

A Call for Action: II

A Report by the Manufacturing Competitiveness Committee of the
Canadian Automotive Partnership Council



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EXECUTIVE SUMMARY

Ten years ago, CAPC established its vision as the following:

"To be the location of choice for automotive manufacturing within North America, driven by globally competitive innovation in a profitable and growing new-vehicle market."

Then, as now, governments around the world recognized that automotive production can act as a catalyst for rapid economic development. As a result, governments compete vigorously with a wide variety of public policy tools to attract and retain automotive production footprints.

When CAPC first released 'A Call for Action' in 2004, the total number of vehicles produced in Canada was 2.9 million units: nearly a record. The exchange rate was 70 cents to the U.S. dollar and Canadian labour costs were appreciably lower than they were in the U.S. With only 10 percent of the North American market, everyone in the Canadian automotive industry – including government policy makers – understood that to be perceived as attractive as the U.S., Canada actually had to be significantly better than the U.S. In 2004, many would say that Canada did, in fact, offer a more compelling story for investment than the U.S.

In the intervening years, the Canadian industry has experienced significant upheaval. The dollar has soared, major industry players have been restructured, and transformational labour agreements have interrupted the competitive calculus between Canada and its NAFTA partners.

Certainly, production has steadily recovered to pre-financial crisis levels, but encouraging signs on the surface hide worrying trends. Many have observed that Canada has gone from being one of the lower cost places to build vehicles in the world, to one of the more expensive. The Canadian industry is responding by keeping its cheque book closed.

- Capital spending is now half of what it was in the 1990s and 2000s. Even without factoring in inflation, spending has dropped to levels not seen since the 1980s.
- Of the 3.5 million units of assembly capacity that will be added to the North American auto industry between 2011 and 2015, Canada will receive just three percent ... despite having 16 percent of production and 10 percent of sales.

The longer the Canadian industry is starved of investment, the older and less productive its capital base will become. The less productive Canadian plants get, the more difficult it will be to justify new spending; a cycle of spending deferral that, left unchecked, will eventually send the industry to irrelevance.

But it is not too late. Steps can be taken. Therefore, Canada – its policy makers and its automotive industry alike – must sharpen its game. For the Canadian automotive industry to compete and thrive in this new global arena, CAPC has identified several actions that both the government and the private sector should undertake. These include:

PUBLIC SECTOR ACTIONS:

1. **Compete for Investment with Globally Competitive Investment Supports:** Given the global competition between jurisdictions for automotive investment and the relatively small size of Canada's automotive sales market when compared with other auto producing countries around the world, Canada must compete with meaningful, tangible, and effective support measures.
2. **Reduce the Fully-Loaded Cost of Labour:** At current exchange rates, the fully loaded cost is higher in Canada than it is in the U.S. This is a problem for Canada because:
 - The cost of labour is a high profile differentiator with investment decision makers
 - This traditional source of advantage for Canada has shifted so rapidly

In such a difficult and competitive context, ancillary labour costs under government direction need to be carefully controlled. This includes items like employment insurance, the employer health tax and workers compensation premiums

3. **Provide One Stop Support for Investment Attraction:** Provide a single window experience for investment that coordinates federal, provincial and municipal government stakeholders; similar in approach to that so successfully employed by ProMexico.
4. **Improve Transportation Infrastructure and Border Policy:** Undertake measures to reduce logistics costs and risks by closing the transportation infrastructure gap. This includes timely construction on the Windsor- Detroit Bridge and taking major action to reduce GTA gridlock without adding new costs to businesses.

Also, given the integrated nature of the industry, continue efforts to reduce the cost and improve the speed of the movement of goods and people between Canada and the U.S.
5. **Ease Regulatory Burden:** Redouble efforts to eliminate unique, overlapping or redundant regulations between provinces, between Canada and the provinces, and between Canada and the U.S.
6. **Pursue a Free and Balanced Trade Agenda:** Pursue trade policy initiatives based on principles that:
 - a) Respect commitments made by existing manufacturers
 - b) Increase export opportunities for Canadian manufacturers in a sustained and measurable manner
 - c) Provide reciprocity, ensuring the industry in Canada derives a net benefit from both sales and production of automotive vehicles
7. **Align the Number of Working Days with Competitor Jurisdictions:** The number of days available for work is less in Canada than in the U.S. Ways must be found to maximize Canadian operations' use of fixed capital.

PRIVATE SECTOR ACTIONS:

1. **Invest in Plant, Machinery and Equipment:** Plants must be up to date with the most productive, effective technology. The Canadian auto industry must respond to the improved fiscal and economic environment (including favourable tax changes, such as the extension of the Accelerated Capital Cost Allowance), by expanding investment in machinery and equipment.
2. **Invest In People:** To meet future challenges, Canada must become more productive and more innovative. Along with re-investing in its facilities, the Canadian automotive industry must also invest in the training and development of people. Improved innovation and productivity - the lifeblood of the industry – is achieved when companies and countries invest in machinery and equipment AND the people who operate and manage those investments.
3. **Invest in Research and Innovation:** Improve the capabilities of Canadian researchers and the Canadian automotive industry to develop mutually beneficial relationships that:
 - Create highly-qualified people
 - Demonstrate the talents of Canada to global decision makers
 - Create innovation and commercialization opportunities in Canada
4. **Develop a Clear and Compelling Narrative for Canadian Investment:** Collaborate with governments in Canada to develop a clear, compelling and consistent case for investment in the Canadian automotive industry – one that may be utilized by industry and government alike to support an ongoing message to:
 - Global decision makers about why Canada can be a better, more dependable and secure long-term investment option
 - Canadian taxpayers about why supporting the Canadian auto industry is essential

1. THE CONTEXT: CAPC AND THE CANADIAN AUTOMOTIVE MANUFACTURING INDUSTRY

BACKGROUND

The Canadian Automotive Partnership Council (CAPC) was formed in September 2002. The Council, consisting of senior executives and stakeholders involved in the industry, was established to provide a forum for industry stakeholders, government, and the research community to discuss common issues and to identify actions to strengthen the Canadian automotive industry in both the short and long terms.

Following broad consultation and discussion during its formative years, the Council established the following as its vision for the Canadian automotive industry:

"To be the location of choice for automotive manufacturing within North America, driven by globally competitive innovation in a profitable and growing new vehicle market."

The Council is a unique and valuable forum where firms who compete daily in the marketplace set aside their competing interests to come together with labour, researchers and governments to collaborate in the best interests of the industry as a whole. This report is an example of that collaboration as it was developed through a process of analysis and discussion among CAPC members.

Note: *The views and recommendations contained herein are a consensus reflecting the collective deliberations of CAPC members and working group participants, but do not necessarily represent the view of any individual, organization or government participating in the CAPC process.*

The Council has also established a series of working groups that support the overall direction of the Council. The Manufacturing Competitiveness Committee, under which this paper was developed, is one such group, consisting of representatives of all Original Equipment Manufacturers (OEMs), suppliers and labour.

CANADA'S AUTOMOTIVE INDUSTRY: DRIVING GROWTH

The Canadian automotive industry is a critical engine for innovation and economic growth in Canada. By virtually any quantifiable standard, the contributions that the automotive sector makes, either directly or through spinoff benefits to the Canadian economy, are impressive. Those contributions come in the form of assembly capacity, employment, innovation, trade, capital investment, or its capacity to generate spin-off benefits.

ASSEMBLY CAPACITY

Dependent upon one's perspective, the data surrounding Canada's auto industry can be interpreted as evidence of success or failure. The reality, however, is more textured and examination reveals concerns for policy makers and industry participants.

On a positive note, Canada's eight high-volume assembly plants produce more than 2.4 million vehicles annually. That makes Canada the world's 11th largest auto assembly nation. Despite representing less than 10 percent of North American automotive sales, Canada currently produces approximately 19.6 percent of all vehicles made in the U.S. and Canada and about 16 percent of all vehicles produced in North America, including Canada, the U.S. and Mexico.

It is also relevant to note that Canada has maintained a 16 percent North American share of production throughout the period 2000 to current. Meanwhile, Mexico has jumped from 11 percent to 19 percent. To date, all of the Mexican increase has come at the expense of the U.S.

While it may be convenient to represent the stability of Canada as evidence of relative

success, doing so would be naive. Since CAPC was originally established in 2002, several automakers have closed manufacturing capacity in Canada. Others have added capacity, effectively mitigating the net effect of the closures. However, most of those decisions were made early in the last decade ... before the trough ... before the escalation of the Canadian dollar ... before the U.S. government's intervention in the industry.

Going forward, as the preponderance of North American automotive investment announcements made in the past two to three years come on-stream (investments that have almost exclusively targeted the U.S. South and Mexico), Mexico's growing share will continue to climb and the U.S. decline appears set to reverse.

The eventual effect of this is that Canada will be hard-pressed to maintain its 16 percent share.

