2014 Energy M&A Trends in Canada

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Whether measured by volume or aggregate value, 2013 was a weaker year for energy-related M&A than 2012, continuing a four-year decline in activity in the sector. There was a noteworthy lack of public company M&A in 2013 and nothing to match the marquee deals of 2012: PETRONAS' $6B acquisition of Progress Energy or CNOOC Limited's $20B acquisition of Nexen. In spite of that, 2013 still saw a significant number of large and complex transactions, including Suncor's sale of its conventional natural gas properties for $1B to Centrica and Qatar Petroleum, Progress/PETRONAS' $1.5B acquisition of Talisman Energy's Farrell Creek and Cyprus properties and Exxon Mobil/Imperial Oil's $750M acquisition of part of ConocoPhillips' non-producing Clyden oil sands acreage.

Reasons for the decline in M&A activity in 2013 included the following:

- Asian investors paused to digest what they bought after five years of significant investment in the Canadian energy sector, particularly in the oil sands.
- Changes to Industry Canada's State Owned Entity (SOE) guidelines **announced in December 2012** under the ***Investment Canada Act***, coupled with the failure of two transactions to pass "national security" reviews, have chilled foreign investment by SOEs.
- Increased uncertainty about whether regulatory approvals would be obtained for pipelines and other projects needed to expand the capacity to transport Canadian crude oil and natural gas to the U.S. and to provide access to offshore markets contributed to investors' concerns about the future prospects for Canadian production.

In addition to the absence of major acquisitions, 2013 also saw a decline in financing activity by oil and gas issuers. While a select few were able to raise the equity they required, many others could not – at least until Q4 when a spike in oil and gas-related capital markets activity occurred. The numbers of oil and gas issuers on the TSX and TSXV, the number of financings by those issuers and the aggregate equity capital raised to the end of Q3 of this past year were all significantly lower than over the same period in 2012.

The key question for 2014 is whether Canada's energy sector will begin to see an upswing in M&A activity and, if so, where that upswing will first be felt. As transactional counsel to a significant number of companies in the energy sector, we have identified a number of trends, opportunities and challenges that are likely to influence Canada's M&A activity in 2014.

1. Scrutiny of SOEs will continue to chill the market for Asian investors

The changes announced in 2012 were enacted in June 2013, although not all of the changes have taken effect. The SOE guidelines were amended to clarify that, in addition to considerations regarding the corporate governance of the investor and its management on profit-maximizing lines, the degree of foreign-state control of the SOE would be considered, along with the importance of the Canadian target in the industry and the degree of existing participation of SOEs in the sector. In the words of the Prime Minister, "Canadians have not spent years reducing the ownership of sectors of the economy by our own governments only to see them bought and controlled by foreign governments instead." Majority acquisitions in the oil sands by SOEs will be permitted going forward only on an "exceptional basis".

The *Investment Canada Act* itself was also amended in June 2013 to include a broad definition of SOEs – including entities that are "influenced" by foreign states. The Minister has been given the power to determine – retroactively – whether an investor is in fact an SOE or in fact controlled by an SOE, even if it does not meet the test for "control" that otherwise applies in the Act. As well, the higher dollar thresholds for the review of transactions by Industry Canada will not apply to SOEs.

At the same time, the Government began to use its new (since 2011) national security powers under the Act. Despite pronouncements welcoming – indeed urging – foreign investment in telecommunications, national security reviews led to the demise of two proposed high-profile telecom investments in Wind Mobile Canada and in Manitoba Telecom's Allstream division by foreign acquirors.

Together with depressed prices for Canadian oil and gas production, high costs and regulatory burdens, the uncertainty over deal completion created by Ottawa's pronouncements on SOEs and its unexplained rejections of the telecom deals has poured cold water on foreign investment in the energy sector, estimated by CIBC in late 2013 to be down 92% from the same period in 2012.

2. There will be lots of properties for sale. Will there be buyers for them?

Persistently low natural gas prices and an oversupply have resulted in several large producers, including Penn West Exploration, Talisman and Encana Corporation, announcing asset disposition programs in an effort to shift their focus away from natural gas to liquids-rich gas and light oil plays. In addition, Devon Energy recently announced its intention to sell most of its Canadian natural gas properties to help finance its US$6B acquisition of GeoSouthern Energy's Eagle Ford light oil assets.

These asset disposition programs add more properties to an already overcrowded market that has been characterized by unsuccessful attempts to sell assets and joint venture offerings that were postponed or withdrawn because of a lack of interest.

