

TORYS  
LLP

# Canadian Oil & Gas

2017 Outlook



MERGERMARKET

# Methodology

Torys LLP commissioned Mergermarket to interview 100 senior corporate executives and investment bankers with recent Canadian oil and gas experience to gain insight into their predictions surrounding some of the key challenges and opportunities for the sector. All responses are anonymous and results are presented in aggregate.

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# Introduction

Canadian oil and gas companies are being squeezed by the double pressure of commodity prices and pressure to reduce emissions. While Justin Trudeau's government is looking to support the oil industry during the longest downturn in prices in recent history, it also has to meet the challenge of lowering Canada's emissions output to satisfy environmental concerns, which could come at a high cost to producers.

Uncertainty about long-term global supply and demand patterns for oil and gas and their impact on oil prices are both a challenge and an opportunity for dealmakers.

The survey results show that respondents expect the Canadian energy M&A market in 2017 to be more robust than in the previous year. Buyers may be enticed by a price deck above \$50 per barrel, with both Brent crude and WTI largely buoyant since December, and they may also be ready to meet the seller's price expectations informed by a longer than expected commodity price decline but tempered by a strong reluctance to part with quality assets in a downturn.

At the same time, Canada is adjusting to a changing world in which environmental and climate change policy has taken centre stage.

Embracing this change is also expected to foster new technologies and bring efficiency to the industry. Indeed, technology acquisition to create cost savings is one of the most frequently cited factors to drive Canadian oil and gas M&A in 2017. Domestic consolidation and inbound buyer interest are equally important trends driving M&A activity, according to respondents.

Agreements with Indigenous peoples in Canada also continue to play an integral role in planning the country's future energy mix. This is particularly true for new midstream infrastructure for exports, and much of the progress of Pacific-side LNG projects will also depend on these negotiations. Geology, infrastructure and getting product to market are all essential factors affecting companies looking to compete—or, as in some cases, survive.

“E&P companies looking to make opportune investments in 2017 will have to contend with many of the same issues as existed in 2016, including low commodity pricing, market access issues and reticence by sellers to part with crown-jewel assets, and consider new factors such as how a Trump administration's policies may impact the investment climate in the Canadian oil patch.”

Derek Flaman, Partner, Torys

# Key findings

Some of the most pertinent findings from our survey include the following:

- 67% of respondents believe that M&A volume in the Canadian oil and gas industry will increase. Over half (54%) said the same of value.
- Inbound dealmaking from the US is expected to be a key driver of activity levels, according to 73% of respondents, closely followed by strong activity from Asia-Pacific buyers, as China continues to secure energy assets abroad (69% of respondents).
- The top target sectors for inbound buyers are LNG, oil sands and offshore oil facilities.
- Private equity firms continue to be strong partners for Canadian oil and gas companies. Forty-four percent of respondents say companies will look to PE firms for financing, in particular junior E&P companies.
- Environmental regulations loom large as a challenge to Canadian oil and gas companies over the next 12 months, say 42% of respondents.

**67%**  
BELIEVE CANADIAN  
DEAL VOLUME IS ON  
THE RISE

**44%**  
WILL LOOK TO  
PE FIRMS FOR  
FINANCING



# Strategic initiatives: M&A overview

## Exploring the current state of M&A in the Canadian oil and gas industry

The majority of respondents anticipate an increase in oil and gas M&A in Canada, as seen in Chart 1, which at 67% is slightly more optimistic than in our 2015 survey at 62%. Upstream companies with enough funds, for example, may look to grow through acquiring strategic producing assets rather than investing in costly exploration activities.

“As the oil and gas industry transforms itself to become profitable at lower price levels, there will be an increased focus on M&A over the next 12 months,” says the managing director of a Canadian investment bank.

However, one-quarter of respondents believe the market will remain stagnant due to a persistent buyer-seller valuation gap, both globally as well as in Canada, as many sellers are unwilling to dispose of high-quality assets in a lower commodity price environment.