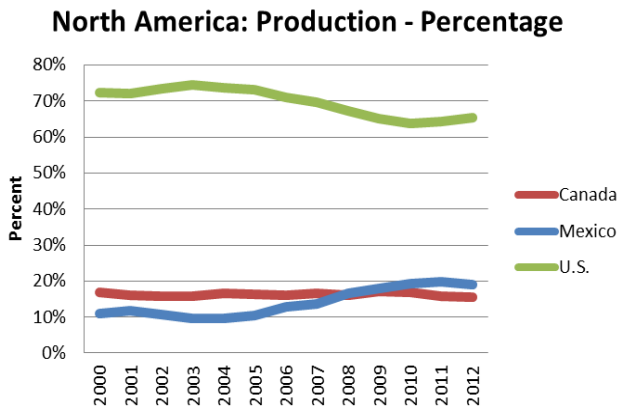


FIG. 1

EMPLOYMENT

More than 115,000 Canadians are directly employed in vehicle and motor vehicle parts manufacturing - 7.7% of all manufacturing jobs in Canada. A significant number of jobs were lost during the period 2007-2009, but some stability has returned. 160,000 more are employed in automotive wholesale and retail operations; and hundreds of thousands of additional jobs result from the spillover of the

auto industry and the purchasing power of its employees.

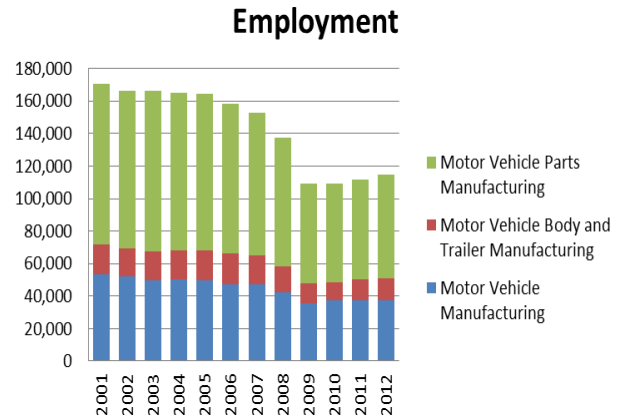


FIG. 2

INNOVATION, TECHNOLOGY AND PRODUCTIVITY

If Canada aspires to remain a large and relevant automotive manufacturing jurisdiction, doing so on the basis of low cost labour is no longer an option. Instead, it must be a leader in productivity, deploying leading edge technology in both products and processes. Over the past few years, the Canadian automotive industry has consistently demonstrated greater productivity gains than manufacturing overall. In fact, Statistics Canada shows that labour productivity in the automotive sector grew by 22.5% between 2009 and 2012.

BALANCE OF TRADE

Annual automotive exports are approximately \$64 billion. For decades, the Canadian auto sector delivered a large net balance of trade. Historically, the parts sector generated a deficit; however, deficits on the parts side existed to support a disproportionately large final assembly industry. Furthermore, those deficits in parts were always overcome by significant positive balances in final assembly.

In 2006, however, a historical positive trade balance in the overall sector slipped into deficit.

This occurred because huge surpluses on the assembly side started to slide. Indeed, a \$33 billion surplus in motor vehicle trade, which existed as recently as 2001, slipped to just over \$7.9 billion in 2012, not nearly enough to mitigate a \$22.6 billion deficit on the parts front.

Despite the negative trade balance, the auto sector continues to be Canada's #1 manufactured export, accounting for 14.8% of all Canadian exports in 2013, and Canada's #2 overall export behind oil.

CAPITAL INVESTMENTS

Annual investment in fixed capital (plant and equipment) by the Canadian automotive industry is in the range of \$1.5 billion, down from an average of at least \$3 billion each year during the early 2000s. This lack of spending may be an offshoot of decision makers' increasingly pessimistic view of Canada.

Prolonged low levels of spending will ultimately make the productivity improvements noted above difficult to sustain. If the trend is not reversed, the effect will be that the Canadian automotive industry will be less competitive.

Canadian Auto Sector: Balance of Trade

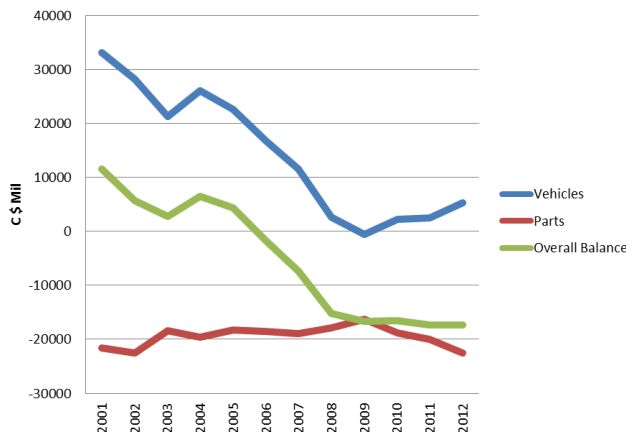


FIG. 3

SPIN-OFF CONTRIBUTIONS

The auto sector continues to be Canada's #1 manufactured good and a key driver of high-value added manufacturing jobs capable of sustaining a vibrant middle class in Canada. External studies (Center for Automotive Research, 2010) indicate that every one job in an automotive assembly plant supports an additional nine jobs, for a total of ten, in the broader economy. This is the highest multiplier of any sector. Put another way, every assembly plant with 5,000 direct jobs generates a total employment impact of 50,000.

2. OUR POSITION IN NORTH AMERICA

HISTORICAL CONTEXT

Canada has many positive attributes that support manufacturing. These include:

- A competitive tax system
- Highly skilled and motivated workers
- Proximity to markets
- Well-developed transportation infrastructure
- Leading edge post-secondary institutions that support both training and research and development

Yet competition is fierce, particularly in high value-added industries like auto production. Right now, the challenges seem overwhelming. However, this is not the first time Canada's auto industry has been beset by challenge. Each time the industry has confronted structural hurdles in its 100 plus years of history, the industry and its policy makers have collaborated to build new sources of competitive advantage. For example:

- High tariffs in Canada caused Henry Ford to partner with Gordon McGregor to build vehicles in Walkerville, Ontario in 1904... the effective start of the industry in Canada
- Preferential trade agreements in the first half of the 20th century allowed Canadian facilities to grow beyond North America... allowing an expansion of the industry
- Tariff adjustments occurred regularly in the 1920's and 1930's... ensuring survival of the industry
- The AutoPact was introduced in 1965... providing the framework for a sustainable future
- Trade policy tools and incentives were utilized in the 1980's... introducing new entrants to the industry

In more recent times, the resilience of Canada's automotive sector saw it through the financial crisis

and the deep, prolonged global recession of 2008/09. A historic collaboration between private and public sectors in two countries recognized and valued the integrated nature of the auto industry and supported the auto sector during that difficult period. Now, although the industry would appear to be in a period of recovery, the reality is that many of Canada's original competitive advantages have been eroded.

Canada is not alone in utilizing policy tools to support the automotive industry. It is a century-old practice because policy makers all over the world understand that automotive manufacturing provides a unique and powerful capability to generate significant and rapid benefits to workers, to communities, and to governments.

As it has in the past, our industry must continue to adapt, innovate and work together to ensure it remains viable and competitive.

AUTOMOTIVE CONTRIBUTION TO GDP

Manufacturing remains relevant and automotive manufacturing, in particular, is important. The facts are these:

- Ontario's auto sector remains the #1 contributor to Canada's manufacturing GDP
- In 2012, manufacturing represented roughly 11 percent of Canadian GDP and 10 percent of Canadian employment. Auto manufacturing made up about 9.6 percent of overall manufacturing GDP and 7.7 percent of manufacturing employment

Manufacturing is an important contributor to a healthy, sustainable economy, and automotive production anchors and drives the manufacturing sector. It continues to sustain a healthy middle class in Canadian society because it is highly productive and provides high value-added jobs.

3. WHERE WE STAND

FAIR SHARE OF NORTH AMERICAN INVESTMENT

The recipe for being a competitive place to make autos has three key ingredients:

1. A location close to customers
2. High quality products
3. Competitive costs

Over the past decade, despite fierce competition and unprecedented upheaval in the manufacturing sector, FIG. 4 shows Canada’s output ratio has remained relatively constant. Further, as demonstrated earlier in FIG. 1, when production figures are compared from 2001 to 2012, we see that Canada has maintained its share of North American production in the 16 percent range despite the dramatic events of that decade (including a major currency appreciation and the global financial crisis and subsequent recession). Mexico’s share has grown from about 12 percent to about 19 percent, while the U.S. share has declined from about 72 percent to about 64 percent.

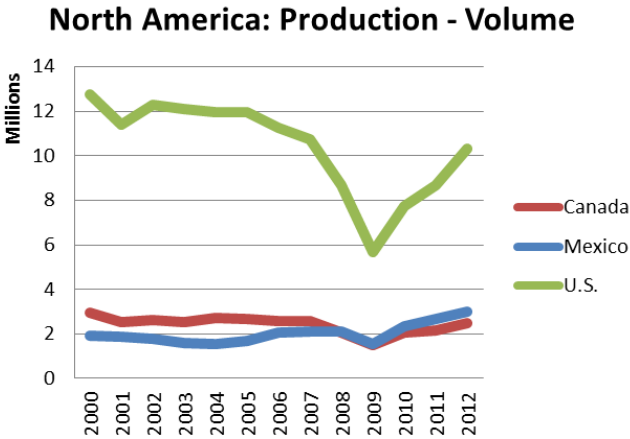


FIG. 4

However, a closer look at the Canadian situation reveals a looming challenge if the country is to retain its share of production and investment, particularly when one considers projections into the latter years of this decade and into the next.

The truth is this: Canada is no longer getting its ‘fair share’. During the period 2011 to 2015, Morgan Stanley estimates that 3.5 million units of capacity will be added by automotive manufacturers in North America. Of that, the U.S. is poised to receive 63% and Mexico will gain 34%. Canada will add 110,000 units of capacity, just 3% of the total.

