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Trans Mountain Pipeline Financials Suggest Taxpayer Dollars at Risk

The Government Has Yet to Provide Full Details About the Extent of Project and Financing Costs

I. Principal Report Findings

For the period January 1, 2019 through June 30, 2019, the Canadian government, its subsidiaries and the Alberta provincial government provided direct and indirect subsidies to the Trans Mountain Corporation of $320 million.[1] The subsidies covered operational deficits and the costs of financing a $5 billion investment made by the Canadian government for the project.

Table 1: Direct and Indirect Subsidies Provided by the Canadian Government to the Trans Mountain Corporation and the Trans Mountain Pipeline Project, First Six Months of 2019

Type of Subsidy	Amount
Direct	**$135,805,000**
Indirect	**$183,777,000**
Total	**$319,582,000**

The Trans Mountain Corporation (TMC), the operations company that runs the existing pipeline and is developing its expansion, is operating at a loss. The subsidy to TMC to cover its losses came from the earnings of the Canada Hibernia Holding Corporation (CHHC), a Crown corporation that manages federal oil and gas assets in Newfoundland and Labrador, and tax benefits provided by the Alberta government.

Operating and financing costs for the Trans Mountain pipeline will exceed revenues in the future. CHHC is likely to be a continued source of operational subsidies, but is unlikely to produce sufficient revenues to also subsidize the project's growing interest charges, as additional loans are needed to finance the pipeline's expansion.

The source of future subsidies to cover operating deficits and debt service is unspecified. This places Canada's principal economic development agencies under significant stress. The financial arrangement puts the Canada Development Investment Corporation (CDEV) at risk of running deficits at least through the life of the Trans Mountain pipeline project. Deficits at CDEV are unprecedented. The Canadian government has also utilized the Canada Account[2] to provide resources to

[1] Canadian dollars are used throughout this report.
[2] Under Section 23 of the Export Development Act ("the Act"), the Government of Canada (the "Government" or the "Crown") is able to authorize support for transactions which, on the basis of

the project, which means that Ottawa is borrowing to meet the project's growing financial requirements. IEEFA expects that the Trans Mountain Corporation project will add significant increased risk to the Canada Account's portfolio.

IEEFA's analysis of recent financial disclosures indicates that deficits for TMC and the economic development agencies will continue into the foreseeable future and will contribute to the aggregate cost of the project to the Canadian government.

This report is not a full accounting of the total subsidies to date. It covers only the period January 1, 2019 through June 30, 2019. IEEFA's prior studies analyzed the Trans Mountain pipeline sale that transferred ownership of the pipeline from Kinder Morgan to the Canadian government and reviewed the Canadian government's reporting on the sale. In those reports, IEEFA identified more than $5 billion in prior investments by the Canadian government. IEEFA's reporting is being undertaken as the Canadian government has yet to adopt a full reporting to the public of the level of Canadian tax dollars being put at risk by this investment. IEEFA relies on public accounting documents from multiple Canadian agencies. This method of reporting by the Canadian government affords accountability for its economic development programs, but impairs a clear picture of the money flow that is paid for by Canadian taxpayers. IEEFA is preparing a full accounting of all TMC subsidies since the project's inception and a dynamic monitoring tool that will be provided in the near future.

The Canadian government has yet to report fully on the level of tax dollars being put at risk.

Export Development Canada's ("EDC" or the "Corporation") risk management practices, would not be supported under EDC's Corporate Account but are in the national interest. Such transactions are referred to as Canada Account transactions. The Government effectively assumes the associated financial risks for Canada Account transactions by providing all monies required for any transaction from the Consolidated Revenue Fund ("CRF") (emphasis added). However, Canada Account transactions are assessed, entered into and managed by EDC, and are structured the same as Corporate Account transactions in that, for example, loans are fully repayable, are subject to interest and fees and policies are subject to premiums and fees. See: EDC. Canada Account, Annual Report, 2016-2017, for year ending 3/31/17. p. 1.

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II. Financial Structure of Trans Mountain Pipeline Project and System of Accounting

In August, CDEV and TMC released their respective 2Q 2019 financial reports that cover the first six months of activity in 2019. Those filings are the basis for this report.