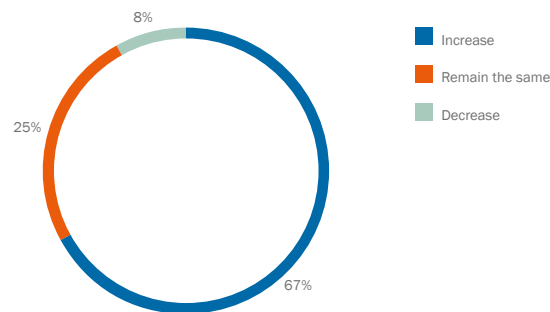
The manager of another investment bank points out that the currency spread may nevertheless be a perk for inbound buyers. “The cost of investing in Canada has been significantly reduced because of the devaluation of the Canadian dollar. This will boost M&A in Canada in the oil sector,” he says.

More than half of respondents (54%) believe the value of M&A transactions in Canada will also increase over the next 12 months (Chart 2). Some respondents pointed to increased private equity activity and foreign buyers in the oil patch as drivers. “Private equity firms are expected to have more interest in oil and gas M&A transactions. Compared to the past three years, this should become particularly visible in the junior exploration and production space,” says the managing director of an investment bank.

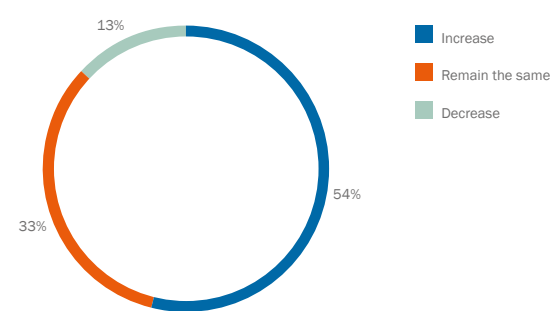
### E&Ps on the acquisition trail

Senior E&P companies, meanwhile, are also targeting acquisitions. The primary focus for these firms is expected to be growth through acquisitions (43%), as seen in Chart 3. Meanwhile, on the divestment front, 24% of junior E&P companies are expected to focus on a sale or merger, likely to senior E&P companies—a complementary result to that of senior companies wishing to grow through acquisitions—and an indication that a wave of consolidation might be imminent in the market as junior E&P companies struggle with high

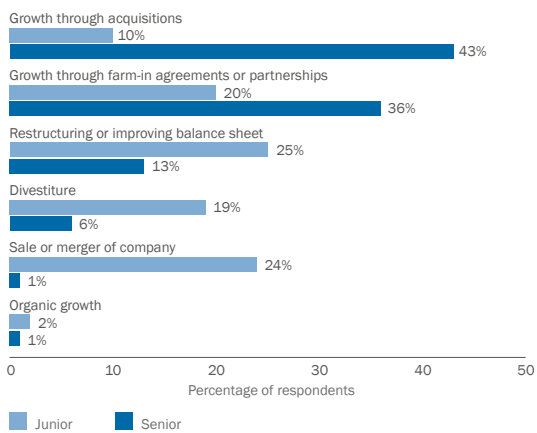
C1: What do you expect to happen to the overall volume of oil and gas M&A transactions in Canada over the next 12 months?



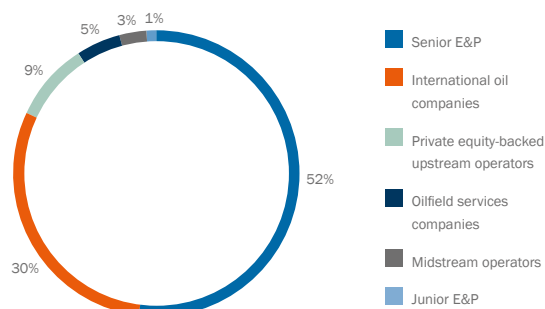
C2: What do you expect to happen to the overall value of oil and gas M&A transactions in Canada over the next 12 months?



**C3: What will be the primary focus of junior and senior E&P companies in Canada over the next 12 months?**



**C4: Which of the following will be most acquisitive in the Canadian oil and gas sector over the next 12 months?**



levels of debt and reduced levels of cash flow given distressed commodity prices (Chart 3).

Similarly, Chart 4 details that 52% expect senior E&P companies to be the most active buyer group. Many E&P companies have been able to maintain solid balance sheets and are therefore able to more successfully tap lenders for acquisitions and take on new debt. At a price deck of US\$45-50 bbl, the industry seems to have stabilized—if the price holds, debt/equity markets may open in 2017. Until that happens, banks continue to look to safe havens—sustainable, quality players with quality assets and firm balance sheets.