Left unchecked, the industry will decline. Statistics Canada shows that over the period 2009 through 2011, an average of only \$1.5 billion was directed to capital spending. This is a sharp drop from the approximately \$3 billion the industry invested annually in Canada between 2000 and 2008.

If this trend is not reversed, Canada's production levels will actually decline.

Capital Spending, Construction, and Machinery &

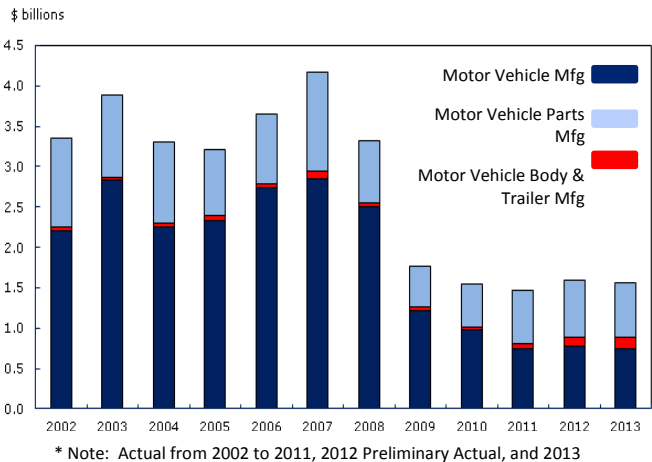


FIG. 5

Investments have heavily favoured the U.S. and Mexico. Mexico is maturing to become a low-cost, export-friendly manufacturing jurisdiction. The U.S. is starting to benefit from a manufacturing renaissance prompted by “re-shoring”, transformational labour agreements and a renewed emphasis by governments at all levels to support, attract and retain manufacturing operations.

Thus far, the re-shoring phenomenon has bypassed Canada. In a developed economy like Canada – one with relatively high cost labour – there can be no manufacturing renaissance without long-term, sustainable, elevated levels of productivity growth. Although the Canadian automotive industry has demonstrated higher than average productivity growth in recent years, relatively low levels of productivity enhancing investments in the post-2008-2009 period will eventually show through. Productivity will decline, investment levels will drop further, and employment will eventually decline.

Canada's troubling trend with respect to investments in auto-related machinery and equipment has occurred despite the fact that other indicators would suggest that the opposite should have occurred. For example, the appreciation of the Canadian dollar should have made such expenditures more affordable. Meanwhile, the perceived high relative cost of labour in Canada, compared to many competitor jurisdictions, would suggest that productivity enhancing investments in capital equipment should have occurred. Beyond that, tax changes - including accelerated depreciation and lower corporate income tax rates - have enhanced the business case for Canadian investments.

It is imperative that policy makers, researchers, and the industry collaborate to understand what is happening here.

- Have the arguments in favour of investment in the U.S. South or Mexico siphoned scarce resources out of Canada?
- Are Canadian based executives fighting for investment with the same intensity as in earlier years?
- Are Canadian governments working with the right tools to compete?

Similar questions could be asked with respect to Canada's recent performance in terms of expenditures in research and development.

As the landscape shifts, it is essential that Canadian plants be well-invested. Certainly, failure to maintain investment spending in one year does not

mean immediate closure or decline, but the buildup of non-spending over multiple years can only lead to a single, inevitable conclusion. Facilities that do not have leading-edge technology struggle to compete, and are less productive, thus perpetuating their owners' decisions to delay re-investment. Canada has witnessed its share of this cycle of non-investment with devastating consequences for affected communities, and our overall automotive footprint. The recent announcement by Ford, supported by the Governments of Canada and Ontario, effectively avoided that fate for Oakville, but that single piece of positive news does not offset an extended list of lost opportunities.

COST

Cost comprises a number of elements, the relative importance of which depends on whether one is looking at a parts supplier or an assembler. Significant cost elements include parts and raw materials, labour, transportation and logistics, utilities and taxes. Overall, however, the following observations must be considered.

- Manufacturing is being directed to the Southern U.S. and Mexico because of the relative cost advantage. The cost differential between Canada and the U.S. South and Mexico results from higher costs in Canada related to labour, logistics and outsourced parts. At least one assembler with operations in both Canada and the U.S. South indicates that, on an annual basis, the costs of operating an assembly facility is significantly less in the U.S. South than in Canada.
- Productivity is another variable that enters relative cost comparisons. It is important to note that all automakers employ some form of lean manufacturing and sharing of best practices, a condition which limits any productivity divergences between assemblers' facilities on one side of the border versus another [i.e. a single automaker's plant(s) in Canada is not meaningfully different, in terms of productivity, than another plant owned by that automaker in the U.S.].

- Negotiated contract provisions in Canada have responded to the impact of the rising dollar and new U.S. labour provisions on the competitiveness of Canadian operations. The resulting decline in labour costs in Canada, however, has not fully offset the appreciation of the Canadian currency, so relative costs (in U.S. dollar terms) have increased, and labour costs at current exchange rates are somewhat higher than in the U.S. (and much higher than in Mexico).
- Differences between Canadian and U.S. pension costs and other benefits provided to employees may also lead to labour cost differences between Canada, Northern U.S. states, and Southern U.S. states. Canadian plants have typically migrated to various forms of hybrid defined benefit-defined contribution pension plans. U.S. plants are almost exclusively defined contribution for new hires; a situation which does not always equate with lower cost, but most certainly shifts future risk.
- Canada's traditional advantage of public health care is being eroded because assemblers in the U.S. have been able to shift retiree healthcare costs to Voluntary Employee Beneficiary Associations (VEBAs). That means risk has been reduced in the U.S. as it has shifted from the company to the employee. It must be acknowledged, however, that Canada still retains an advantage in active health care costs.
- Mexico's significant labour cost advantage is only marginally reduced by higher taxes and transportation costs.

4. OPPORTUNITIES AND CHALLENGES

Canada has a relatively strong foundation of automotive assemblers and suppliers. Automotive operations in Canada date back to 1904 and today five of the world's leading global automotive Original Equipment Manufacturers (OEMs) have production facilities in Ontario. The southern Ontario automotive cluster connects a critical mass consisting of five global automotive assembly firms (Chrysler, Ford, General Motors, Honda and Toyota) with world-class parts suppliers and a number of automotive research and development facilities (see Appendix A). Many of the world's largest and most successful original equipment suppliers have facilities in Canada.

However, there are growing challenges. For example, the U.S. is becoming an increasingly attractive destination for auto investment. Particularly since the global financial crisis in 2008/2009, there has been a strong push by U.S. firms to re-shore or move manufacturing operations back to the U.S. from other countries. This re-shoring has resulted in a renaissance in manufacturing in the U.S. that has been supported and encouraged by governments at all levels. Indeed, Michigan recently overtook Ontario as the preeminent auto-producing jurisdiction in North America – displacing the province from its long-held perch.

What is also clear is that Mexico, with its low labour cost and proximity to markets is a preferred location for investment. Certainly, when global decision makers look to invest in North America, they always consider the biggest market – the U.S. – first. However, what has changed is that their second choice is now Mexico, not Canada.

Therefore, Canada must confront a number of challenges if it is to regain its position as a preferred location for global automotive investment and achieve the vision established in 2004.

In this section we look at factors that lead to both opportunities and challenges for the Canadian industry.

MACROECONOMIC STABILITY

The Canadian economy has achieved one of the best performances of the G7 both leading into and coming out of the 2008/2009 global financial crisis. Canada has led the recovery among G7 countries, the first to return its GDP to pre-recession levels. Inflation is low and the country boasts the lowest debt to GDP ratio of any country in the G7. In automotive sales, the decline in Canadian vehicle sales of 11 percent during the financial crisis was not nearly as severe as the dramatic drop in the U.S. sales market of 37%, which led to the need for restructuring actions in the North American auto industry. Since the financial crisis, Canada's new vehicle sales have already returned to pre-recession levels, and 2013 will set a new record. The U.S. is still expected to take several more years to return to its pre-crisis level of 17 million units.

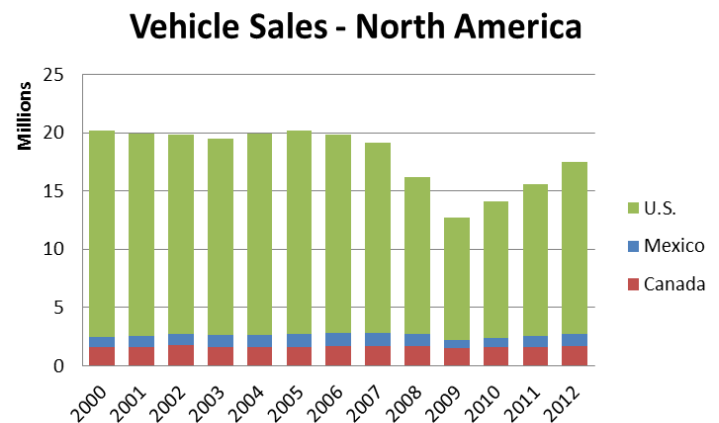


FIG. 6

TAXATION

Canada is a leader in offering low corporate tax rates. At 26 percent for 2013, the combined Canada/Ontario rate is lower than Mexico by 4

percent, and the U.S. by 14 percentage points. However, the effect of Canada's low corporate tax rate vis-à-vis the U.S. can be muted. That's because U.S. companies earning income in Canada are subject to U.S. taxes. Canadian taxes paid are credited against U.S. corporate taxes owing, effectively eliminating the effect of Canada's low corporate tax rates for those companies.

