promoting the industry. The reason was clear; successful oil sands development would have a positive impact to the provincial economy. The Ontario government's reason for wanting the project to continue also related to the economy. If Canada's oil production was not expanded, "Ontario ha[d] the most to lose"[250] because Ontario's industrial base relied entirely on a pipeline system from Western Canada, and the loss of the orders for steel and manufactured goods that would be needed for the construction of the Syncrude plant would be a huge loss for the province.

[248] *Ibid*.

[249] Larry Pratt, *supra* note 179 at 173.

[250] Judith Maxwell, *supra* note 194.

4.2 Oil Sands Development in the 1980s

4.2.1 International Situation

Two major events caused global oil prices to increase again in the early 1980s: the Iranian revolution and the Iraq-Iran war. The Iranian revolution, begun in September 1978, was known as the catalyst for the second world oil price shock.[251] This event resulted in an oil loss of 2 to 2.5 million barrels per day between November 1978 and June 1979.[252]

Another major event in the early 1980s was the Iraq-Iran war. This eight-year war caused the decrease of oil supply which led to a rise of world oil prices.[253] If the Iranian revolution was seen as the second shock to world oil prices, the Iraq-Iran War was seen as "the single most important factor in reducing supplies".[254] Consequently, oil prices increased from $14 in 1978 to $35 per barrel in 1981.[255]

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[251] John Erik Fossum, *Oil, The State, and Federalism: The Rise and Demise of Petro-Canada as a Statist Impulse* (Toronto : University of Toronto Press, 1997) at 106.

[252] James L Williams, *Oil Price History and Analysis*, online: WTRG Economics <http://www.wtrg.com>.

[253] The dispute between these two countries was multifaceted, a product of political differences, religious schisms, geo-political influence, and border disputes. See John Erik Fossum, *supra* note 248 at 106;Iran Chamber Society, "Iran-Iraq War 1980-1988", online: History of Iran <http://www.iranchamber.com>.

[254] John Erik Fossum, *ibid*.

[255] James L Williams, *supra* note 256.

4.2.2 Domestic Situation

Within Canadian borders, the development of the oil sands in the 1980s was influenced by the introduction of the National Energy Program (NEP), completely unrelated to taxation.[256] The introduction of the NEP led to many policies that received negative reactions from foreign investors. The first policy was that oil companies could only charge a Canadian price for Canadian oil. The other important policy was in relation to "Canadianization" –the government program to increase Canadian ownership. This Canadianization policy combined with the increased rigidity of the Foreign Investment Review Act (FIRA) was perceived as a political threat to foreign investment. Foreign investors felt insecure and uncertain about investing in Canadian energy because of the combination of the NEP and FIRA. As a direct result of these initiatives many foreign investors began to close their Canadian operations. Two important oil sands projects that were to supply one-fifth of Canada's oil needs by the end of the decade withdrew.[257] In July 1981 the Cold Lake Tar Sands megaproject was cancelled by Imperial Oil.[258] In April 1982 Shell and Gulf decided to drop their Alsands project.[259] Similar reactions came from conventional oil producers and 227 drilling rigs stopped their activities in August 1982.[260]

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[256] The oil sands development was influenced by the political nature of the NEP. The NEP had impacted taxation in Canada. However, the foreign investors negatively reacted to the NEP because of the strong political implication of it.

[257] Barbara Jenkins, "Reexamining the Obsolescing Bargain: A Study of Canada's National Energy Program" (1986) 40 International Organization 139 at 163.

[258] *Ibid.*

[259] *Ibid.*

[260] *Ibid.*

4.2.2.1 A Made in Canada Price

"One of the centerpieces of the NEP" was the introduction of "made-in-Canada" prices for Canadian crude oil.[261] In the late 1970s the oil sands industry became more attractive due to the increase in world petroleum prices. Oil sands producers lobbied the federal government to allow them to charge the world price for their oil. For a short period, during Joe Clark's time as Prime Minister, the federal government allowed the price of synthetic crude to rise to the world price. However, the policy was reversed in the period of the Trudeau government. The latter government's policy restricted prices to a made-in-Canada price instead of allowing prices to rise to the world price [262] This meant that even with the increased world oil price, the oil sands producers received less for their synthetic fuel.