“Increased M&A activity is to be expected as industry players seek to increase cash flow, reduce costs and bolster balance sheets.”

Ron Deyholos, Partner, Torys

**Divestments rising**

Seventy-two percent of respondents expect an increase in divestments in the sector. “Low oil prices stir shareholder activism and will accelerate the number of companies looking to divest their business or a part of their business in response to the building pressure,” says the CFO and VP of finance of a Canadian junior E&P company.

Besides having to address debt obligations and shareholder concerns, one of the drivers behind divestments is to raise funds to finance acquisitions and capital spending. For example, following Enbridge’s bid for Spectra

Energy in September, Enbridge announced more than US\$1.5bn in planned divestments to maintain financing flexibility and focus on its core business, which includes the divestment of liquids pipeline assets owned by Enbridge Income Fund Holdings to Tundra Energy Marketing for \$814m.

### Technology and distress-driven deals

Unsurprisingly, the majority of respondents (79%) are looking to new technology to increase cost savings, as seen in Chart 6. Digitalization in the E&P process is making big strides as companies seek to maximize efficiency and bend the cost curve. This is most often achieved by bringing new technology and intellectual property in-house through acquisitions. Among deals involving the bigger North American oilfield services players was the acquisition by US giant Schlumberger of the Canadian coiled tubing segment of Xtreme Drilling and Coil Services, which designs, builds and operates a fleet of high-specification drilling equipment, and has activities in Canada, the US and Saudi Arabia. The deal will allow Schlumberger to provide more cost-efficient services.

In addition, technologies that achieve a reduction in the emissions footprint of the natural resource extraction process will become desirable assets for producers and midstream companies.

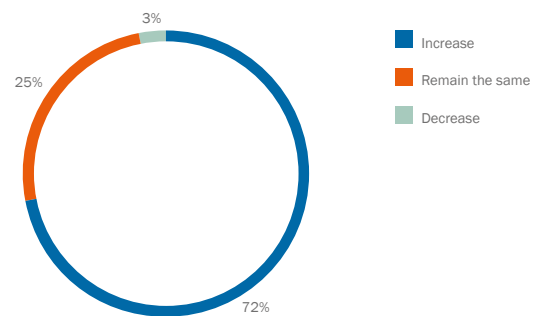
One corporate CFO explains: “To comply with various environmental and other regulatory requirements, companies are trying to find new ways to reduce costs and improve efficiency at the same time. Technological advancement is needed and companies have realized that and will focus on technological acquisitions to create cost savings.”

It is also worth noting that 76% of respondents anticipate that distressed situations will continue to drive deals (Chart 6). However, as the price of oil has hovered above US\$40/bbl since April 2016, distress-driven asset sales may have stalled with lenders, allowing producers to catch their breath after the brutal price drop in late 2015.

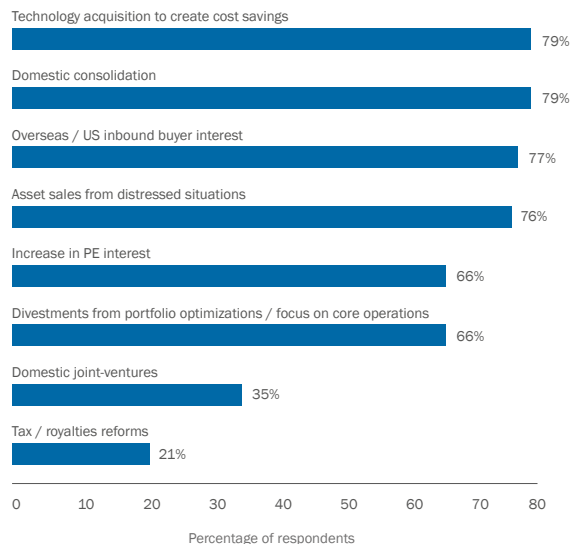
### Offshore drives domestic M&A, LNG pushes inbound deals

Lifting costs for existing platforms in Canada’s Atlantic Ocean basins are high, squeezing profits for upstream operators. Reasonable optimism surrounds estimates of the recoverable resources offshore following discoveries by Statoil, and a high oil price in past years sparked new infrastructure,