A. Who Are the Operational Players for the Trans Mountain Project?

CDEV[3] is a crown corporation charged with the mission of furthering Canada's economic development goals. CDEV's second quarter report identifies four principal subsidiaries of the corporation:

- **Canada Hibernia Holding Corporation (CHHC)** operates the Crown's interest in oil reserves off Newfoundland and Labrador. It drills for oil and sells it for a price tied to the Brent price benchmark.[4]
- **Canada Eldor (CEI)**'s sole purpose is to manage the remaining liabilities of the Eldor nuclear plant.[5]
- **Canada TMP Finance Limited (TMP)** is the parent corporation of Trans Mountain Corporation and was incorporated to provide debt and equity financing to the Trans Mountain Corporation.[6]
- **Trans Mountain Corporation (TMC)** was created to acquire, operate and construct the Trans Mountain pipeline and its expansion.[7]

CDEV's quarterly report includes basic revenue and expense disclosures for each subsidiary, a consolidated financial statement of the financial activities of CDEV as a whole, and a description of the functions of each subsidiary corporation.

B. Who Provided What Cash to Which Agency and How Is It Supposed to Be Paid Back?

The financial disclosure provides a description of CDEV's role in the development of the Trans Mountain pipeline project. CDEV received $5.035 billion in direct cash from the Canadian government from the Canada Account administered by the Export Development Corporation (EDC) to finance the acquisition of the Trans Mountain Pipeline. CDEV must make regular interest payments to the Canada

[3] For more details on the statutory mission, status and reporting mechanisms of the economic development fiscal agencies identified in this report see IEEFA's two prior studies, Canada's Folly, June 2018 and Trans Mountain Pipeline Financials: Built on Quicksand and Clear as Mud, April 2019.
[4] CDEV, Second Quarter 2019 Interim Financial Report, August 22, 2019, p. 3-4 and 11.
[5] Canada Eldor, Purpose of Corporation
[6] CDEV, Second Quarter 2019 Interim Financial Report, August 22, 2019, p. 3 and 11.
[7] Ibid., p. 2-3 and 11.

Account based on agreements for the acquisition and construction. The interest rate is 4.7%.

CDEV's finance subsidiary is TMP Finance. TMP Finance was created to own, acquire and finance the project. TMP Finance made the direct investment in Trans Mountain Corporation, the operating arm of the project, with funds advanced through the Canada Account. The Canada Account in turn borrowed these funds in the capital markets.[8]

TMP Finance made the financing available to TMC in two tranches. Neither transaction requires regular repayment of principal. There is a $2.769 billion loan[9] to TMC that requires regular payments of interest from TMC. There is an equity investment of $2.266 billion.[10] The repayment of the equity or principal by TMC is, in theory, related to the resale of the project. Regular interest payments from unspecified sources are expected from CDEV to the Canada Account.

Note that CDEV must pay the Canada Account interest on the full $5.035 billion, but CDEV only receives payment from the business activity of TMC for interest on the $2.769 billion that is considered a loan to TMC. The structure of this arrangement ***requires*** that a third-party source of revenue be used to pay interest on the additional $2.266 billion that CDEV owes to the Canada Account on a regular basis. Thus, the structure requires an ongoing subsidy.[11] As discussed below that third-party source during the first six months of 2019 was revenue derived from the business activity of CHHC.

C. How Are the Players Reporting Their Receipt and Use of the Cash Involved?

CDEV's quarterly financial reporting includes a quarterly disclosure filed by the Trans Mountain Corporation, CDEV's subsidiary. Selected aspects of the TMC quarterly report are incorporated in the CDEV consolidated financial disclosure and the entire TMC report is incorporated by reference.

The CHHC and CEI financial disclosures are also part of the CDEV quarterly report and are reported as entities conducting separate businesses. Selected financial information is included for each individual entity in the report and as part of the consolidated financial statement contained in the CDEV second quarter financial report.

[8] Government of Canada, Department of Finance, Details of Trans Mountain Pipeline, see also Debt Assets and Liabilities section.
[9] 55% of $5.035 billion.
[10] 45% of $5.035 billion.
[11] See Appendix for more detailed discussion of subsidies.

III. Selected Financial Highlights of the CDEV and TMC 2 Q 2019 Reporting

This report concentrates on the financial disclosures for the first six months of 2019. The CDEV financial statement reports on the second quarter of 2019 and also includes the full six-month financial presentation.