4.2.2.2 National Energy Program

During the oil sands development, the federal and provincial governments disputed control of the energy sector. The battle between the federal and provincial governments adversely affected the oil sands development. There was little cooperation between the two levels of government and the introduction of the NEP came at the height of the battle over Canadian energy.

[261] The made in Canada prices were to be paid to different categoris: the conventional oil was being the lowest; higher for tertiary recovery oil and highest for oil sands. However, these prices were way below the world oil price. John F Helliwell, *et al*, *supra* note 147 at 466.

[262] Paul Chastko, *supra* note 123 at 176.

On 28 October, 1980, Pierre Trudeau's Liberal government introduced the NEP as part of the federal budget.[263] The introduction of the NEP by the federal government increased tension between the two levels of government concerning the future of Canadian energy. Dissatisfaction over the sharing of oil revenues, with most of the rewards going directly to Alberta, and concern over foreign ownership drove the federal government to bring in the NEP. In the event that world oil prices rose the federal government wanted to be able to acquire a larger share of Canada's oil revenue. The NEP was the federal government's effort to take advantage of the increased world oil price.[264] The objectives of the NEP were:[265]

1. to establish the basis for Canadians to seize control of their own energy future through security of supply and ultimate independence from the world market
2. to offer to Canadians, all Canadians, the real opportunity to participate in the energy industry in general and the petroleum industry in particular
3. to share in the benefits of the industry expansion; to establish a petroleum pricing and revenue-sharing regime that recognizes the requirement of fairness to all Canadians no matter where they live.

Generally, the NEP attempted to achieve the security of the oil supply, to enhance opportunity for all Canadians, as opposed to principally Albertans, to participate in the petroleum industry, and to ensure the fairness of the distribution of energy benefits and burdens.[266] Although the objectives were sound on paper, the reality was the opposite. The NEP was designed by Federal Energy Minister Marc Lalonde and the Ministry of

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[263] Ian Wilson, *supra* note 108.

[264] Barbara Jenkins, *supra* note 257 at 146.

[265] The National Energy Program (Ottawa: Minister of Supply and Services, 1980) at 2 as cited in Paul Chastko, *supra* note 123.

[266] Energy, Mines and Resources Canada, *The National Energy Program, Update 1982* (Ottawa: Published under the authority of the Minister of Energy, Mines and Resources Canada, 1982).

Finance without consulting the provincial government or US government officials[267] (the initial foreign investors for oil sands project were US companies). The NEP generated protests from foreign investors and the US government in particular.[268] The IOCs reacted by threatening to move their investments to the US, where there was a "warmer political climate".[269]

The NEP also affected the tax regime by imposing the Petroleum and Gas Revenue Tax (PGRT). The PGRT was created to fund the Petroleum Incentives Program (PIP) and to halt the loss of the federal tax base, which had been used to offer "generous incentives for exploration".[270] The NEP was intended to replace the earned depletion allowance with a system of cash payments known as PIP grants. The PIP was created in 1982 to provide incentives specifically for Canadian-owned or Canadian-controlled enterprises for exploration and development expenditures in the oil and gas industry[271]. These incentives varied between regions and were granted proportionately based on Canadian ownership.[272] It meant that the larger the percentage of Canadian ownership or control, the greater the tax deduction. Such a situation was perceived by the foreign investors as a

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[267] Ian Wilson, "Nep: 25 Years Later, Over a Barrel" Calgary Sun (28 October 2005) online: The Calgary Sun < http://www.calgarysun.com>.

[268] Barbara Jenkins, *supra* note 257.

[269] Charles Pekow, "Canada Takes on the Oil Giants: Ottawa's New Energy Policy Has the Western Provinces and the Oil Multinationals Up in Arms", online: (1980) 1 Multinational Monitor 11<http://multinationalmonitor.org>.

[270] Commissioner of the Environment and Sustainable Development, *supra* note 178.

[271] Government of Canada, *Petroleum Incentives Program*, online: <http://mikan3.archives.ca>.