**C5: What do you expect to happen to the volume of oil and gas divestitures in Canada over the next 12 months?**



**C6: Which of the following factors will drive Canadian oil and gas deal volume over the next 12 months? Respondents selected all that applied.**







**51%**  
 LNG PROCESSING  
 IS TIPPED TO SEE THE  
 BIGGEST INCREASE  
 IN INBOUND M&A

exploration, and production activity in the Atlantic’s hostile climate and rough waters. This trend has since been challenged by lower profitability for these capital-intensive projects. Respondents expect domestic M&A activity levels in the offshore and oil sands sectors to increase the most over the next 12 months (Chart 7). This is perhaps not surprising given the relative low levels of activity in those sectors in recent years.

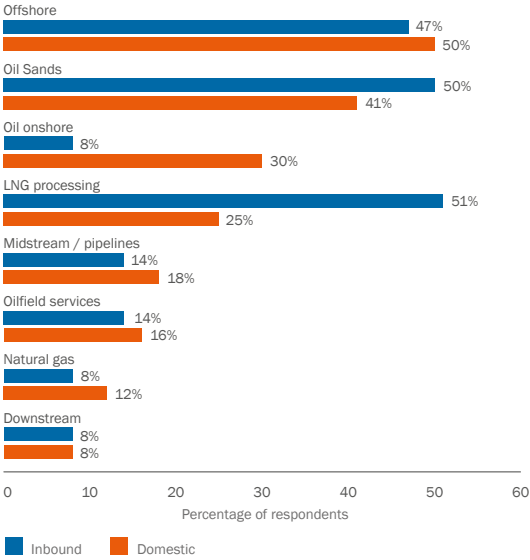
“Domestic deals will increase, especially offshore and oil sands. Offshore activity has slowed down, and companies are divesting to save on costs and get capital. Meanwhile, the oil sands producers have been negatively affected by recent forest fires. The slump in these sectors will force companies to merge and work together to make profits,” says the managing director of a US investment bank.

On the upside, factors such as the EU-Canada Comprehensive Economic and Trade Agreement (CETA), signed last October, will see taxes removed for refined crude product imports into the EU, and offer incentives for continued extraction in Atlantic Canada.

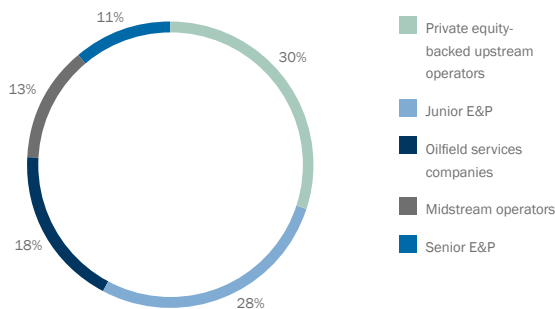
Meanwhile, LNG terminals are thought to be one area of focus for inbound M&A, according to 51% of respondents (Chart 7), continuing the trend of Asian corporates securing LNG infrastructure for long-term supply from the Pacific Coast.

“Inbound acquisitions in LNG processing and natural gas will increase as there is a lot of demand and opportunities for companies in this sector that will be boosted by the development of different pipelines,” adds the US investment bank managing director.

**C7: Which of the following Canadian oil and gas industry subsectors will see the most increase in domestic and inbound M&A activity over the next 12 months? Respondents were asked to select the top two subsectors.**



**C8: Which of the following will be the most common target in the Canadian oil and gas sector over the next 12 months?**



“The Investment Canada Act regulation of foreign investment into Canada’s oil sands assets will continue to play a prominent role in shaping inbound investment.”

Neville Jugnauth, Partner, Torys

### Bidders and targets

The majority of Chart 8’s respondents see senior E&P companies as the most acquisitive, followed by international oil companies (IOC). “Those IOCs with cash surplus will be willing to acquire midstream operators and junior E&P companies to reduce operational costs on projects, and use their expertise to handle project approvals and stringent environmental conditions set by the government,” says the managing director of a US-based investment bank.

Indeed, junior E&Ps are seen as the second-most common targets for acquirers over the next 12 months (Chart 8), topped only by PE-backed upstream operators. Meanwhile, oilfield services companies will also be targeted, according to 18% of respondents, as service providers are squeezed by lower profit margins and idle equipment.