It must also be recognized that many automakers and parts suppliers incurred significant losses leading into the 2009 restructuring, which can be carried forward and applied to future years. As a result, some of those companies are not presently in a position to benefit from low corporate tax rates, and may not be for years to come.

Meanwhile, Canada currently permits accelerated capital cost allowances (fifty percent straight line depreciation) for investments in machinery and equipment to be deducted from income. Canada's two to three year timeframe for full depreciation of capital investments compares favourably with the five or more years it takes in the U.S. or Mexico. Again, however, many firms are not in a position to benefit from this due to tax loss carry forwards.

In general, it is important for Canada's tax system to be competitive, and by practically any measure, the Canadian regime is, in fact, a leader. The challenge for the Canadian automotive industry is to generate the levels of profitability that will allow many of its key players to leverage the benefits the Canadian system offers.

WORKFORCE

Canada has a well-trained automotive industry workforce.

- Fully 25 percent of young Canadians, 18 to 24 years old, are enrolled in university; a further 14 percent are enrolled in colleges or a skilled trade. It is one of the highest rates in the world
- The Swiss-based Institute for Management Development (IMD) ranks Canada highest in the G7 for the availability of qualified engineers

- In 2010, Canada had the highest proportion of post secondary graduates (51 percent) in the 25 to 64 age group among member countries of the Organization for Economic Co-operation and Development (OECD)

The Global Competitiveness Report for 2012-2013 gives Canada outstanding rankings for its investments in education including:

- First in the G7 in quality of its educational system (sixth in the world)
- Second in the G7 in quality of management schools (fifth in the world)
- First in the G7 in quality of primary education (eleventh in the world)
- First in the G7 in quality of math and science education (fourteenth in the world)

The results documented above speak to the fact that Canada has the capacity to provide high quality management and engineering personnel. What is equally important to the auto industry however, is the assured quality of skilled trades that the Canadian system provides.

The Canadian system of standardized qualifications ensures that individual tradespeople possess a uniform, defined set of skills. This applies to a range of trades, including electricians, millwrights, and tool and die makers. Although this system is well understood in Canada, it may be underappreciated, as similar rigour does not exist in other jurisdictions.

QUALITY OF LIFE

An important and sometimes discounted element of new investment location decision making is quality of life in the jurisdiction in question. In fact, research has shown a positive correlation between quality of life and foreign direct investment. By that standard, Canada should perform very well.

In 2012 the Economist Intelligence Unit Quality of Life Index ranked Canada #1 in North America and #9 in the world. As well, the United Nations Sustainable Development Solutions Network, which monitors a series of factors that contribute to

individual happiness (i.e.: GDP per capita, healthy life expectancy, perceived corruption, social support, etc.), had similar findings, again ranking Canada #1 in North America and #6 in the world.

PRODUCTIVITY

At the most basic level, there are two ways to lower cost: decrease the rate one pays for the input (e.g. reduce the labour rate) or improve productivity by decreasing the amount of the input used (e.g. reduce the number of people employed). In a higher-cost jurisdiction like Canada, it is essential that these two elements be effectively balanced.

Productivity improvements typically require significant capital investments in new production technologies, robotics, and new processes. While some process improvements are ongoing, the bulk of the "step change" improvements in productivity and innovation for an OEM occur every four to six years when an auto company makes a major investment to build a new plant or retool an existing facility. Earning these new or renewed product mandates, therefore, is essential. Gaining mandates not only secures four to six more years of production and employment, it also ensures the plant is rejuvenated, making it more efficient, more up-to-date, and more difficult to abandon long-term.

With the prolonged elevation of the Canadian dollar vis-à-vis the U.S., labour contracts that differ from U.S. equivalents, and the rise of low cost Mexico as an auto producing nation (with all the concomitant infrastructure its rise has generated), measures to increase productivity must be an essential tool for addressing competitive issues in the Canadian industry.

Greater levels of productivity in the auto sector in Canada may mitigate the effects of high relative labour costs and a high Canadian dollar. Increasing productivity can also keep Canada competitive with U.S. equivalents benefitting from more aggressive labour negotiations. Therefore, to ensure that Canada's automotive sector continues to innovate and become more productive – to ensure Canadian plants maintain their competitiveness against plants in other jurisdiction -- it is critical that Canadian

facilities are capable of attracting new product mandates.

QUALITY

The Canadian automotive industry has a well-deserved reputation for quality. Ontario assembly plants have won about one-third of all J.D. Power plant quality awards for North America since 1990. Over the same period, Canadian plants have earned approximately two-thirds of the J.D. Power Gold Quality Awards for vehicles. This has occurred even though Canada has had only about 16 percent of the total assembly plant capacity.

J.D. Power Plant Quality Awards

1991	Toyota Cambridge (Gold)
1992	Toyota Cambridge (Silver)
1993	Toyota Cambridge (Bronze)
1994	Ford St. Thomas (Silver)
1995	Toyota Cambridge (Gold)
1996	Toyota Cambridge (Gold), Honda Alliston (Silver)
1998	Ford St. Thomas (Gold)
1999	GM Oshawa 1 (Bronze)
2000	Toyota Cambridge (Bronze)
2001	Toyota Cambridge (Gold)
2002	GM Oshawa 2 (Gold)
2003	GM Oshawa 1 (Gold)
2005	GM Oshawa 2 (Gold), GM Oshawa 1 (Silver)
2006	GM Oshawa 2 (Gold), Chrysler Windsor (Silver)
2007	GM Oshawa 2 (Silver)
2009	GM Oshawa Car (Silver)
2010	Toyota Cambridge (Gold)
2011	Toyota Cambridge (Platinum)
2012	Toyota Cambridge (Gold), Woodstock (Bronze)
2013	GM Oshawa (Silver), Honda Alliston (Bronze)

FIG. 7

Meanwhile, Canadian-made vehicles also won category awards (placing in the top 3 per category) in the 2013 J.D. Power Initial Quality Study survey. These include General Motor's Impala, Equinox, Camaro and Regal; Chrysler's Town & Country Minivan and 300; Toyota's Corolla and Honda's CR-V and Civic.

AUTOMOTIVE ECOSYSTEM

Canada has an extensive first-class supplier base that covers every product category. A number of leading global Tier 1 suppliers (e.g. Magna, Linamar, Martinrea) are headquartered in southern Ontario. The graph below shows that many of the world's top OEM suppliers have operations in Ontario.

Also, Canada has world-class transportation infrastructure and is proximate to key markets in the U.S. Access to these markets is assured through NAFTA.

Top Suppliers with Operations in Canada

- #2 Denso (Japan)
- #3 Continental AG (Germany)
- #4 Magna International (Canada)
- #5 Aisin Seiki (Japan)
- #6 Johnson Controls (U.S.)
- #7 Faurecia (France)
- #10 Yazaki (Japan)
- #11 Lear (US)
- #12 Delphi (US)
- #13 TRW (US)
- #14 BASF SE (Germany)
- #17 Toyota Boshoku (Japan)
- #19 Hitachi Automotive (Japan)
- #21 Schaeffler AG (Germany)
- #24 Benteler (Germany)
- #26 Dana (US)
- #28 Toyoda Gosei (Japan)
- #29 BorgWarner (US)
- #30 Mahle GmbH (Germany)
- #32 Visteon (U.S.)
- #48 Tokai Rika (Japan)
- #68 Martinrea (Canada)
- #80 Linamar Corp (Canada)

FIG. 8

TARIFFS AND TRADE

Canada boasts a duty-free manufacturing regime (i.e. all tariffs on manufactured inputs and machinery and equipment will be reduced to zero by 2015).

Auto parts destined for assembly plants currently are not subject to tariffs, and this represents a significant benefit for Canada when it seeks automotive investments. The zero tariff treatment for non-NAFTA auto parts used in final assembly represents a modest advantage for some vehicle manufacturers in Canada vis-à-vis their U.S. counterparts.

Today, Canada is also in the midst of a series of ambitious trade initiatives, the results of which could have a lasting effect on the country's automotive manufacturing landscape.

As it pursues its trade agenda, it is imperative that Canada negotiate trade agreements which result in net benefits to the industry; that its negotiators do not sacrifice the automotive industry for other, potentially short term, priorities. Canada's auto sector has made – and continues to make – economic contributions disproportionate to the sector's already large size. Other countries recognize the importance of the auto sector and consistently take measures to nurture and grow their industry. Canadian negotiators must not allow a century of success to cause them to become complacent about the role governments in other jurisdictions play in ensuring the automotive industry's capacity to generate employment and economic growth.

Bilateral agreements with the European Union, Korea and Japan, and a multilateral agreement such as the Trans Pacific Partnership could represent a marked change to the industry. Such agreements will require ongoing monitoring to ensure a net benefit to the Canadian automotive industry from the perspective of manufacturing and sales, as well as the import and export of finished vehicles.

Canada's automotive manufacturing industry supports free and mutually beneficial trade. Indeed, the Canadian auto sector was built on trade; the industry having evolved in response to a series of trade initiatives dating back to its earliest days and the introduction of production in Canada more than a century ago. The most visible of these initiatives was the original Canada-U.S. AutoPact, which eventually led to the Canada-U.S. Free Trade

Agreement and finally to NAFTA. The point: smart and strategic trade policy has always been a feature in the development and growth of the industry in Canada.

