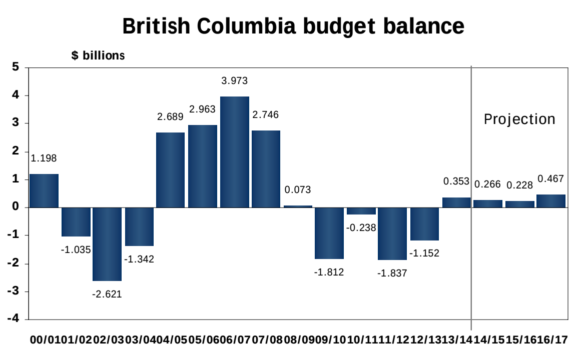
October 22, 2014

The BC government releases details on new Liquefied Natural Gas income tax



Source: British Columbia Ministry of Finance, RBC Economics Research
*Updated projections reflect figures in the First Quarterly Report 2014/15

As promised in its February 2014 Budget, the government of British Columbia released details pertaining to its earlier proposed LNG income tax yesterday. Few details were released at the time of the Budget, with the exception that the tax would likely be a two-tier income tax with a tentative Tier 1 tax rate of 1.5% and a Tier 2 rate of up to 7%. At that time, the province announced that it would take into account "global and local economic conditions" as it finalized the key components of the tax to promote a competitive environment in the province. On account of a shift in market conditions since the time of the Budget, notably declining LNG prices and increased construction costs, the government announced that the Tier 2 tax rate will instead be half of the earlier proposed rate at 3.5% effective January 1, 2017 before rising to 5% on January 1, 2037.

The higher of the two tax rates, applicable to net income from the liquefaction of natural gas at all LNG facilities in the province regardless of its destination, will come into effect when a facility's capital account is depleted and the taxpayer does not have a net operating loss. If, however, an LNG income tax taxpayer experiences a period of net operating losses and deductions from the capital investment account, the 1.5% rate will be applied to net operating income. As previously announced, the amount paid at the lower rate would be accumulated in a tax pool balance to be credited against tax payable when the higher tax rate comes into effect. No deduction will be allowed for capital cost allowance, however, an LNG taxpayer may deduct an 'investment allowance' based on the capital cost of accumulating tangible capital investment property less the funds derived from the disposition of such property.

Moreover, to attract potential new investments to the nascent industry, the government announced a natural gas corporate income tax credit that has the potential to effectively reduce the tax owing by an LNG income tax taxpayer to an amount equivalent to what would be payable if the general corporate income tax rate was 8% (it is currently 11%). This is done by applying a credit equal to 0.5% of a corporation's input of natural gas at an LNG facility. Overall, the detailed tax framework lessens the uncertainty for potential investors to the province's yet-to-be-established LNG industry.

The introduction of the province's Liquefied Natural Gas Income Tax Act followed the announcement a day earlier that BC will implement a greenhouse gas intensity benchmark as part of the Liquefied Natural Gas Strategy. This is to ensure that the province's LNG facilities are the "cleanest" in the world and that development of the industry is done safely "with great environmental standards". The emissions benchmark will be set at 0.16 carbon dioxide equivalent tonnes per tonne of LNG produced which represents the lowest benchmark in the world - the intensity of global facilities currently ranges from 0.18 to 0.27 tonnes. As this initiative has the potential to impede new investment in the province due to higher relative compliance costs, the government also introduced offsets and an incentive program. If an LNG facility determines that it is not economically feasible to increase energy efficiency or adapt clean tech-

Laura Cooper
Economist
(416) 974-8593
laura.cooper@rbc.com

nology, it can invest in BC-based emissions reduction projects (ie. offsets) or contribute $25 per tonne of GHGs to a technology fund, which would then be targeted to investments to further reduce emissions. Moreover, the government introduced an incentive program to reward cleaner technology investments for facilities who achieve an annual performance below 0.23 tonnes and 'performance credits' that can be sold to other facilities if the 0.16 benchmark is met. The cost to the government of implementing this program has yet to be determined, however, the government anticipates that these will be reimbursed through the taxes and royalties that will be collected from a "thriving LNG industry".

As we noted in our analysis of Budget 2014, the development of the LNG industry in BC could have potentially transformative power for the province's economy, with $7 billion already invested for the acquisition of natural gas assets and $2 billion related to preparations for construction of LNG infrastructure. With 18 potential LNG projects identified by the province, although none with final investment decisions yet, the introduction of a detailed tax framework to create conditions for an accommodative, competitive investment environment is expected to yield overall net benefits to the province including, but not limited to natural gas royalties which are expected to amount to only 1% of the province's revenues in 2014/15. At the same time, the net impact on the industry of greater environmental standards and additional government costs has yet to be determined. That said, the implementation of the plan will not be in effect until 2017 and does not impact the province's fiscal situation through the projection period as potential revenues related to the tax framework were not incorporated into the recent budget projections. With respect to the impact on industry, our equity research colleagues view it as a positive benefit in the context of intensified LNG supply competition from the US, East Africa and elsewhere. The details released in recent days lay the foundation for approval decisions and environmental reviews to proceed, and we will be monitoring approval decisions over the coming months and year to gauge the implications for the provincial economy over the medium term.