During the first six months of 2019, CDEV concentrated its efforts on working to insure the smooth integration of the Trans Mountain Corporation from a subsidiary of Kinder Morgan to a Crown corporation. It was also involved in the Canadian government's effort to sell the Ridley Terminal.[12]

According to the financial reports:

- CDEV's consolidated revenues equaled $322 million, including $109 million in earnings before interest, taxes and depreciation (EBITDA).[13] CDEV had $30.2 million in net income.[14]

- TMC revenues were $219 million,[15] $115 million in EBITDA and net income of $43 million.[16]

- TMP Finance provided financing to TMC. The terms were 45% equity and 55% debt. TMP also successfully negotiated a revised credit agreement with the Canada Account extending TMP's credit limit from $2.6 billion to $4 billion to support the construction of the pipeline through the first quarter of 2020.[17]

- CHHC revenues were $102.8 million mostly from the sale of crude oil and $85 million in EBITDA.[18] CHHC had $38.1 million in net income.[19]

These reported numbers, however, do not tell the full story, as we discuss below.

IV. Subsidy Analysis and Findings

The scope of this review identifies subsidies[20] provided by the Canadian and Alberta government to the Trans Mountain pipeline project during the first half of 2019. **The subsidies are not labeled as such in the CDEV or Trans Mountain financial reporting or Alberta budget documents**. The subsidies for the first half of 2019 come in three forms: direct cash transfers from other subsidiaries within CDEV,

[12] CDEV, Second Quarter 2019 Interim Financial Report, p. 2.
[13] Ibid., p. 2-3.
[14] Ibid., p. 33.
[15] Ibid., p. 3.
[16] Ibid., p. 33.
[17] CDEV, Second Quarter 2019 Interim Financial Report, p. 3.
[18] Ibid.
[19] Ibid., p. 33.
[20] See Appendix for discussion of Methodology and Subsidy Considerations

through an indirect interest rate (or finance) subsidy provided to the project by the Canada Account and from tax benefits from Alberta.

Table 2: Consolidated CDEV Financial Statement (unaudited) for the Six Months Ending June 30, 2019

The consolidated financial statements of the Corporation include 100% of the assets, liabilities, revenues and expenses of TMC, CHHC as follows. CDEV corporate, CEI and TMP Finance are grouped as Others:

	Six months ended June 30, 2019						
	TMC (US GAAP)	IFRS Adjustments	TMC (IFRS)	CHHC	Others	Eliminations	Consolidated
Statement of Comprehensive Income:							
Revenues:							
Transportation revenue	$ 170,574	$ 17,406 [1]	$ 187,980	$ -	$ -		$ 187,980
Lease Revenue	$ 29,904		$ 29,904				$ 29,904
Net Crude oil revenue				$ 100,089	$ -		$ 100,089
Other income/ FX	$ 1,311		$ 1,311	$ 2,733	$ 875	$ (875)	$ 4,044
	$ 201,789		$ 219,195	$ 102,822	$ 875	$ (875)	$ 322,017
Expenses:							
Depletion and depreciation	$ 50,167	$ 3,884 [2]	$ 54,051	$ 31,081	$ 54		$ 85,186
Operating and production	$ 68,222	$ (395)	$ 67,827	$ 14,556	$ -		$ 82,383
Salaries and Benefits	$ 31,800	$ 1,995 [3]	$ 33,795	$ 874	$ 737		$ 35,406
Other and FX	$ 4,377	$ (1,390)	$ 2,987	$ 2,495	$ 4,820	$ (74)	$ 10,228
	$ 154,566		$ 158,660	$ 49,006	$ 5,611	$ (74)	$ 213,203
Finance Costs							
Equity AFUDC	$ 37,875	$ (37,875) [4]	$ -		$ -		$ -
Unwind of Discount	$ -	$ (4,536) [4]	$ (4,536)	$ (1,285)	$ (74)		$ (5,895)
Net Interest (expense)	$ (44,295)	$ (22,644) [4]	$ (66,939)	$ 2,004	$ (46,337)	$ 801	$ (110,471)
	$ (6,420)		$ (71,475)	$ 719	$ (46,411)	$ 801	$ (116,366)
Earnings/loss before tax	$ 40,802		$ (10,940)	$ 54,535	$ (51,147)		$ (7,552)
Taxes (recovery)	$ (46,315)	$ (7,855) [5]	$ (54,170)	$ 16,435	$ -		$ (37,735)
Net Income	$ 87,117		$ 43,230	$ 38,100	$ (51,147)		$ 30,183
Other Comprehensive Income	$ (12,615)	$ (11,743) [6]	$ (24,358)	$ -	$ -		$ (24,358)
Statement of Financial Position:							
Assets:							
Current	$ 285,257	$ (11,995) [7]	$ 273,262	$ 170,238	$ 93,655	$ (990)	$ 536,165
Non-Current	6,062,252	458,699 [8]	6,520,951	383,572	5,236,892	(5,226,977)	6,914,438
	$ 6,347,509	**$ 446,704**	**$6,794,213**	**$ 553,810**	**$5,330,547**	**$ (5,227,967)**	**$ 7,450,603**
Liabilities							
Current liabilities	$ 448,449	$ 217,250	$ 665,699	$ 32,503	$ 369,393	$ (218,240)	$ 849,355
Non-current liabilities	3,579,283	317,691 [9]	3,896,974	182,268	4,678,380	(2,506,350)	6,251,272
	$ 4,027,732	**$ 534,941**	**$4,562,673**	**$ 214,771**	**$5,047,773**	**$ (2,724,590)**	**$ 7,100,627**
Equity	**$ 2,319,777**	**$ (88,237) [10]**	**$2,231,540**	**$ 339,039**	**$ 282,774**	**$ (2,503,377)**	**$ 349,976**
	$ 6,347,509	**$ 446,704**	**$6,794,213**	**$ 553,810**	**$5,330,547**	**$ (5,227,967)**	**$ 7,450,603**