[272] John F Helliwell *et al, Oil and Gas in Canada: The Effects of Domestic Policies and World Events* (Toronto: Canadian Tax Foundation, 1989) at 96.

major political threat for their businesses. Though Canada did not seize the foreign investors' assets such as in real nationalization, the NEP sent a loud message about that as a possibility.[273]

In order to maintain a good relationship with the US investors and protect the oil industry, the Alberta government responded by reducing the allowed conventional oil production, and temporarily stopped the approval process for new oil sands plants. They also made an official statement that the action taken would remain in effect until the differences in energy policy were resolved. The long dispute between the federal and provincial governments was exacerbated by the introduction of the NEP. Moreover, the battle between the two levels of Canadian government discouraged foreign investment in Alberta. The IOCs expressed their hesitation in continuing investment until the two sides solved their differences. [274]

4.2.2.3 Foreign Investment Review Act

Another barrier to foreign investment in the petroleum industry came in the form of the *Foreign Investment Review Act*[275] (FIRA). The Parliament of Canada enacted FIRA in December 1973 and established the Foreign Investment Review Agency.[276] The agency was responsible for gathering information about FDI in Canada, advising foreign firms in

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[273] Barbara Jenkins, *ibid*; Jock A Finlayson & David G Haglund, "Oil Politics and Canada-United States Relations" (1984) Pol Sci Q 271.

[274] Charles Getman, "Canada's National Energy Program: An Analysis" (1980-1981) 3 Hous J Int'l L 155 at 174.

[275] *Foreign Investment Review Act*, SC 1973-74, c 46.

[276] A Claire Cutler & Mark W Zacher, eds, *Canadian Foreign Policy and International Economic Regimes* (Vancouver: UBC Press, 1992) at 123.

making applications, reviewing the applications, and making recommendations to the federal government concerning the applications.[277] FIRA gained negative responses from both existing and potential foreign investors beginning in its first year of operation.[278] The agency had been criticized for its inconsistency in applying criteria for selecting reviewable FDI.[279]

In relation to the oil sands development, FIRA was one factor that prevented foreign investment in Canada. The problem with FIRA started in 1980, when Prime Minister Trudeau expressed in the 1980 election campaign the Liberal party's intention to strengthen FIRA and expand the role of the agency.[280] He then assigned a "well-known economic nationalist" Herb Gray to be the minister of industry, trade and commerce after the Liberal party won the 1980 election.[281] By assigning an economic nationalist to be the industry minister, Prime Minister Trudeau ensured a more rigid reviewing process.

The introduction of the NEP and the increased rigidity of FIRA caused foreign investors to rethink investing in Canadian industries, including the oil sands.[282] When FIRA was replaced with the *Investment Canada Act* it solved the problem of discouraging foreign

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[277] *Ibid.*

[278] J Lewington, "U.S. Sets New Fight on Energy" *The Globe and Mail* (24 March 1982) P1; "Report on Canada FIRA Criticized" *The Globe and Mail* (17 May 1980) B4.

[279] Steven Globerman, "The Consistency of Canada's Foreign Investment Review Process-A Temporal Analysis" (1984) 15 Journal of International Business Studies 119.

[280] Law Society of Upper Canada, *Corporate Law in the 80s* (Don Mills : Richard De Boo, 1982) at 467.

[281] Barbara Jenkins, *supra* note 257; Jock A Finlayson & David G Haglund, *supra* note 273 at 276.

[282] Barbara Jenkins, *ibid* at 152; Jock A Finlayson & David G Haglund, *ibid*.

investment[283]. This change occurred due to a change in the federal government. In the 1984 election, the Liberal government was replaced by a Conservative government. Under the new *Investment Canada Act*[284], the Foreign Investment Review Agency changed its name to Investment Canada.[285] Although the review function still remains, Investment Canada's main purpose now is to encourage investment.[286]

4.2.2.4 Political Risk

Because the initial IOCs that started the oil sands projects were coming from the United States this section discusses the impact of the NEP on the United States. After World War II the United States and Canada built a special relationship as cultural cousins with similar social and political values and they managed to have a good relationship since then.[287] The preservation of this special relationship, however, was always "more important to Canada than to the United States because the U.S. giant was a potential threat to Canadian sovereignty and identity, whereas the United States had little to fear from Canada".[288] This unbalanced relationship and the fear, on the Canadian side, that the US was a threat to its sovereignty ensured that there was always a possibility that nationalism would interfere. The federal government perceived the fact that Canada's

[283] *Investment Canada Act*, RSC 1985, c 20 s 46.

[284] *Ibid.*

[285] *Ibid*, s 6.

[286] *Ibid.* s 2.

[287] Anthony Westell, "Poison Pinpricks" (1980-1981) 41 Foreign Policy 95 at 96.

[288] *Ibid.*

petroleum industry was controlled mainly by American IOCs as a major threat. [289] The NEP was the federal government's strategy to protect its own sovereignty.