Negotiators need to recognize that the Canadian automotive manufacturing industry has been established to support the North American market only. This is different than many of the countries or blocks with which it is negotiating. The industry in those jurisdictions is host to indigenous players – companies that have a global perspective; that were established to support global mandates. Therefore, any measures that expand their market – to make selling in Canada easier – are welcomed by those firms. Meanwhile, the Canadian industry is comprised of subsidiaries; established and mandated to support a North American market.

While Canadian manufacturers may have long-term interest in accessing new markets; making those kinds of adjustments and gaining those mandates takes time and resources. Obviously, any new trade agreements should allow and encourage those opportunities, however, it must be recognized that they are either relatively minor in nature or several years from realization.

Therefore, the Canadian auto industry supports free and mutually beneficial trade. However, policy-makers must understand and respect:

- The significant contributions Canada's existing automakers have made - and continue to make - to Canada's economy and manufacturing sector
- The fact that those investments were made in response to an integrated North American marketplace
- Adjusting for new opportunities outside of North America will take time
- New trade agreements should not put Canada's existing automotive production footprint at risk and should focus on markets that provide meaningful opportunities to grow exports of Canadian-produced vehicles on a sustained basis, with timelines that allow the existing Canadian footprint to adjust

REGULATORY BURDEN

The burden of regulation can be a costly, high profile irritant, particularly when the benefits of certain regulations are unclear. No automotive manufacturer disputes the necessity for clear standards and regulatory oversight. However, when left unchecked, situations can arise when the costs of regulatory burden are greater than the risks of failure.

Insofar as the Canadian automotive industry is concerned, policy makers must avoid the trap of creating inefficient regulations that are not aligned with other auto manufacturing jurisdictions in North America, or which cannot be justified against the costs and associated benefits. Doing so can only serve to fuel perceptions by decision makers that Canada's cost structure is uncompetitive.

The reality is this: 90 percent of the market for Canadian-produced vehicles is in the U.S. The more magnified the negative differences are between doing business in Canada versus the U.S., the less likely decision makers will be to place investment dollars in Canada.

Governments in Canada have recognized this as an issue and have responded with specific and welcomed initiatives. For example, the federal government has established the Regulatory Cooperation Council (RCC) and the Red Tape Reduction Commission to promote regulatory simplicity, efficiency and alignment within North America. The RCC has made progress on product regulatory harmonization for consumers in Canada. Canadian manufacturers will benefit from scale economies associated with the changes.

Despite the progress, federal and provincial governments must accelerate work in this regard with the aim of making Canada's regulatory regime as efficient and cost-effective as possible. If Canada develops a reputation as a "problematic", overly regulated jurisdiction, that reputation will pervade, potentially undermining the more positive messages that Canadian industry leaders and politicians may want to present regarding Canada as a location for investment.

Going forward, CAPC recommends that specific focus be given to environmental regulation. At the federal level, it is recommended that Environment Canada conduct a review of the burden and overlap associated with the Chemicals Management Plan. Meanwhile, it is requested that Ontario's Ministry of Environment review the impact that the following measures or initiatives have on the industry's competitiveness:

- Toxics Reduction Act and associated regulations
- Greenhouse Gas Cap & Trade
- Environmental Compliance Approvals application - response time improvement

(**Note:** please see Appendix C for additional details)

EXCHANGE RATE

With so much trade in parts and vehicles between Canada and the U.S., fluctuations in the exchange rate can be a big disruption to the industry. A decade ago, the Canadian dollar was equal to about 70 cents U.S. Today, the Canadian dollar has risen to near parity with the U.S. and has seen levels as high as 110 cents U.S. For automotive suppliers with payments (costs) in Canadian dollars and receipts (revenues) in U.S. dollars, the rise in the value of the Canadian currency resulted in enormous pressure, forcing suppliers to either find ways to drastically reduce costs or lose money and/or close up shop. This pressure came on top of the drastic drop in demand following the financial crisis of 2008 and subsequent global recession.

The impact of the rising Canadian dollar tended to be not quite as difficult for assemblers and some parts suppliers. For assemblers, the impact has been partially mitigated by the fact that some of their costs and revenues (given Canada's strong net exports of vehicles to the U.S. and import of parts) are in U.S. dollars. Likewise, for some parts suppliers, especially the largest ones with international operations, a mix of costs and revenues in both currencies has given them a partial hedge against currency fluctuations.

EXCHANGE RATE: U.S. \$/C \$

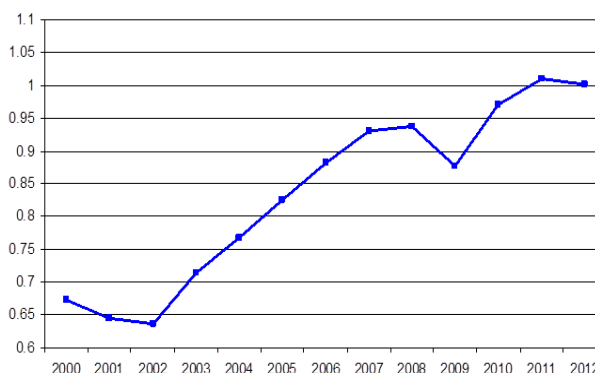


FIG. 9

The OECD places Canada's Purchasing Power Parity (PPP) exchange rate at 81 cents, a barometer indicating that the price of goods and services are generally higher in Canada than in the United States. If the Canadian dollar is in fact overvalued to such an extent, it is possible that the Canadian auto industry has learned to over-perform. Therefore, if the real rate moved closer to its true value, the auto sector could be positioned for a substantial rebound.

Forecasters are of differing views regarding the future path of the Canada-U.S. exchange rate. However, no one is forecasting a return to a Canadian dollar in the 60 cent range. The Canadian automotive industry has worked hard to make the difficult adjustments necessary to compete at a higher exchange rate. The lesson from that period — that a competitive advantage cannot be built on a particular exchange rate — is not likely to be forgotten soon.

LABOUR COSTS

For automotive assemblers, a major source of their Canadian dollar cost is their direct labour expenses, representing between 5 and 10 percent of the final cost of an assembled vehicle (including the expenses associated with administrative staff).

Those making decisions about where to place North American investment understandably place substantial focus on this area:

- Most decision-makers view labour as a controllable cost
- Many actions have been undertaken to reduce labour costs in the U.S
- Measures to reduce labour costs in Canada have not fully offset the impact of the appreciating Canadian dollar
- Labour is the most visible differentiator of costs in Canada versus competing jurisdictions

Until the middle of the last decade Canada's automotive labour costs were relatively low compared to other auto-producing jurisdictions. The foundations of Canada's labour cost advantage were the relatively low value of the Canadian exchange rate and Canada's publicly funded, universal health care system. Since then, the rising Canadian dollar, the emergence of low-cost production jurisdictions (such as Mexico), and changes in compensation practices in other countries has eliminated that advantage, and Canada's labour costs are now relatively high. The shift is described below.

First, the Canadian dollar began to appreciate in 2002, reaching a high of 110 cents relative to the U.S. dollar before moving back towards parity. It currently trades slightly below parity with the U.S. dollar. While forecasts of the future value of the Canadian dollar vary, and some economists expect the dollar to depreciate further, no-one expects it to return to the low levels that prevailed prior to 2002.

Second, Mexico, with its very low labour costs has matured as a manufacturing jurisdiction and has become an increasingly important location of choice for auto production, as a result of its cost advantages and capability to produce high quality vehicles.

Third, as a part of restructuring labour agreements in the U.S., the United Auto Workers (UAW) took a number of actions. This included a new system for funding retiree health benefits, effectively removing this liability from the balance sheet of the assemblers into independent trusts (endowed with large one-time payments from the employers). This shifting of responsibility for future health care costs from companies to VEBAs has insulated companies from the risk of escalating future health care costs,

and has reduced the traditional cost advantage associated with Canada's publicly funded health care system. In Canada, similar independent trusts have been set up to fund retiree health benefits at some companies. Even with the U.S. actions, Canada continues to enjoy a significant cost advantage (worth around \$4 per hour worked) on health care expenses for active workers.

Finally, other features negotiated in UAW contracts also reduced labour costs in unionized U.S. plants. This includes a "two-tier" wage structure that provides a lower wage rate for new hires, subject to company-specific quotas that presently cover about 20 - 25 percent of a company's workforce.

Negotiated contract provisions in Canada have responded to the impact of the rising dollar and the new U.S. provisions on the competitiveness of Canadian operations. Base wages have been frozen for several years, vacation entitlements and other benefits have been reduced, and pensions have been restructured. Similar measures have been taken to control labour costs at non-unionized facilities in Canada.

The most recent CAW/Unifor contracts also include a graduated new hire program, whereby new assembly workers begin work with lower wages and benefits, with improvements phased in over the subsequent decade. They also receive a different pension plan than existing workers. This plan has the potential to reduce labour costs for new hires, at least during their first years of employment, to levels that are competitive with the UAW new hire system. CAW/Unifor new hires reach full base wages after 10 years. How this affects relative competitiveness in subsequent years will be determined by the evolution of negotiations in both countries, and by the impact of the 20 – 25 percent cap on new hires in U.S. facilities.