A. Direct Subsidies

The source and size of the direct subsidies ($135.8 million) consist of financial resources provided to TMC from a third-party source (CHHC) and the Alberta government. These subsidies are identified and quantified by IEEFA's review of the Consolidated Financial Statement of CDEV and budget documents of the Alberta government.[21]

Table 3: Direct Cash Subsidies from CDEV Subsidiaries to TMC (Canadian dollars, thousands)

Line Item	Expense Assigned To	Amount	Nature of Subsidy
Net Interest (expense)	Others	$46,337	TMC interest liability paid by other subsidiary
Earnings/loss before tax	TMC (IFRS)*[22]	$10,940	TMC operational loss covered by Consolidated earnings/loss before taxes
Other Comprehensive Income	TMC (IFRS)	$24,358	TMC pension liability covered by net income of consolidated operations
Alberta Tax Rate	TMC (IFRS)	$54,170	Tax benefits from corporate tax rate reduction
Total		**$135,805**	

i. Net Interest

The net interest owed by CDEV to the Canada Account for the period is not clearly presented in the Consolidated column as $110 million. This interest expense is covered by TMC direct expenditures of $66.9 million and $46.3 million from "Others."[23]

CDEV has two sources of revenue, $219 million from TMC and $103 million from CHHC, for a total Consolidated revenue of $322 million. (See Table II)

The amount of net interest paid to settle CDEV's interest liability for the entire pipeline debt is paid for in part by cash from TMC and the remaining $46.3 million is

[21] CDEV, Second Quarter 2019 Interim Financial Report, Note 19, p. 33.
[22] International Financial Reporting Standards (IFRS) used in Canada are slightly different from reporting standards required under the Financial Accounting Standards Board (FASB), which govern United States accounting.
[23] The $110 million in the Consolidated Account is the actual amount of interest paid to the Canada Account for the period. A total of $113 million in interest, $66.9 million from TMC and $46.3 million from Others, is listed as being paid for the period. The $113 million is adjusted with additions and subtractions attributed to CHHC and Others in the Consolidated Statement.

attributed to "Others." The source of the additional cash on the consolidated statement is CHHC's $103 million contribution.

ii. Earnings/Loss Before Tax

TMC posts a $10.9 million loss, prior to taxes. The Consolidated loss for CDEV of $7.5 million consists of the TMC loss of $51 million and a substantial earnings gain from CHHC of $54.5 million.

The full Consolidated $7.5 million loss is subtracted against the enterprise-wide revenue base of $322 million. TMC's $10.9 million component loss is subsidized in the consolidated financial presentation by CHHC's revenues.

iii. Other Comprehensive Income

The Consolidated Statement carries an expense of $24.4 million as Other Comprehensive Income. This is a pension expense attributed to TMC/IFRS. The $24.4 million is carried in the Consolidated column as a below-the-line expense of CDEV. It is effectively covered by CDEV's enterprise-wide net income for the period of $30.2 million.