The American IOCs reacted negatively to the program and asked for the United States government' support.[290] The main concern of the United States' IOCs regarding the NEP was the strong message of "Canadianization".[291] The American IOCs believed that the NEP was an "assault on the foreign-owned oil firms ….. part of a broader strategy systematically to reduce the degree of foreign ownership in Canada".[292] Myer Rashish, a former United States Under Secretary of State for Economic Affairs argued that "Canadian investment policies unjustly discriminate[d] against US and foreign investors. These policies clearly represent a major departure from the principle of national treatment for all enterprises established in a country, regardless of their nationality".[293] When the federal government was becoming more nationalistic the IOCs believed that the political risk in investing within Canada was too high. This suggested that political risk was the primary reason for declining foreign investment in the petroleum industry in the 1980s.

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[289] The provincial government, on the other hand, "tend to be less nationalistic…….some will probably seek to strengthen trade, tourist, and cultural ties with neighboring regions of the United States". See Anthony Westell, *ibid* at 104.

[290] Barbara Jenkins, *supra* note 257.

[291] Barbara Jenkins, *ibid*; Jock A Finlayson & David G Haglund, *supra* note 273.

[292] Jock A Finlayson & David G Haglund, *ibid.*

[293] Myer Rashish, *Information Release: Speech to the Center for Inter-American Relations, New York City* (Ottawa: United States International Communication Agency, United States Embassy, 22 September 1981) as cited in Jock A Finlayson & David G Haglund, *ibid* at 273.

4.3 Oil sands Development in the 1990s

4.3.1 International Situation

The world condition in the 1990s indirectly fostered oil sands development. The increased world oil price associated with the Gulf War caused foreign investors to consider the Canadian oil sands as a profitable investment.[294] The Canadian government began to use a different approach to invite foreign investment. In this period, the Canadian government's attitude towards IOCs became more tolerant than in the 1980s. Both federal and provincial governments had come to realize that it was not just tax incentives that made their country attractive. The stable political situation within the country was also a main factor for oil sands investment. Federal and provincial governments started to work cooperatively to stimulate development. The combination of the foreign investment-friendly situation in Canada and the rise of world oil prices proved to be effective in bringing back the IOCs' confidence.

[294] Energy Information Agency, "Annual Market Chronology", online: the Energy Information Agency <http://www.eia.doe.gov>; The Gulf War was started when Iraq invaded Kuwait on 2 August 1990 and causedanother sudden increase of the world oil price. Jerry CY Han & Shiing-wu Wang, "Political Costs and Earnings Management of Oil Companies During the 1990 Persian Gulf Crisis" (1998) 73 The Accounting Review 103 at 104; "Fears of Gulf War Fuel Crude Price Increase Oil price up $1.30 to $27.22 a Barrel" *The Globe and Mail* (27 December 1990) B 7.

4.3.2 Domestic Situation

Canada's investment climate in general had improved in the 1990s. While Indonesia generated many complaints regarding its lack of legal certainty, there was no literature that brought up problems in relation to legal certainty in Canada. Using the CPI approach to measure the corruption level in Canada, business people, political analysts, and the general public around the globe perceived Canada as a country "clean" from bribery and extortion.[295]

As for the political situation within the country, the situation in the period of 1990s started to improve. The elimination of the NEP in the late 1980s had established a better relationship between the federal and Alberta governments. During the early years of the oil sands development there had been a gap between government and industry. The government wanted to increase its control over natural resources and acquire maximum economic rent. The IOCs, the primary actors in the industry, wanted to reduce costs as much as possible and acquire huge profits from their investments. Both sides were trying to achieve their goals without working together. This conflict caused a slowdown in the progress of oil sands development. The shifts in the political climate in the 1990s that saw an improved relationship between the different levels of government also saw in improvement in the relationship between governments and the oil industry.

[295] The available data for CPI in Canada started from 1995. Since 1995 until 2000, Canada has maintained its CPI level high, which means that the country was perceived clean during such period of time. For further details see Transparency International, *supra* note 14.