Fully Loaded Labour Costs, Base Rates, and Decision Makers' Perceptions

Investment location decisions are influenced not only by moment-to-moment relative cost factors, but also by the perceptions and expectations of senior decision-makers. In recent years, trends with

respect to labour costs in Canada versus those in the U.S. have had a tremendous effect on the perceptions of automotive investment decision makers.

If the Canadian dollar was still at 70 cents U.S., as it was in 2004 when the first 'Call to Action' was being compiled, a Canadian assembler's fully loaded labour costs would not be about \$50 per hour (expressed in USD) as they are today. Instead, they would be closer to \$35. If that was the case, discussions about the competitiveness of the Canadian auto industry would most certainly have a much different tone.

A decade ago, low cost labour was a major benefit of making vehicles in Canada; possibly the most important advantage of all.

Canadian auto assembly labour costs have been reduced significantly in own-currency terms in recent years. But the appreciation of the Canadian dollar has more than offset those savings when expressed in U.S. dollar terms.

Canada's main advantage vis-a-vis the U.S. has been rapidly eliminated, and this could prove devastating. To inspire the location of investment in Canada, removed from the "head office" and "home market" pulls experienced by international OEMs, Canada needs to have an advantage – and it is no longer labour costs.

When Canada had a major labour cost advantage, it received automotive investment disproportionate to the size of its market. Now that this major advantage has evaporated, automotive investment spending north of the border has diminished.

Despite the upheaval that has been witnessed over the past decade, the reality is that the fully loaded labour cost for Canadian assemblers is still only marginally higher than it is in the U.S. Mid-west. But rather than focus on fully loaded costs, most discussions around labour costs focus mostly on the base rate. That is because it is easy to compare base rates in one company or jurisdiction to another. It is more challenging to consider additional cost elements like costs of training or attrition, employee insurance, pension plans, social security, bonuses or other benefits.

Per hour base rates in Canada are generally higher than in the U.S. (when the Canadian dollar trades at or near par with the U.S. dollar). It must be recognized, however, that consumer prices are higher in Canada so the real purchasing power of workers' base wages in Canada is not higher. There can be no disputing, however, that costs do appear higher to international industry executives. On a fully loaded basis, one assembler's data shows that the cost per hour in Canada is also higher, but that company's data shows that the gap is less than \$2.00 per hour – within striking distance of their U.S. competition, even with the Canadian dollar at or near parity.

In such a difficult and competitive context, ancillary labour costs under government control need to be carefully controlled – for items like employment insurance, the employer health tax and workers compensation premiums. Also, if hard dollar supports for training new or existing employees can be provided, Canadian operations will be able to more confidently declare their costs are below U.S. alternatives. Only then will those advocating for Canadian automotive investment be able to do so with a strong and compelling message.

Estimated Fully-Loaded Cost per Hourly

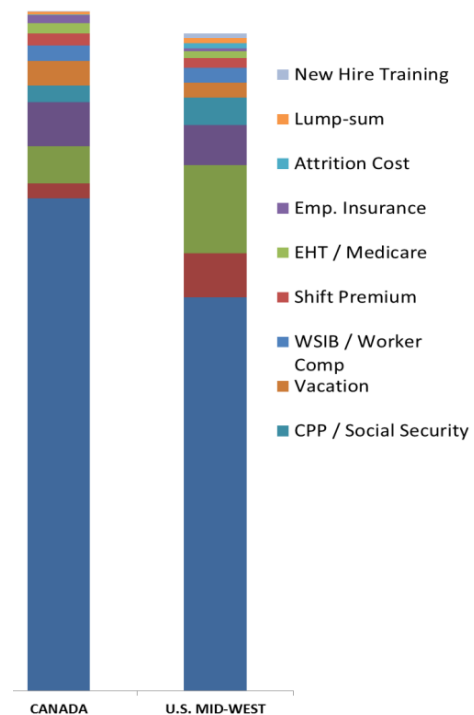


FIG. 10

“RIGHT TO WORK”

Almost half the states in the U.S. now have laws prohibiting contracts that require workers to pay union dues as a condition of employment. When Michigan became the 24th state to enact such legislation in early 2013, Canadian manufacturers, labour groups and policy makers took notice.

Understandably, a significant divergence of opinion exists regarding the efficacy of the “right to work” tool. These laws are clearly associated with lower levels of unionization and, consequently, lower labour costs. Whether or not that leads to more investment and employment is debated.

Regardless of the true effect of “right to work” measures, there can be no question that the Michigan legislation has received notice in Canada. Some manufacturers believe it makes Ontario’s most proximate competitor for automotive investment a more compelling alternative. Others doubt it will have a significant additional impact on competitiveness over and above other factors (such as taxes, logistics, exchange rates, and others). Stakeholders involved in the Canadian automotive industry will need to consider both the realities and the perceptions that reverberate from the Michigan decision.

UTILITIES

Utility costs are largely outside of the control of industry in Canada. However, demand and supply disparities in other jurisdictions certainly impact Canada’s competitiveness. For example, the recent decline of the cost of natural gas is an emerging competitive advantage for the United States.

In the case of electricity, rates are largely regulated, often driven by governments’ policy goals. It was not many years ago that electricity costs were touted as a benefit of doing business in Canada. More recently, however, a combination of factors – not the least of which is revised policy goals – have converged to make Ontario rates higher than competing jurisdictions. For example, electricity costs for a typical large scale assembly operation in the U.S. South or Mid-west are estimated to be as

much as \$5 million lower than those in Ontario, a penalty that is now well-known to decision makers. Hydro-Québec’s 2013 survey of power rates in competing jurisdictions shows that for large power customers, Ontario is significantly more expensive. For example, Toronto large power users pay 123 percent more than Chicago customers, 50 percent more than Nashville and 37 percent more than Detroit.

In its 2012 study of costs of the automotive parts industry, KPMG provides an explicit comparison of utility costs for firms in Canada, the U.S. and Mexico. For an average sized Tier 2/3 supplier with revenues in the \$40 million U.S. range, annual utility costs amounted to \$507,000 U.S. (1.3 percent of revenue) in Canada, \$466,000 (1.2 percent of revenue) in the U.S. and \$537,000 U.S. (1.4 percent of revenue) in Mexico.

TRANSPORTATION

Transportation costs are another important factor in the competitive calculus of the automotive industry. Shipping is most cost-effective when the value to weight ratio is high. Shipping assembled vehicles long distances is expensive given the relatively large volume they encompass. Thus, when sales volumes permit, assemblers would prefer to manufacture vehicles close to where they are sold. Further, given the integrated nature of the Canadian and U.S. automotive industry, parts may actually cross the border several times before the vehicle is finally assembled.

These factors explain why the quality and cost of transportation infrastructure are key to the automotive industry. Once again, the 2012 KPMG study of costs for the automotive parts industry provides a valuable benchmark.

Looking across the three North American jurisdictions, one sees (for a firm with roughly \$40 million U.S. in revenues) costs of:

- \$2.041 million U.S. (5.2 percent of revenue) for Canada
- \$2.020 million (5.1 percent of revenue) for the U.S.

- \$2.344 million U.S. (5.9 percent of revenue) for Mexico

These costs differences are aligned with relative distance to markets.

The governments of Canada and Ontario should be congratulated for their persistence and creativity in supporting a second span across the Detroit River at Windsor / Detroit. The new bridge, with six lanes and new customs and border processing areas, will represent a significant upgrade to the current situation and reduce both the perception and the realities associated with a so-called thick border.

Even though the industry applauds the focus and commitment governments in Canada have demonstrated on the Windsor border file, significant infrastructure issues remain. Crucial in that regard is congestion in the Greater Toronto Area.

Furthermore, consideration about the imposition of tolls on 400 series highways is problematic.

Obviously, these challenges are more acute for firms that are located in or near the GTA.

It is also important to maintain predictable operation of Canada's railway service and avoid negative impacts on the operation of Canadian automotive firms.

The Canadian auto industry recognizes that governments in Canada understand that a transportation infrastructure deficit has emerged. It appreciates the concrete measures that have been taken in some areas (the border being the premier example) and encourages all levels of government to take aggressive measures to address the challenges that exist in other important areas.

GOVERNMENT INVESTMENT SUPPORTS

Competition among jurisdictions for automotive industry jobs is fierce. The reasons are clear. Automotive is a high value-added industry and workers are thus paid proportionally more than their counterparts in other areas of manufacturing or the general economy. Automotive production also acts as an anchor for direct and spin off economic activity, leading to many jobs up and down the value chain.

Additionally, the taxes paid by firms and workers contribute substantially to the government revenues that support schools, hospitals and all the other government services that societies require. For these reasons, governments around the world seeking to attract automotive investments offer inducements. It is not uncommon for packages to contain a mix of cash and non-cash programs and for those packages to be very large; in the magnitude of 60+ percent of the capital investment. The flexible mechanisms deployed include refundable tax credits, property tax abatements and infrastructure investments.

In Mexico, for example, rarely will one see repayable contributions, or restrictive covenants that can claw back co-investment programs. Through ProMexico, companies can secure cash grants with no strings attached.

The power of automotive industry investments to generate government revenue can be demonstrated by building on the following assumptions:

- An assembler decides to build an incremental 200,000 vehicles per year in Canada
- The new program will run through two product cycles lasting a total of eight years
- 2,000 direct assembly jobs will be created and another 3,000 spin-off jobs will ensue in auto parts and the larger economy; a very modest assumption. (Note: This number does not include the additional jobs being created in other jurisdictions.)