That being said, 2013 concluded with an increase in M&A activity.

Indications that this trend may continue into 2014 include:

- Spain's Repsol Energy is reported to be looking to make a US$5-10B purchase of a North American oil company. This is part of Repsol's push to increase its investments in politically stable countries after the Argentinian government seized Repsol's controlling stake in YPF SA. As well, Indian Oil Corporation (IOC) is rumored to be in talks to buy a stake in Progress Energy Canada's shale assets for US$1.1-1.5B. If Repsol's target is in Canada, a transaction of that magnitude would boost interest and M&A activity in the sector. That transaction, and the IOC acquisition if they occurred, would reinforce Canada's reputation as a safe geopolitical environment for business and the Canadian energy sector as an attractive place for foreign investors to deploy capital.
- Asian investors continue to be interested in making energy sector acquisitions in Canada. However, these are likely to be strategic additions to existing positions and smaller transactions, rather than the marquee deals of the past five years.
- The push to develop LNG export projects on the West Coast may drive investment in natural gas assets in northeastern British Columbia in 2014, as the participants in those LNG projects move to build reserves and consolidate landholdings to feed their export projects.

- Continued weakness in prices and intense competition in markets for conventional dry gas will continue to result in property sales as smaller producers look for capital and larger producers look to shed non-core assets. The purchasers of these assets will include producers taking advantage of counter-cyclical opportunities by buying assets for depressed purchase prices. These producers with strong balance sheets and minimal debt will look to purchase natural gas production for less than it would cost them to develop that production through the drill bit.

3. Innovative marketing strategies will emerge

The company owns approximately 5.2 million net acres of fee title oil and gas rights. These rights were granted to the Canadian Pacific Railway (CPR) when the CPR built its rail line across the prairies in the 1880s. Those fee title rights were transferred to PanCanadian Energy and then to Encana when PanCanadian and the Alberta Energy Company merged in 2002.

In Q4 of 2013, Encana announced plans to transfer its fee title rights and associated royalty interests across southern Alberta into a separate company, followed by an IPO of that company that is to be completed by mid-2014.

The new company will then lease these fee title rights to explorers in exchange for royalty interests.

Encana will benefit from the deal in two ways:

- First, it will receive the proceeds of the IPO.
- Second, it plans to retain a significant number of shares in the new royalty company and thus will participate in dividends paid from cash flows from the royalties paid to the new company.

The proposed formation of this new royalty company is considered to be an innovative alternative to Encana attempting to sell those fee title rights in an already crowded marketplace. Currently, there are only a few royalty companies available to investors including Freehold Royalties, which is publicly traded, and Range Royalties, which is private. However, if Encana's concept is successful others may adopt similar strategies.

Various companies including Apache, Talisman and Canadian Natural Resources Limited hold significant fee title interests. Their interests were part of what was originally granted to the Hudson Bay Company. While their fee title holdings are not as extensive as Encana's, they may be sufficient for additional royalty company offerings similar to Encana's concept.

4. Resistance to proposed pipeline projects will continue

Expect some important decisions regarding these pipeline projects in 2014. However, the road ahead for most of them still looks long and difficult, and which of these projects will actually be completed remains highly uncertain.

The following is an update on the current state of a few of the major projects, and what may occur in 2014.

Keystone XL

TransCanada Corporation split its Keystone XL project into two parts when the Presidential Permit for the combined project was denied in 2012. The southern part has been completed and will deliver 700,000 barrels per day of crude from Cushing, Oklahoma to the Texas Gulf Coast. The northern part of the project is proposed to ship up to 590,000 barrels a day of crude oil from Hardisty, Alberta to Steele City, Nebraska. A new application for a U.S. Presidential Permit for the northern part was made in May 2012. A decision on the application was expected in the first quarter of 2013. However, that did not occur.

The U.S. State Department issued a Draft Supplementary Environmental Impact Statement on March 1, 2013 stating that the Keystone pipeline would not significantly impact the rate of extraction in Canada's oil sands, and that with or without Keystone, oil will be shipped to refineries either by rail (which could be more carbon intensive), or through new alternative pipelines to either coast in Canada.