To resolve conflicts between the government and the oil companies, the Alberta Chamber of Resources[296] initiated the National Task Force on Oil Sands.[297] It was formed in March 1993 to act as a facilitator for further development of the oil sands.[298] This committee consisted of representatives from both federal and provincial governments as well as the oil sands producers and supporting industries.[299] With the establishment of the Task Force, the governments and industries began to work together to develop the oil sands. The federal government, provincial government, and oil sands producers designed a 25-year strategy for oil sands development in 1995. It projected an increase in oil sands production, with production doubling or tripling to reach between 800,000 and 1.2 million barrels per day by 2020.[300]

In 1997 investment in oil sands projects increased significantly. The 1997 Economist Intelligence Unit (EIU) report showed that Alberta's economic growth was higher than other provinces. The Alberta government believed that the province's economic growth in the mid-1990s was associated to a great extent with the development of oil sands

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[296] The Alberta and North West Chamber of Mines and Resources were formed in 1935. It changed its name to The Alberta Chamber of Resources in 1977. This chamber has influence in Alberta's public education, worker safety, oil sands development, mineral exploration and environmental protection. See Alberta Chamber of Resources, *supra* note 207.

[297] National Energy Board, *Canada's Oil Sands: A Supply and Market Outlook to 2015* (Calgary: National Energy Board, 2000) at 52; Paul Chastko, *supra* note 123 at 215.

[298] National Task Force on Oil Sands Strategies of the Alberta Chamber of Resources, *A New Era of Opportunity for Canada's Oil Sands* (Edmonton: Alberta Chamber of Resources, 1996).

[299] Richard Masson & Bryan Remillard, "Alberta's New Oil Sands Royalty System", online: (1996) Alberta Department of Energy <http://www.energy.gov.ab.ca>; National Energy Board, *supra* note 292.

[300] Canada's Environmental Community, "Managing Oil Sands Development for the Long Term: A Declaration by Canada's Environmental Community", online: (2005) The Pembina Institute <http://www.pembina.org> at 2.

projects.[301] In 1997, Alberta was set to be the "star performer" among other provinces in Canada because its GDP was accelerating by more than 4% in 1997 and 1998.[302] The GDP growth was caused by the increase in oil sands projects as well as other oil and gas revenues and an influx of migrants.[303] The 1997 report also emphasized that Canada's investment climate was "…high—and mostly improved—ranking in several international business and investment surveys published in the second quarter of 1997".[304] The EIU even placed Canada in third place (out of 58 countries) in terms of its business environment over the next five years.[305] The development of the oil sands continued to improve and between 1996 and 2004 the oil sands industry generated over $35 billion in revenues.

The improvement in the oil sands industry was, however, not caused by tax incentives only. To foster industry efficiency and growth the Task Force believed that "no single lever for oil sands development is sufficient for growth. All levers influence investment decisions".[306] The Task Force recommendations touch not only fiscal regime, but also

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[301] Robert Mitchell, *et al, supra* note 215 at 1.

[302] The Economist Intelligence Unit (EIU), *Country Report Canada: 3rd Quarter 1997* (London: The Economist Intelligence Limited, 1997) at 9.

[303] *Ibid.*

[304] *Ibid.* at 25.

[305] *Ibid.*

[306] The Task Force recommendations suggested that there were seven important factors that influence the development of oil sands, other than tax incentives. They indicated that although important, tax incentives were not the main driving force in the development of the oil sands industry. National Task Force on Oil Sands Strategies of the Alberta Chamber of Resources, *The Oil Sands: A New Energy Vision for Canada* (Edmonton: Alberta Chamber of Resources, 1995) at 46.

other aspects.[307] The Final Report suggested that there were eight "levers of development" that "if correctly manipulated would result in optimal oil sands development in the next twenty-five years:[308]

> (1) A market-driven science and technology innovation system that results in sustainable development and lower supply costs.
> (2) New generic, competitive and fixed royalty and taxation regimes.
> (3) Diverse, internationally based capital finance formation
> (4) Sustainable development and environmental compliance
> (5) Aggressive national and international marketing for bitumen and oil sands products
> (6) A complete pipeline transportation system to ship product to market.
> (7) "Fair, predictable, timely and competitive regulation".
> (8) Informed and committed stakeholders.

The progress in the oil sands development after collaboration began shows that foreign investment can be heavily influenced by investor confidence in the host government. The establishment of the National Task Force on Oil Sands restored investors' trust in Canada, and thus investment increased.