### LNG sellers see valuation bump

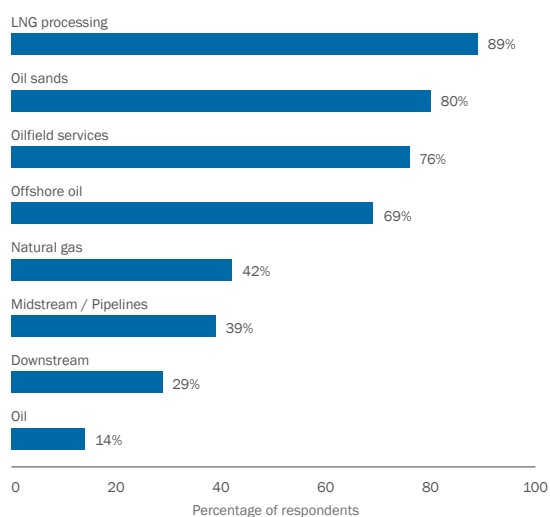
When it comes to valuations for sellers, LNG processing facilities are out in front, as Canada needs to prioritize infrastructure that aids in getting gas to global markets (Chart 9). Eighty-nine percent of respondents think valuations will remain favorable for sellers in this segment.

“As of now among all the subsectors, LNG is one that is experiencing significant demand, and there is also a lot of support for LNG from the government. Sellers would be able to reap a significant valuation. If we take a look at the partnerships that have taken place in the past, we can easily make out how well this subsector is growing,” says the CFO of a Canadian corporate.

Sellers also expect valuations to be strong in the oil sands over the next 12 months (80%). As costs in the oil sands are relatively fixed with respect to infrastructure, sellers don’t expect to sell at lower valuations with a low break-even price. The cost of production per barrel in Canada in March 2016 equaled US\$26.64, only marginally higher than US shale at US\$23.35, according to Rystad Energy data quoted in *The Wall Street Journal*. While initial capex is high, longevity provides stable returns over time.

“Oil sands have been affected by the natural disaster [in Fort McMurray] that took place recently, but we expect sellers to get a good amount of returns from the oil sands as the cost of extracting is quite low. Hence sellers will be able to generate strong returns from this sector and there will be buyers willing to invest,” says a partner of M&A at a Canadian investment bank.

**C9: In which subsector will valuations be most favorable for sellers over the next 12 months? Respondents selected all that applied.**



“The prolonged lower-for-longer commodity environment, expiry of favourable hedges and resultant reduced cash flow combined with the lack of diversification, increased regulatory burden, challenged access to capital, restless shareholders and low reserve replacement ratios make junior E&P companies prime targets for acquisition.”

Scott Cochlan, Partner, Torys

## Evolving E&Ps

### Senior E&Ps

On the senior E&P side, there has been significant transactional activity resulting from global divestment programs as the majors rationalize portfolios and shed non-core or less profitable assets.

We are seeing some of the large divestitures come to fruition. These headline deals often involve legacy assets and can take years to execute, with significant regulatory hurdles. Drivers of these deals are not only acquisition price, but also reducing residual liabilities, transitioning the workforce and maintaining a good corporate reputation.

As a prominent example, Shell announced plans to divest of US\$30bn in assets globally to deleverage after its US\$54bn acquisition of BG Group. In Canada, this has included the 2016 sale of shale oil and gas assets to Tourmaline Oil and the sale of offshore interests to Anadarko, as well as halting or deferring commitments on certain capital intensive projects.

### Junior E&Ps

Meanwhile, junior E&Ps found it extremely difficult to access capital for the development of international projects in a low commodity price environment and, if they could get equity finance, it was very dilutive at depressed prices.

These international E&Ps have high G&A due to structuring and staffing in multiple jurisdictions, more complex public disclosure and compliance costs, often with added risks related to currency fluctuations, uncertain pricing markets and unique challenges on the operations side. Many juniors have been forced to transact and consolidate. We have seen companies pursue creative partnerships and asset deals to attract the capital needed to meet commitments and advance projects.

— Stephanie Stimpson, Partner, Torys

# Cross-border view: Canadian investment inbound and outbound

Domestic dealmaking continues to be the staple of the Canadian oil patch, followed by the US as the second most active buyer. However, China and Hong Kong are catching up fast, with buyers willing to pay a premium for quality assets.