Considering taxes on labour, one can expect that combined income and payroll taxes will yield in the area of \$100 million in annual incremental revenue to federal and provincial governments. Therefore, a typical combined federal- provincial package of \$200 million would be fully repaid in approximately two years.

Whether firms are considering new investment in Greenfield operations or expansion/re-investment in existing facilities, they must consider a range of issues:

Must Haves: These are generally long-term and structural in nature. It is, for all practical purposes, impossible for either government or industry to profoundly adjust or alter these factors over the short term. These include:

- Proximity to customers
- Reliable and cost-effective energy infrastructure
- Transportation infrastructure
- Labour quality and availability at competitive cost

Influencers: Once the availability (or lack thereof) of the must haves is understood, investors can start to consider supplementary aspects of their locational decision making. Such elements are critical because:

- Now that the ‘must haves’ hurdle has been reached, decision making can coalesce around these ‘influencers’
- They can be adjusted up or down over the short term
- They can have a direct bearing on the decision at hand

The key influencer in this regard is government participation. In the competition for new plants, the involvement of government is essential and competition among jurisdictions is fierce. Industrial incentives to secure an automotive production mandate represent an important and tangible signal that the jurisdiction in question wants and values the investment.

Why Governments Compete with Co-Investments

As assemblers strive to maximize the efficiency of their operations through just-in-time manufacturing methods, firms want their suppliers of key parts to be close at hand. This allows them to minimize transportation costs and to optimize the logistics associated with the

assembly process. Thus, assembly plants become the catalyst for parts suppliers and the industries that service both assemblers and suppliers. External estimates are as high as a multiplier of 9 additional jobs for every one assembly job (Center for Automotive Research, 2010). It is, therefore, not surprising that competition among jurisdictions for assembly investments is particularly strong.

The Competition's Use of Co-Investments

Governments enter the picture both in adapting existing facilities to fit new mandates and in building Greenfield facilities. Government partnerships are the tools that are required to keep and maintain competitiveness in a globally competitive marketplace. Government investments in recent years have demonstrated a quick return on investment, even during times of restraint. Although there is often not a lot of information regarding such participation, the reported figures from some jurisdictions are often substantial. For example:

- Missouri provided Ford with tax savings of \$100 million to \$150 million over 10 years for its Kansas City Assembly Plant
- Kentucky provided Toyota with as much as \$146 million to produce an additional model at its Georgetown Assembly Plant
- Tennessee recently attracted a \$1 billion investment from Volkswagen by offering almost \$600 million

Meanwhile, the Government of Mexico has not been content to rely solely on low cost labour to build its industry; it too has become an aggressive manager of investment incentives. The Government of Mexico's website states:

"Mexico's government understands it must be competitive in the newly difficult economic landscape to entice foreign manufacturers to make relocation decisions in these uncertain times. Once again, valuable incentive packages are on the table from several sources. Each package is

different as they vary by location, sector, level of financial investment, type/number of jobs created and strategic benefits to Mexico's long term goals. In essence, if your company will be creating quality jobs while making a substantial and long term investment in Mexico; the government wants to help you make that happen."

Indeed Mexico is reported to have used a \$400 million U.S. loan to have Chrysler/Fiat produce the Fiat 500 in Toluca.

While historically, the U.S. federal government did not partner with automotive companies, it recently launched a variety of programs to assist companies in developing the car of the future. For example, programs include funding for battery and electrification research as well as a \$25 billion Department of Energy (DOE) loan program for fuel -efficient vehicle assembly and components production.

Canada's Position

In Canada, the average federal-provincial participation relative to investment cost is about 20-25 percent of upfront capital costs, which is roughly shared between the federal government and the Province of Ontario. The federal contribution is a zero-interest long-term, but fully repayable loan, while the Province of Ontario's contribution has traditionally been in the form of a cash grant to reimburse a certain percentage of eligible costs.

Industrial incentives for automotive facilities in the U.S. have recently been in the range of 25 – 30 percent of total investment (of which a substantial portion may be in the form of grants), although there have been a few investments where government involvement was more than 60 percent. The big difference between Canada and the U.S. is the form of the involvement. Canada's incentive mechanisms are typically in the form of grants or loans, both of which contain job and investment targets as well as medium and long-term covenants and claw-back mechanisms, whereas the U.S.

typically utilizes flexible tax measures that are performance-based, with relatively few covenants and claw-back mechanisms.

Canada has traditionally supported automotive production investments with incentives geared to innovation. Appendix B provides a list of federal and provincial government support. The recently announced renewal of the Automotive Innovation Fund (AIF) by the federal government is a welcome sign that Canada is serious about competing for assembly investments. However, its complex structure involving refundable contributions and challenging tax treatments lessens its potential impact to investors.

The bottom line is that while co-investments are just one of the important factors influencing investment decisions, they are essential in the competition to anchor investments in automotive assembly.

Improving the Government-Industry Partnership

In the paragraphs below, opportunities to improve the delivery of incentives in Canada will be offered. It is worth commenting at the outset, however, that the level of partnership that the governments of Canada and Ontario have developed insofar as automotive investment attraction is concerned is notable. Most important in that regard is the fact that the federal government is at the table. This is not always the case in competitor jurisdictions.

However, as indicated, there are opportunities for improvement. Those adjustments are described below.

Good decisions are predicated on full and accurate information. Clearly, when firms consider investments – and the placement of those investments – they want knowledge of what they should factor in with respect to government support for the project in question. This notion of certainty has two components: timing and form.

Timing: Receiving assurance with respect to government partnership as early as possible in the planning process is helpful. However, it has been observed by some considering investments in Canada that gaining reasonable levels of assurance in an early and rapid manner has not been possible. When that assurance is not provided, Canadian projects – and those advocating for them – are placed at a significant disadvantage. That is because governments in other jurisdictions have learned that success comes not just from offering the largest packages, but offering those packages in a timely way.

In the most ideal of circumstances, investors would be able to understand what can be expected without the back and forth that typifies industry to government discussions. Canadians advocating for their projects in international head offices would benefit if they were able to point to clear standards and expectations.

In the absence of the ideal – a chart or matrix that articulates how a program or budget will be administered – industry suggests that governments in Canada consider developing a joint (i.e. Canada-Ontario, Canada-Quebec), streamlined approach; one that could expedite the process and provide industry partners with a stronger hand when they advocate for investment with their head offices.

Form: Typically, the intra-company competition for investment is intense and those advocating for investment need to step forward with a clear and compelling story. Packages that are too complex – ones based on long-term interest free contributions and built on a foundation of net present value (i.e. those offered by the Government of Canada through the AIF) – are a tough sell; particularly when decision makers must weigh them against competing bids.

Canadian Federal Government incentives need to be competitive on both a before and after tax basis. In the highly competitive arena for automotive investment, a package that contains an expectation of eventual repayment and which is taxed as income in the year it is received, is not very persuasive. Meanwhile, competing bids are in the form of straight cash: easy to understand, easy to assess, easy to accept.

The Government of Ontario, it should be noted, does offer incentives that are provided in the form of cash. The Government of Canada should consider a similar approach.

While messages from the Canadian automotive industry in earlier years might have inferred that large-scale inducements were not necessary and that more modest signals and generally positive underlying economic conditions (compared to competitors) were adequate (e.g. a low Canadian dollar, government funded health care costs), this is no longer the case.

Automotive plants, notwithstanding their massive size, are portable. Today, automotive assemblers have many choices and options as to where to place their next investment. It is recognized that other competing jurisdictions are successfully utilizing incentives as a key component of their comprehensive industrial strategy to acquire new automotive investment. Therefore, to compete for large-scale automotive investment today, Canada and the provinces must step forward with large-scale, easy to understand partnerships that announce to the world's automakers, "*We want your investment and we're prepared to compete.*"

The Government of Canada's Automotive Innovation Fund and its Ontario equivalent are helpful, but they must be structured in a manner that is transparent in nature and provide real and substantial support. Only then will Canada be in a position to support CAPC's original vision:

***"To be the location of choice for
automotive manufacturing within North
America, driven by globally competitive
innovation in a profitable and growing
new-vehicle market."***

5. CONCLUSIONS AND RECOMMENDATIONS

RECOMMENDATIONS FOR PUBLIC SECTOR:

The recommendations below are designed to help governments in Canada support an environment conducive to automotive investment in Canada.

1. COMPETE FOR ASSEMBLY MANDATES WITH GLOBALLY COMPETITIVE INVESTMENT SUPPORTS

Competition for the mandate and facilities that anchor the automotive industry is fierce. Unfortunately, Canada has not seen its traditional share of investment since the economic recovery began. With its strong foundation, Canada can make a compelling case for new investment, particularly if it is competitive in terms of government support.

Also, federal and provincial governments have done a commendable job of making overall levels of business taxation competitive. Further tax initiatives should be aimed directly at rewarding investment and job creation.

2. REDUCE THE FULLY LOADED COST OF LABOUR

The fully loaded cost is higher in Canada than it is in the U.S. even though the Canadian industry has taken major steps to reduce the gap. More steps are needed in areas under government control. These include employment insurance, the employer health tax and workers compensation premiums.

3. PROVIDE ONE-STOP SUPPORT FOR INVESTMENT ATTRACTION

Some jurisdictions do a better job than Canada in pitching for new investments. ProMexico is an example of best practice in this regard. Better coordination among all three levels of government is essential.