Based on the analysis in Chapter Three and Chapter Four, there are several important points which need to be underlined. In the 1970s, the GCOS's and Syncrude's initial oil sands projects indicated that the Alberta oil sands and Canada's situation, as a whole, was attractive for foreign investors. While many studies and reports cited Indonesia as a country with a high degree of legal uncertainty, Canada has never faced such a problem. The series of negotiations for tax incentives between oil sands producers and the Canadian government suggested that tax incentives are crucial in the calculation of

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[307] *Ibid.*

[308] National Oil Sands Task Force on Oil Sands Strategies, *Securing a Sustainable Future for Canada's Oil Sands Industry* (Edmonton: Government Printer, 1995) as cited in Paul Chastko, *supra* note 123 at 216.

economic opportunity only. The foreign investors had already decided that they wanted to put their money within the country, and the tax incentives occurred as compensation to counterbalance potential losses in starting the high-risk projects.[309]

In the 1980s Canada was perceived as unattractive due to the political situation at the time. The introduction of the NEP received negative responses from foreign investors. Many policies in Canada in the 1980s were perceived by foreign investors as having a high degree of political risk. The political battle over Canadian energy revenues between the federal and provincial governments also added to the high degree of uncertainty. The "nationalistic policy" of the Federal Government to increase Canadian ownership was a serious political risk to foreign investment. The uncertainty and perception of risk that was generated by these policy shifts resulted in a decline in foreign investment.

Though the Canadian government offered a generous tax incentive (ACCA) the major success of oil sands development was not caused by such incentive. Foreign investors returned to having confidence in Canada mainly because of the changing political situation rather the incentive factor. The prevailing situation in 1990s indicated that the success of the Canadian oil sands in generating over $35 billion from 1996 until 2004 was mainly caused by the changing attitude of the Canadian government towards foreign

[309] It can be assumed that the IOCs might have expected some special tax treatment from the Canadian government. However, in conducting analysis for investment, the IOCs will analyze all aspects; i.e. the oil reserves, country risk (political and legal certainty), and fiscal regime. If there was any weakness in a specific country, they would use it as a bargaining point for acquiring host government assistance. This government assistance can be in the form of tax incentives and/or subsidy. For example, in the case of the low productivity suffered by GCOS, Syncrude can negotiate for more generous tax treatment in order to help compensate for their potential loss. The GCOS and Syncrude cases suggested that based on their investment analysis, investing in the oil sands can be profitable. It can also be assumed that the investment analysis was based on the existing situation (including existing tax incentives). However, given the large initial capital required, the foreign investors might continue to negotiate for more tax incentives.

investors. The ending of the notorious NEP reassured foreign investors that the Canadian government was welcoming of foreign investment. The understanding relationship between the two levels of government also provides political certainty. Based on several points previously mentioned, the attractiveness level of an oil-producing country is influenced by legal certainty, country risk, and economic opportunity. Tax incentives were subject to negotiation when estimated operational costs appeared to be very high.

CONCLUSION

The increased competition in obtaining funding for the development of petroleum industries forces many countries to find the most effective and efficient way to attract foreign investment. Although tax incentives are often cited as the best or preferred method, there has been no definitive resolution on the influence of tax incentives in cultivating foreign investment. Using the Canadian oil sands project as a case study, this research canvasses the significance of tax incentives in the early development of the project.

Oil and natural gas are the cornerstones of the petroleum market. The demand for oil as a non-renewable energy source is continually increasing, while the supply is gradually decreasing. The map of the oil industry has now changed because of the growing demand for oil. The new oil industry consists of conventional oil, substitute liquid fuels, and efficiency. Oil sands have emerged as one of the most attractive substitute liquid fuels for investment. Investing in oil sands is considered a profitable business considering the fact that the conventional oil supply is gradually decreasing.

Looking at the tax incentives provided, the political situations that prevailed, and the levels of foreign investment in the 1970s, 1980s, and 1990s, it is clear that tax incentives deployed in Canada to assist in the development of its oil sands are not, on their own, a significant factor in attracting foreign investment to the petroleum industry. Oil prices

and potential reserves are the main driving forces for foreign investment. However, these two factors, of course, cannot be controlled by a country seeking to exploit its resources.

In the case of the Canadian oil sands, this research indicates that Canada, with its generally stable legal and political situations, was already an attractive place for investment, regardless of the various tax incentives that have been offered. There are several points that deserve attention:

(1) The GCOS's and Syncrude's initial oil sands projects emphasized that foreign investors were already interested in placing their money in Canada. They saw economic opportunity in Canada's abundant oil sands reserves. Using the investment equation in Chapter Three, tax incentives appeared as compensation for additional operational costs incurred by foreign investors, but not as the original impetus for investing in the first place.