However, this positive preliminary result for Keystone has been undermined by two subsequent developments:

- First, the U.S. Environmental Protection Agency challenged the State Department's analysis of the oil market, and particularly the U.S. State Department's ultimate conclusion that Canada would find another way to ship its oil, if Keystone was not approved. The Environmental Protection Agency strongly suggested that the State Department redo its energy/economic modeling effort.
- Second, the State Department opened an investigation into whether a consulting firm that worked on the draft Environmental Impact Statement had previously worked for TransCanada. If a conflict of this nature is confirmed, that finding could undermine the benefit of the Environmental Impact Statement.

At this time, there is nothing to indicate when President Obama will make a decision on the Presidential Permit application for Keystone. Last year, most observers expected that a favourable decision would be made early in President Obama's second term. Now, it is not clear whether a decision will be made before the November 2014 U.S. mid-term elections.

The longer it takes to make the decision, the more uncertain it becomes whether Keystone will be approved.

Energy East

There is greater optimism that TransCanada's proposed $12B Energy East project will be successful. That project is intended to deliver 1.1 million barrels per day of crude from Alberta and Saskatchewan to refineries in eastern Canada. TransCanada intends to convert an existing gas pipeline into oil service, construct new lines to link up to the converted pipe and construct ancillary facilities, including tank terminals and marine facilities that will provide waterborne access to markets. Filing of the application in respect of Energy East with the National Energy Board (NEB) is expected in early 2014.

The fact that most of the Energy East line will be on the existing right of ways for the gas line should expedite approvals and reduce opposition. Moreover, the Premiers of the Provinces through which Energy East passes are supportive of the project. However, the line traverses the traditional territory of 180 aboriginal communities and some new build is required in Quebec and New Brunswick. The concerns of those communities will have to be accommodated if TransCanada is going to win approval for the project. The experiences of Keystone and Northern Gateway show that nothing can be taken for granted.

Northern Gateway

The Northern Gateway Pipeline is being proposed by Enbridge to carry up to 525,000 barrels of crude oil a day from Alberta to Prince Rupert on the west coast of British Columbia. The project could be constructed by 2018 if approvals are obtained.

The joint Canadian Environmental Assessment and NEB review panel issued its decision on Northern Gateway on December 19, 2013. It recommended that the federal government approve the pipeline, subject to Enbridge satisfying the 209 conditions that will be included in the NEB's Certificate of Public Convenience and Necessity.

This is a positive development, but there are still significant obstacles in the way. While the federal government is expected to approve the pipeline it remains to be seen whether Enbridge can satisfy the joint review panel's numerous conditions and whether the project will be delayed by expected legal proceedings challenging the approvals.

TransMountain Expansion

Kinder Morgan has put considerable effort into consultations with those affected by the expansion project. Whether those efforts will be successful should become more clear in 2014.

The significant increase in oil tanker traffic on the West Coast that would result from the construction of Northern Gateway and the TransMountain expansion has led to greater scrutiny of tanker safety and the adequacy of spill response measures. On November 15, 2013 the federal government released an expert panel report entitled "A Review of Canada's Ship-source Oil Spill Preparedness and Response Regime – Setting the Course for the Future". In the report the panel made 45 recommendations which if implemented would "set Canada on a course of continuous improvement". One of the recommendations was the abolition of the current limit of liability per incident.

Line 9 Reversal

In October 2013 the NEB concluded its hearing of Enbridge's application to reverse the flow (from east-west to west-east) of its Line 9. If approved, the Line 9 reversal would allow Western Canadian oil producers to displace up to 300,000 barrels per day of crude oil from the North Sea, West Africa and the Middle East currently being delivered to eastern Canadian refineries. The NEB's decision is expected in January 2014.

5. The shipment of oil by rail will continue, but with an appropriate response to public safety concerns

That anticipated increase has resulted in conjecture that rail shipments might replace the need for new pipeline capacity. It's more likely, though, that rail will be a supplement to, not a substitute for these pipeline projects.

Not only is shipping crude oil by rail much more expensive than shipping it by pipeline, it is also more dangerous to ship crude by rail. Increased rail shipments of crude oil have resulted in more rail-related accidents, such as:

- the derailment in the summer of 2013 in Lac-Mégantic, Quebec that resulted in a fire that caused several railcars carrying highly flammable crude oil from the Bakken to explode, killing 47 people and destroying the downtown of the village; and
- the derailment in Gainford, Alberta in October that resulted in a dangerous fire that forced the evacuation of the village.

Companies that transport crude oil by railcar in 2014 should accordingly expect regulators to aggressively enforce existing regulations. In addition, a host of new regulations may be passed in an attempt to reduce the risk to the public of oil shipments by rail.