4. IMPROVE TRANSPORTATION INFRASTRUCTURE AND BORDER POLICY

CAPC applauds the federal government's efforts to keep border links open and efficient. The work on the Detroit River International Crossing is especially noteworthy. Meanwhile, Canada must continue the process of improving the speed and efficiency of administrative controls at the border. For Canada to reap the maximum benefits from its automotive cluster, provincial and local governments need to take concrete action to address a key risk: congestion in the GTA, without adding costs to supply chain inbound and outbound logistics.

5. EASE REGULATORY BURDEN

CAPC members understand and support government efforts to green the economy. It is an initiative that is aligned with the automotive industry's efforts to reduce the environmental footprint of its processes and products. However, doing so should not put a disproportionate burden on business and should not have the effect of undermining competitiveness and discouraging investment.

6. PURSUE A FREE AND BALANCED TRADE AGENDA

Free trade must be mutually beneficial. Canada is a trading nation and its auto industry has long been an advocate of increasing prosperity through mutually beneficial trade. As it seeks to develop new trade agreements, Canada should ensure that it gains meaningful and sustained access for Canadian-produced vehicles and encourages investment in the Canadian auto industry. Trade policy initiatives should be motivated by a goal of strengthening investment and production in Canada.

7. ALIGN THE NUMBER OF WORKING DAYS WITH COMPETITOR JURISDICTIONS

The number of days available for production is less in Canada than in almost all competitor jurisdictions. When a multi-billion dollar industry is idled for just one day, millions of dollars are lost. In today's competitive environment, keeping plants open and maximizing the use of capital is imperative.

RECOMMENDATIONS FOR PRIVATE SECTOR

1. INVEST IN PLANT, MACHINERY AND EQUIPMENT

In recent years, Canadian automotive firms have confronted the challenges of recession, an appreciating dollar, relatively high cost labour and a political environment in the U.S. that has compelled the industry to place a premium on U.S. investment. But to remain competitive and viable, to avoid the cycle of declining competitiveness, the Canadian industry must heighten investment. Plants that do not have fresh machinery and equipment eventually become less productive and their assets become fully depreciated. It becomes easy to abandon the asset and move on. Firms need to work with all of their partners (including government and labour) to build the best possible business case for investment in Canadian facilities.

2. INVEST IN PEOPLE

The Canadian automotive industry can no longer define its success on the basis of low cost labour

and an undervalued currency. Instead, future success will be dependent upon global best productivity growth and innovative capacity. That means firms must work with government and its agencies and aggressively invest in both current and future workforces.

3. INVEST IN RESEARCH AND INNOVATION

The Canadian automotive industry has demonstrated pockets of significant and meaningful investments in Canadian research infrastructure. These investments, however, have been inconsistent across segments and companies: the result of differing mandates and proximity. The industry must share best practices and set a positive, mutually beneficial path going forward so that the capabilities of the Canadian research community are understood, represented, and accessed.

4. DEVELOP A CLEAR AND COMPELLING NARRATIVE FOR CANADIAN INVESTMENT

Over the past decade the Canadian automotive industry has undergone a significant transformation. Various challenges and opportunities have transformed the industry and the capabilities of its key participants. Unfortunately, global decision makers do not universally understand the emerging capabilities that Canada and its automotive industry have developed in terms of its research, capacity to manage complexity or deliver quality. Going forward, the industry must come together and work with government to redefine its source of competitiveness, and devise a consistent framework and message for promotion of Canadian automotive investment to both global decision makers and the Canadian public.

APPENDICES

Appendix A

Large Industry Automotive Research and Development Facilities in Canada:

Chrysler Canada Inc.

Automotive Research and Development Centre (Windsor ON)

General Motors of Canada

Automotive Centre of Excellence (Oshawa ON)

GM Canadian Regional Engineering Centre (Oshawa ON)

GM Cold weather Development Centre (Kapuskasing ON)

Ford Motor Canada Ltd.

Ford Powertrain Engineering R&D Centre (Windsor ON)

Ford Manitoba Extreme Cold Weather Testing Facility (Thompson MB)

Ford Fumes to Fuel R&D Center (Oakville, Ontario)

Honda R&D Americas Inc.

Environmental testing laboratory (Dartmouth NS)

Toyota Canada Inc.

Toyota Canada Cold Research Centre (Timmins ON)

Appendix B

Gov't of Canada Programs supporting automotive R&D in Canada:

Direct Support:

Automotive Innovation Fund (AIF): \$250 million over five years

Government programs support for collaborative R&D activities related to auto industry:

Auto21

Scientific Research and Experimental Tax Incentive

National Research Council - IRAP program

Sustainable Development Technology Canada

NRCan programs on clean transportation systems and

CANMET Advanced Material Technology Laboratory

Canada Research Chair

Automotive Partnership Canada (APC): \$145 million in research funding over five years

Provincial government's research programs on automotive R&D include:

Ontario Centres of Excellence

Ontario Research Fund

Consortium Recherche et d'Innovation en Aérospatiale au Québec (CRIAQ)

Appendix C

Government policies negatively impacting the cost of manufacturing in Ontario, relative to plants with which the industry must compete in other jurisdictions, may detract from a positive business case for new investment. Some of those policies are described below.

Ontario specific

Toxics Reduction Act

Despite all automakers in Ontario maintaining independently validated ISO 14001 certified Environmental Management Systems that have targets for reducing the use of energy and other natural resources and diverting waste to recycling opportunities as well as reducing painting emissions in a systematic and efficient manner, the MOE introduced the very duplicative Toxics Reduction Act with very prescriptive planning methodologies and reporting obligations. The majority of substances that have to be traced are either constituents of the steel used to build engines and transmissions (alloys), substances contained in product (such as anti-freeze and paints) or by-products of combustion – related to building heat. Compliance costs for automakers in Ontario are in the hundreds of thousands of dollars per year with no reductions attributable to the program and therefore no added value. No similar requirement exists in any other auto assembly jurisdiction in North America.

GHG Cap & Trade requirements on auto assembly

The Ontario Ministry of Environment (MOE) is considering a proposal for Greenhouse Gas Cap and Trade that is much broader in scope than any regulatory action occurring at the federal level (sector specific LFE program) and is inconsistent with competing manufacturing jurisdictions.

Air Standards approvals delays related to permitting of new paint recipe constituents

Traditionally based on independently assessed approval toxicology for a new paint constituent, an automaker could after thirty days change to a new paint formulation. MOE has recently halted this acceptance process, instead indicating MOE reviews must be completed before the new paint formulation is introduced (even though independent toxicology has determined risk is acceptable). For automakers subject to changing consumer tastes or addressing potential quality concerns this creates an unacceptable new timing uncertainty, not encountered in other NA assembly jurisdictions. Furthermore, noise regulations could be better managed by municipalities.

Ontario compliance for facility noise based on engineering modeling

Engineering models have built in conservatism and are used predictively for system design with verification based on site specific field testing allowing for more practical considerations. This more stringent approach based on conservative modeling increases costs for industrial equipment and in many instances there is no commensurate benefit.

MOE Approvals Modernization Environmental Compliance Authorization (ECA's)

Extended approval review timing and separate requirements for standardized industrial equipment reviews are being introduced as part of the MOE Approvals Modernization regime. This is creating uncertainties for business. The Ontario Ministry of Environment (MOE) approach is unique in that it requires noise mitigation based

on engineering modeling outputs for equipment used in industrial facilities instead of actual noise measurements.

Bill 91 – Waste Reduction Act; a new regime for the reduction, reuse and recycling of waste

For many years, vehicle manufacturers have understood the environmental and economic value of waste that may be generated during the production process. In Ontario, all vehicle manufacturers have introduced sophisticated environmental management systems (e.g. third party certified ISO 14001 programs). This includes waste reduction targets and extensive waste management programs, which currently divert 85-100% of waste away from landfill. The new Waste Reduction Act, as proposed, introduces several unintended consequences under its individual producer responsibility (IPR) approach. This imposes duplicative and costly administration, which impacts third party certified waste diversion and waste management programs now in place.

Environment Canada – Chemical Management Plan

Canadian vehicle assemblers may be required to track and report usages and work upstream ... with international suppliers ... to identify and validate unique (potentially more expensive) substitute materials. Tracking these requirements demand significant resources and the risk to the integrity of the Just in Time (JIT) delivery supply chain.

In addition, the prolific use of Significant New Activities (SNAc) notices can constrain unidentified existing uses of substances and create noncompliance circumstances. There are many SNAc notices in place for chemicals used in the manufacturing environment where current uses are permitted but any new use is prohibited without EC/HC review and approval

Some specific examples of risk management activities impacting the automotive sector are:

- SNAc constraining the use of widely used automotive clutch spline grease, which is restricted in Canada for “Industrial application only”
- A new substance Notification SNAc may restrict future uses of Vanadate magnesium in emission control equipment.
- Pollution prevention notices and requirements in Canada, which limit the application of advanced production materials, such as BPA in structural adhesives, in the manufacturing of vehicles in Canada, while no such limitations exist in the U.S. or globally.

Sources

FIGURE 1: Ward’s Auto InfoBank

FIGURE 3: Statistics Canada

FIGURE 4: Ward’s Auto InfoBank

FIGURE 6: Ward’s Auto InfoBank

FIGURE 7: J.D. Power and LMC Automotive

FIGURE 9: Bank of Canada