The pension expense is effectively subsidized out of the enterprise-wide revenue base of CDEV ($322 million). CDEV would have a net income of $5.7 million for the period if this below-line accounting treatment were integrated into the expenses of TMC and the total enterprise.

iv. Alberta Tax Reduction

The provincial government in Alberta reduced its corporate taxes through a Job Creation Tax Credit starting in January 2019.[24] This policy action allowed TMC to take a $54.1 million tax savings in this reporting period. The tax is taken on the accounting statement after the $10 million loss is posted and turns TMC's pre-tax loss into a post-tax gain.

B. Indirect Subsidies

The indirect financing subsidy is **the difference between what a private company requires as an Internal Rate of Return (IRR) versus the interest rate charged (Canada's Internal Rate of Return) to the project by the Canadian government.** To obtain an accurate measure of private sector costs, we use the Internal Rate of Return provided by Kinder Morgan during the pipeline proceedings. The company used a rate of return of between 12% and 15%.[25] For this analysis, the lower 12% has been chosen.

The Canada Account provided a loan to CDEV at a 4.7% interest rate to purchase and construct the pipeline. The below-market interest rate is made available by the Canadian government based on the statutory authority that empowers the Canada

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[24] See Appendix I for discussion.
[25] Canada Energy Regulator, Kinder IRR, November 29, 2012.

Account. The below-market financing is designed to support economic activity in Canada that is consistent with the national interest.

The balance on the loan as of June 30, 2019 was $5.035 billion. Our analysis shows that when the respective rates of return are applied to the actual loan balance of $5.035 billion, then the subsidy – or the difference between the private IRR and the Canada Account rate – for the 1H 2019 period is $183.8 million.

Table 4: Indirect Financing Subsidy- Canada to TMC and Pipeline Project

As of 6/30/19 Loan Balance[26]	5,035,000,000.00
Internal Rate of Return Kinder 12% - Commercial Rate[27]	0.12
Annual Interest on Commercial Rate	604,200,000.00
Half year Interest	302,100,000.00
Canada Fund Interest Rate 4.7%[28]	0.047
Annual Interest and Canada Account Rate	236,645,000.00
Half Year Interest Payment (IEEFA Estimate)	118,322,500.00
Market Rate minus Canada Account	367,555,000.00
Indirect Subsidy 1H 2019	183,777,500.00

This amount is considered an indirect subsidy. It is not paid in cash during the accounting period and is neither recorded in the CDEV nor in the TMC presentation. In any calculation of the cumulative subsidy, however, this amount should be identified and added to the principal basis of the direct cash provided by the Canadian government. The Canadian government should recapture the full principal and private IRR (minus the subsidized rate paid by CDEV) through the sale of the pipeline.

IEEFA acknowledges that these are loans provided in the national interest and do not have to adhere to commercial standards. This exercise is a financial analysis with fiscal consequences for Canadian taxpayers. It is about transparency and not meant to be a legal challenge to the right of the Canadian government to subsidize the pipeline project.[29] It is a matter of dollars at risk that the Canadian taxpayer must absorb.

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[26] CDEV, Second Quarter 2019 Interim Financial Report, Note 10: Loan Payable, p. 24.
[27] Trans Mountain Pipeline ULC, CAPP IR Response, b. 9-6, p. 5 f 7. November 29, 2012.
[28] CDEV, Second Quarter 2019 Interim Financial Report, Note 10: Loan Payable, p. 24.
[29] As noted in our two prior reports on the Trans Mountain pipeline, the funds provided by the Canada Account are transactions taken in the national interest. They are considered too risky to be part of the Canadian government's programs to manage risk for other qualified investments. The loans from the Canada Account, nevertheless, are structured very much like the other programs and require loans to be repaid to the Account. As the Canadian government bears the

V. Observation on the Status of the Trans Mountain Corporation (1H 2019)

TMC's operational revenue does not cover its expenses. The Consolidated Statement shows a net income for TMC of $43.2 million (see Table II). This is highly misleading. The presentation relies on an accounting treatment that does not include all the interest and pension costs in the net income calculation. The net income presentation in the Consolidated Statement, therefore, does not capture the full complement of expenses incurred by TMC during the report period.

A more complete picture is achievable if TMC's actual financials are presented that include the full complement of expenses deducted from revenues (See Table V). This full presentation of the financials for 1H 2019 indicates the Corporation has a $67.1 million pre-tax loss and a $12.9 million loss after taxes.