Transport Canada has already taken steps in response to those derailments. It issued Protective Direction No. 31, which requires, among other things, testing to determine the flashpoint of crude oil being transported. It also issued Protective Direction No. 32, which requires information on the nature and volume of dangerous goods to be reported to the designated emergency planning official of each municipality through which dangerous goods are transported by rail.

Despite those steps to improve safety, Canada's Auditor General recently found that Transport Canada needs to address "significant weaknesses" in its oversight of railway-related safety risks. In particular, it found that Transport Canada's level of oversight is not sufficient to ensure that federally regulated railways have implemented adequate and effective safety management systems.

New regulations in response to the foregoing may include requirements that crude oil tank cars be redesigned to avoid tragedies like what occurred in Lac-Mégantic. However, those changes may take time as the tank cars are mostly owned by railway customers and leasing companies as opposed to the railways themselves.

6. The consolidation of proposed LNG projects will occur

More than a dozen liquefied natural gas (LNG) export projects have been proposed for the west coast of British Columbia. Many of those projects will enter into the final investment decision stage in 2014.

The Province of British Columbia is expected to announce its tax framework for LNG export projects early in 2014. That will provide project sponsors greater certainty in determining their economics.

The challenges these projects face include significant capital costs, finding suitable sites for their liquefaction and export facilities, obtaining the required regulatory approvals and entering into the necessary commercial arrangements and alliances with First Nations and other groups in order for these projects to proceed.

There are also limits on the number of LNG facilities that can be built at locations such as Kitimat or Grassy Point (Prince Rupert), as well as on the number of pipelines that the province will allow to be built to bring the gas required by these projects across British Columbia to the West Coast.

In addition, the U.S. holds the lead over Canada in the early stages of the competition to export North American LNG.

For the foregoing and other reasons, only a few projects will ultimately be built in Canada. How the field will be narrowed remains to be seen. Some project sponsors may drop out. Others may combine their projects.

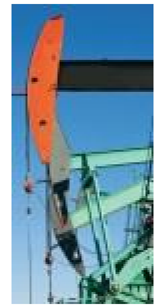
These challenges will also result in the sponsors of export projects selling down their interests in order to reduce their cost exposure and to secure customers for the LNG to be produced from these plants. Expect more deals like the sales PETRONAS made in 2013 to Japan Petroleum Exploration and Petroleum Brunei of part interests in PETRONAS' Pacific Northwest LNG project.

7. Changes to boards and senior management will continue

That prediction turned out to be true. High profile shakeups occurred at a number of companies including Encana, Penn West, Athabasca Oil Corporation, Lone Pine Resources and Baytex Energy as investors grew impatient for share prices to improve. Recently these kinds of changes also occurred at Talisman and Sunshine Oil Sands. After Carl Icahn acquired 7% of Talisman's shares, Talisman announced that two Icahn nominees had been appointed to the board and that those nominees would participate on the committee to identify the successor to Talisman's chief executive officer. At Sunshine, both the president and the chief financial officer resigned.

Many think that the outlook is for declining prices for oil and natural gas during 2014. If true, this trend of changes at the top of Canadian oil and gas companies will certainly continue.

8. Expect more consolidation and M&A involving the juniors



The outlook for juniors continues to be challenging.

Prolonged low natural gas prices have diminished cash flows and deprived juniors of the capital needed to pursue growth strategies. As a result, numerous juniors announced processes to maximize shareholder value in 2013. However, those processes did not always result in transactions.

To make matters worse for juniors, in May of 2013 the Province of Alberta increased its security deposit requirements for oil and gas operators to cover the costs of restoring lands affected by wells, facilities and pipelines. That regulatory change further constrainedthe capital available to juniors and depressed the market for their assets as potential acquirers factored in these new financial requirements.

This environment has contributed to the consolidation or sale of junior companies over the past few years to the extent that *The National Post* reported the number of juniors has shrunk by half from the middle of the last decade.

In 2013, several juniors were either merged or acquired. Deals included acquisitions by Whitecap Resources of Invicta Energy ($63M), Twin Butte Energy of Black Shire Energy ($358M), Yanchang Petroleum International of Novus Energy ($347M), ORLEN Upstream of TriOil Resources ($263M) and Bellatrix Exploration of Angle Energy ($576M).

We expect this activity to continue in 2014 as value-hunting acquirers (including dividend-paying exploration and development companies) take advantage of buying opportunities in this part of the energy sector.

All dollar amounts are in Canadian dollars unless otherwise stated.