Dealmaking between Canada and the US remains a top priority, with 73% of respondents confirming this view (Chart 11). While some of the biggest North American deals this year were initiated by Canadian buyers, there were also plenty of US acquirers looking across the border to Canada, such as Murphy Oil's purchase, among others, of Montney Formation-focused assets from Athabasca Oil for US\$201m. And indeed, in terms of volume, deals from the US accounted for 71% of inbound M&A in the sector, according to Mergermarket data.

Mergermarket data also shows several cross-border acquisitions in the oilfield services segment, where large US players such as Schlumberger and National Oilwell Varco are seeking to expand their territory and expertise in Canada through M&A.

With 69% pointing to strong activity from Asia-Pacific buyers, the region also figures prominently in respondents' minds (Chart 10). Much of the post-Fukushima demand for gas/LNG has abated in Japan with the restart of several nuclear reactors, and prices have adjusted downward accordingly. With a fall in price, many of the Pacific-side LNG projects are now being reconsidered. However, demand from growing economies such as South Korea and China remains a firm long-term proposition.

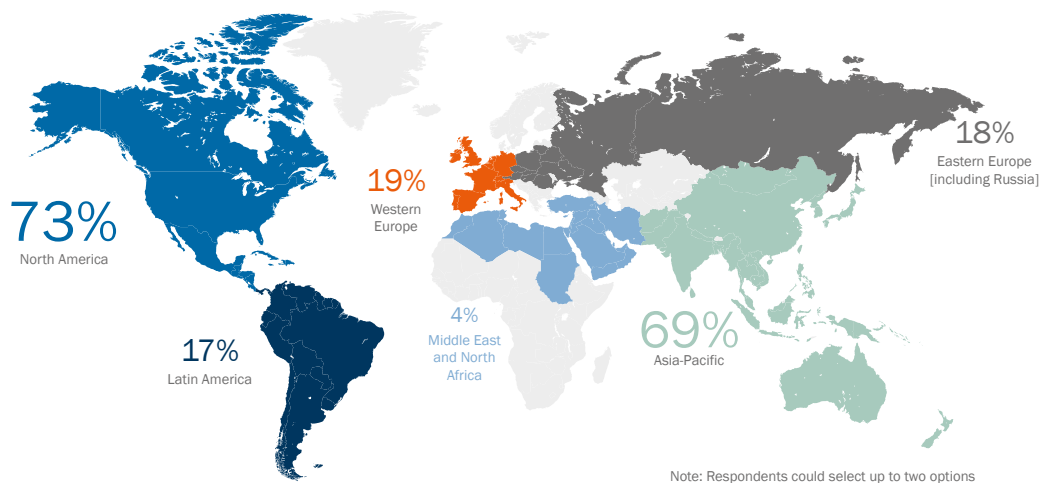
"China favors Canada because of its rich natural resources and the lower regulatory requirements. China and other Asia-Pacific countries are constantly looking for energy supply in order to meet their growing consumer and industrial demand. With an interest in being involved in a more stable market, they are expected to be most acquisitive in the Canadian oil and gas sector," says the CFO of a Canadian E&P company.

Asian buyers also remain important off-takers for Canadian gas. Despite China's move from raw material demand to consumer goods consumption,

“That Canada has an abundance of natural resources is beyond doubt. However, Canada's commitment to the development of energy infrastructure has been uncertain. The recent approval of Trans Mountain by the Canadian government and the continued support for LNG development exhibited by the B.C. government are critical signals for attracting offshore investment dollars in 2017 and beyond.”

Chris Christopher, Partner, Torys

**C10: Companies based in which regions will be the most acquisitive in the Canadian oil and gas sector over the next 12 months?**



the country continues to seek energy assets abroad. In May 2016, Chinese Guangzhou Gas signed a long-term offtake agreement with Woodfibre LNG, owned by Pacific Oil & Gas, and a subsidiary of Singapore-based RGE Group.