Table 5: TMC IEEFA Adjusted Total Gain/Loss for 1H 2019

	Amount
Revenues	219,195,000.00
Expenses	(158,660,000.00)
Financing Expense	(66,939,000.00)
IEEFA Adjusted Pension Expense	(24,358,000.00)
IEEFA Adjusted Other Financing Expense	(46,337,000.00)
Total Operating Gain or Loss	(67,099,000.00)
Tax Offset	54,170,000.00
Total Net Gain or Loss	(12,929,000.00)

IEEFA has made two adjustments to the income and expense disclosures presented in CDEV's consolidated statement.

The first is to consider the $24.4 million Pension Expense (Other Comprehensive Income) as an above-the-line expense that should be subtracted against TMC's revenues. The actual pension expense covers TMC's employees and would normally be part of salaries and benefits.

The second is to consider the Other Financing charge of $46.3 million as an actual expense of TMC. The decision was made to divide the cash provided to TMC into two components 55% debt and 45% equity. This construct creates an accounting treatment that lowers the amount TMC pays for interest out of its own revenues. The 55% TMC debt requires it to pay the direct interest on the debt ($66.3 million).

ultimate risk, it can adjust or forgive outstanding amounts. See: IEEFA, Canada's Folly and Trans Mountain Pipeline Financials.

TMC is not required to make any "dividend" or other payment as part of the 45% equity arrangement. [30]

CDEV, on the other hand, is required to pay the Canada Account for the 45% equity amount and so it must show the $46.3 million in interest payment coming from another source. In this case, it is taken from the profits of CHHC.

The $46.3 million expense now attributed to Other is actually an expense incurred

by Trans Mountain Pipeline and is more appropriately ascribed to TMC's expenses for the purpose of calculating its profit and loss as an independent entity.

These two adjustments increase the actual expenses for TMC. TMC's revenues do not cover the full complement of costs. TMC runs at a pre-tax loss of $67 million. After taxes, the loss is $12.9 million.

TMC will likely continue to run deficits and require additional third party coverage of losses.

TMC is able to achieve a net positive income of $43.2 million in the Consolidated Statement only by using an accounting treatment to offset actual expenditures. The IEEFA adjustments align actual revenues with actual expenses for the period and show a net loss for TMC.

Notwithstanding the accounting treatment in the Consolidated Statement, this analysis suggests that TMC will continue to run deficits into the future and will require additional third-party sources to cover the losses.

1. The net loss for TMC is likely to increase. As noted above, the project has borrowing authority up to $4 billion for construction through 1Q 2020. This will add an estimated $188 million in new annual interest expense onto CDEV and proportionately to TMC's operating expenses. An additional burden, under the current structure, would be placed on CHHC to produce more revenue as well.

2. CDEV, as a Crown Corporation, is at risk of running a deficit that will persist until the pipeline is sold. The 1H 2019 CDEV report identifies $30.2 million in net income. The financial presentation carries $24.3 million in Other Comprehensive Income (pension payment) below the net income line. Essentially CDEV has a net income for 1H 2019 after the subtraction of the pension payment of $5.7 million. As the construction loan amount increases substantially over the next year, CDEV is likely to run a deficit, as CHHC is unlikely to generate sufficient revenue to cover the rising interest expense. It is equally unlikely that TMC's shipping rates are going to increase to reflect

[30] According to Table II, TMC has $2.2 billion in equity holdings.

the actual costs of TMC's operations and construction. A similar set of risks is likely to be transferred to the Canada Account finances.[31]

Conclusion

This paper provides an estimate of the cost of the subsidy to the Canadian government for its participation in the Trans Mountain Project for the period January 1, 2019 through June 30, 2019. The amount is substantial and will grow. The Canadian government has undertaken significant energy sector investment that involves substantial risk. The Canadian government should more fully report on the actual cost of this project to the taxpayer.

[31] Because the reporting period for the Canada Account ends on March 31, 2018, the most recent audit acknowledges the transaction, but does not fully integrate it into its disclosures. The size of this transaction in subsequent audits will require some adjustments by the Canada Account in order to maintain financial and program risk balance. Canada Account Financial Statement 2017-2018

Appendix: Report Methodology and Subsidy Considerations

A. Scope of Report and Principal Documentation

The purpose of this exercise is to analyze the first half 2019 financial disclosures made by the Canada Development Investment Corporation (CDEV)[32] and the Trans Mountain Corporation (TMC).[33] The focus of the review is of direct and indirect subsidies provided by the Canadian government, its related subsidiaries and the Alberta government to support the operations and financing of the recently acquired Trans Mountain Pipeline.