(2) The lack of foreign investment in 1980s was mainly influenced by the political instability within the country. The introduction of NEP was deteriorating the relationship between the federal and provincial government. The United Sates' government and IOCs perceived the energy program as a high political risk. The NEP delivered a strong message of potential nationalization. The result was the withdrawal of two important oil sands projects that were estimated to supply one-fifth of Canada's oil needs.

(3) Foreign investment in the 1990s began to improve due to the improved relationship between the two levels of Canadian government and the oil industries as the establishment of the National Task Force on Oil Sands Strategies reduced the gap between the parties. The Task Force produced a report that identified eight "levers of development" to improve the oil sands industry. The report suggested that tax incentives were not the primary factor behind investment in oil sands development. All of those eight levers (science and technology; capital formation; fiscal regime; environmental issues; marketing; distribution; regulatory framework; and stakeholders) were equally important.[310] Furthermore, the increased foreign investment in Canadian oil sands in the 1990s can be traced to the increased political stability within the country. The federal and provincial governments had been able to solve their differences over the oil sands industry. They agreed to work together to develop the alternative energy source in order to secure the national energy supply. The resolution of the dispute between the two levels government and the elimination of NEP indicated the decline in political risk for foreign investment.

Based on this research tax incentives alone are not a significant factor in attracting foreign investment. Generally, foreign investment levels depend on legal certainty, political stability, and economic opportunity. [311] It is difficult to isolate the only main factor. The Canadian oil sands case study indicated that tax incentives serve as a part of economic opportunity. Economic opportunity in the oil industry is influenced by two

[310] National Task Force on Oil Sands Strategies of the Alberta Chamber of Resources, *supra* note 307.

[311] OECD, Working Group on Trade and Investment, *supra* note 153; BT Partnership Law Firm, *supra* note 9; Pancras J Nagy, *supra* note 9.

variables: oil price and operational cost. The world oil price is an uncontrollable variable, whereas operational cost is a more predictable and controllable variable. The research on Canadian oil sands project shows that tax incentives are part of the operational cost; the variable that the host government can control.

The GCOS's and Syncrude's projects illustrated that foreign investors had started investing money before the Canadian government even realized the urgency of developing the industry. The series of negotiations between the Canadian government and the IOCs showed that tax incentives play an important role to the extent that they can compensate the high initial cost. However it was clear that the IOCs already perceived Canada as an attractive place for investment prior to lobbying the Canadian government for tax incentives. The development or lack of development, of oil sands projects in the 1980s can serve as a good example of how a high degree of political risk can discourage IOCs from continuing old projects or starting new projects. The improvement in the 1990s was mainly caused by the decrease of political risk. The improved relationship between the two levels of Canadian government and the oil industries had brought back the foreign investors' trust.

These findings can be a good reference for Indonesia, a developing country where the oil industry is a major contributor to the economy. Based on Wells and Allen research, Indonesia accepted the significance of tax incentives in attracting foreign investment without any "hard evidence" to support.[312] The Indonesian government tries to promote

[312] Louis T Wells, Jr *et al*, *supra* note 66 at x.

the oil industry development in remote areas by offering tax incentives. The result of this research, however, suggests otherwise. While acknowledging the basic differences between Canada and Indonesia, the Canadian experience in using tax incentives for oil sands development can be a good example for how Indonesia might draft a strategy to promote its own oil industry. With many investment challenges facing the Indonesian government and declining oil reserves, the determination to use tax incentives to promote remote areas for oil exploration can be understood. However, with the case of the Canadian oil sands in mind, it would be wise for the Indonesian government to review its policy as to whether tax incentives are effective in acquiring foreign investment. This research is in accordance with a recent survey on foreign investment in Indonesia.[313] The survey indicated that the lack of legal certainty and political instability have been crucial for potential foreign investors.[314] Though the lack of tax incentives was cited as a barrier to foreign investment, the majority of the respondents were less concerned about this issue than they were with the political and legal issues.[315] The main task for the Indonesian government is to improve the legal certainty and political stability within the country.

[313] Norton Rose, *supra* note 91.

[314] *Ibid*.

[315] *Ibid* at 39.

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