The primary data source for this review is the financial disclosures of CDEV and TMC for the first half of 2019 as covered in the 2Q financial presentation. The government of Canada has acquired and is completing construction of the Trans Mountain Pipeline expansion. At some point, perhaps at the completion of construction, the federal government anticipates selling the pipeline to a private sector concern. Presumably, the government of Canada would hope to recoup its investment and record a surplus, if the sale price exceeds the total project outlay. However, the mounting subsidies for ongoing interest expense and principal repayment of debt incurred suggest that if Trans Mountain is sold, it will be at a loss, representing a taxpayer-funded subsidy for the project.

B. Importance of Sound Financial Benchmarks for Canadian Ownership

At issue is the size of the federal government outlay for the Trans Mountain expansion project. While the flow of funds through the Canadian government's alphabet soup of fiscal and economic development corporations affords program accountability, it also is a hindrance[34] to answering the question: How much money is being spent? The federal government could, quite easily, adopt a financial report detailing the amount being spent and report it to the public periodically. This is not being done in any systematic, transparent way.[35]

Because of the failure of the government to provide clear reporting, IEEFA is working to tally the amount spent to acquire, operate and construct the pipeline in a series of reports, including this one. IEEFA reports are derived from publicly available information.

[32] CDEV, Second Quarter 2019 Interim Financial Report, August 22, 2019.
[33] Trans Mountain Corporation, Second Quarter 2019 Financial Statement and Management Report, August 25, 2019.
[34] IEEFA, Trans Mountain Pipeline Financials, April 2019.
[35] For a discussion of how the government's reporting, absent a more complete discussion of the overall financial context, is inherently misleading see: IEEFA, Trans Mountain Pipeline Financials, April 2019, p. 14.

C. Financial Benchmarks for the January 1, 2019 Through June 30, 2019 Report

i. Key Questions

This report covers the subsidies to the project from January 1, 2019 through June 30, 2019. The time period involved captures the initial operational solvency of the TMC. It addresses the questions: How many public dollars has it taken to maintain the operations of the existing pipeline and to get the construction phase up and running? Are the revenues being generated by the existing pipeline operation that is now in Crown possession sufficient to cover operating expenses and financing costs due and owing to the principal investor, the Canadian taxpayer?

ii. Data and Transparency

In addition to the two quarterly reports recently released by CDEV and TMC, certain supplemental government financial reports have been relied upon. Most notably, the FY 2018 Export Development Corporation (EDC) Annual Report,[36] the FY 2018 Canada Account Annual Report,[37] and various administrative filings identified throughout this report. There are sections of each of these reports that relate to the development of the Trans Mountain pipeline and rate agreements between TMC and its suppliers.

IEEFA has also produced two prior reports on the Trans Mountain Pipeline. The first report covered the details of the acquisition transaction between Kinder Morgan, the prior owner of the pipeline, and the Canadian government.[38] The second report analyzed the publicly available information being made available by the Canadian government and made recommendations for improvements in transparency.[39] Those recommendations have so far been ignored.

The recently released quarterly reports and collection of financial data, taken together, provide a less-than-perfect picture of TMC's and other CDEV subsidiaries' financial condition. The financial disclosures do, however, provide sufficient income and expense and balance sheet information to conduct this analysis. This analysis focuses on:

1. The financial operations of TMC. Is it generating a surplus or a loss, and if a loss, what combination of cash and accounting treatments have been used to address them?

2. The impact of the loan agreements between CDEV and the Canada Account. What are the terms and conditions of the loan, particularly interest rate and

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[36] Export Development Corporation, FY 2018 Annual Report.
[37] Export Development Corporation, Canada Account Annual Report for year ending March 30, 2018.
[38] IEEFA, Canada's Folly, June 2018.
[39] IEEFA, Trans Mountain Pipeline Financials: Built on Quicksand and Clear as Mud, April 2019.

payment terms? What is the configuration used to insure payback of the loan?

3. The effect of CDEV's and TMP Finance's agreements on TMC's profit and loss position.

iii. What Is a Subsidy and How Is It Counted?

Once this analysis is completed, it is easier to identify those areas where the Canadian government has filled the financial gaps in project operation and finance. To establish TMC as a going concern required a substantial outlay of cash by the Canadian and Alberta governments, favorable repayment terms and an ongoing commitment to cover operational losses.

The term "subsidy" in this report, and in future reports, will be used to identify and quantify direct cash outlays made by the Canadian government, its subsidiaries and the Alberta government and indirect financing deferrals or waivers by the Canadian government that accrue to the benefit of the pipeline project. This report assumes that upon sale of the pipeline by the federal government to a private operator, these amounts plus others related to the acquisition and construction are due and owing to the Canadian taxpayer. This report considers the cash outlays and indirect accruals to be subsidies. Until such time as the government sells the pipeline and a complete reconciliation of that sale price with an accurate measure of the Canadian government's costs is undertaken, IEEFA considers the outlays as dollars at risk since there is no guarantee that the eventual sale price will cover all the actual costs.

This report focuses on three specific subsidies that can be found in the 2Q 2019 financial disclosures.

First, the Canadian government's subsidiary, Canada Hibernia Holding Corporation, "CHHC", provided direct cash subsidies to TMC to cover financing expenses that are directly attributable to the TMC pipeline and unrelated to CHHC's business. Specifically, revenues and surplus from the sale of oil by CHHC are derived from a business entity with a separate corporate purpose and business activities from TMC. The Consolidated statement shows that revenues produced by CHHC have been transferred through the Consolidated business statement to TMC. In this report, this is deemed a direct cash subsidy because the proceeds of CHHC are the property of the Crown and the Crown is free to utilize these revenues for any purpose. The Crown has decided to use these revenues to offset TMC's losses instead of for general budget purposes.

Second, the report takes account of indirect financing subsidies made to the project that are tied to the Canadian government's decision to provide funds from the Crown's Canada Account. The interest rate charged by Canada (effectively the Canadian governments internal rate of return for the investment) to TMC is lower (4.7%) than the (12%) internal rate of return that Kinder Morgan, a private corporation would require to undertake the project as a going commercial concern.

The substantial difference in the costs of the different internal rates of return is not recorded anywhere in the financial statements. IEEFA's estimate is that for the six months covered in this report, the savings from the lower government interest cost are $183 million on the basis of the $5 billion outstanding loan.

Third, as of January 1, 2019 the Alberta government initiated a Job Creation Tax Credit[40] that reduced corporate tax rates and provided a benefit to TMC of $54 million. The overall tax change, including the TMC benefit cost the Province $500 million in lost revenue in FY 19-20.[41] The item is considered a subsidy as it is: a) lost revenue to the government to support business generally in a down market; b) the down market is driven in large part by a drop in the price of oil and weaknesses in the oil sands sector; c) is part of the same budget where personal income taxes are being temporarily increased.[42]

To properly determine whether the Canadian government receives a price for the pipeline that breaks even or makes a profit requires a commercial standard of analysis. The proper commercial standard takes the total amount borrowed for acquisition and construction and adds to it any interest accruals and other costs to form the final cost of the project. In such a final tally, the cost of ownership by the Canadian government becomes the target price for the resale of the pipeline and related assets. The price achieved through the sale minus the final project cost determines whether the government breaks even or declares a profit or loss. The loss, if there is one, is the final actual subsidy. IEEFA carries these costs as a subsidy in this report as they are dollars at risk.

Although the Canadian government has provided this financial benefit to TMC, it also acknowledged a fiduciary obligation to secure the repayment of the money it has lent. The use of the Canada Account is an acknowledgement of the high-risk nature of the investment. EDC, with the support of the Finance Minister, has the authority to forgive all or part of any indebtedness issued under this program.[43] It nevertheless uses commercial standards regarding debt management.[44] What is lent to the project must be paid back with interest.

[40] Alberta Province, Annual Budget 2019, p. 8.
[41] Ibid, p. 64.
[42] Ibid, p. 11. See discussion of temporary recession of indexation and a number of tax credits.
[43] Government of Canada. Justice Laws. "Export Development Act. Section 23."
[44] EDC, 2018 Financial Statement, p.1.

About IEEFA

The Institute for Energy Economics and Financial Analysis conducts research and analyses on financial and economic issues related to energy and the environment. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

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