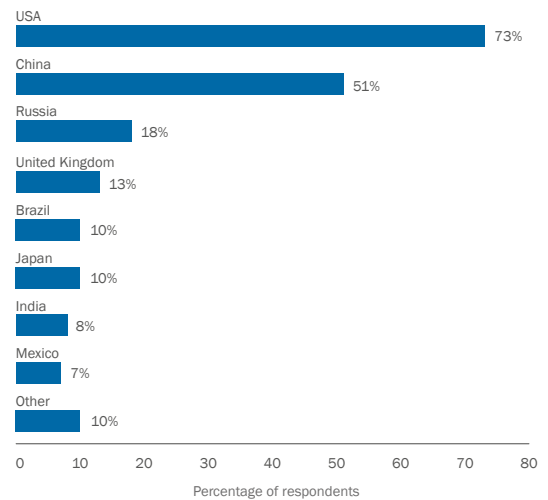
Also earlier this summer, Hong Kong-based Power Assets Holdings and Cheung Kong Infrastructure Holdings completed the acquisition of a 65% stake in senior E&P company Husky Energy’s midstream assets for \$1.3bn, with both buyers expecting steady returns.

**Outbound deals going Latin**

The majority of respondents expect Canadian companies to be the most acquisitive in Latin America (71%). Resources on the continent are plentiful but a lack of infrastructure in most countries still poses a challenge, while other countries such as Mexico are becoming increasingly attractive through ongoing energy reforms.

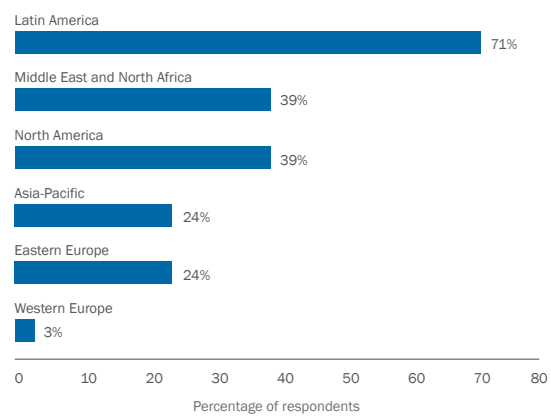
The fast-moving North American market is a focal point for 39% of respondents, along with an equal share of respondents (39%) prioritizing the oil-rich regions of the Middle East and North Africa (Chart 12).

**C11: Which countries in these regions above do you think will be the most active acquirers in Canada over the next 12 months? Respondents were asked to select two.**





**C12: In which region(s) do you expect Canadian oil and gas companies to be most acquisitive over the next 12 months? Respondents were asked to select two regions.**



The prolific but underserved and stagnant basins of South America continued to draw in Canadian upstream companies. After several Canadian acquisitions in Colombia in 2015, dealmaking continued into 2016: Gran Tierra Energy bought PetroGranada Columbia, active in Colombia's Putumayo Basin, for US\$19m. In the summer, Canadian E&P player Madalena Energy ventured into Argentina, buying a 55% stake in Shell's Coiron Amargo Sur Este play in Argentina for US\$5m. The country is also rumored to have potential for shale oil and gas exploration.

"Latin American countries have made a number of changes in their energy policies and governments have taken several effective steps which have had an impact on economic conditions. In addition, regulations have also turned out to be easy to comply with. All this has increased the confidence of Canadian oil and gas companies," says the CFO of a Canadian E&P company.

Canada's top two outbound acquisitions this year were focused on gas midstream infrastructure: Enbridge's US\$40.7bn bid for US gas pipeline operator Spectra Energy, and TransCanada Corporation's acquisition of Colombia Pipeline Group. The latter deal effectively created a vast North American gas transmission system following TransCanada's failed first bid for a Keystone XL pipeline extension. These deals give weight to Canada's increasing focus on gas, as well as the continued hurdle Canadians face in getting both oil and gas to international markets and in competing with US shale producers. And with TransCanada's reapplication still pending for the permit to execute on Keystone XL in response to President Trump's executive order reviving the pipeline, domestic exports to the US remain expected to decline somewhat for the time being, with a focus on Canadian LNG exports to Asia.

69%

BELIEVE ASIA-PACIFIC PLAYERS WILL BE MOST INTERESTED IN BUYING CANADIAN COMPANIES

71%

EXPECT CANADIAN COMPANIES TO BE ON THE LOOK-OUT FOR TARGETS IN LATIN AMERICA

39%

SAY THE BULK OF CANADIAN OIL AND GAS COMPANIES WILL BUY WITHIN NORTH AMERICA



### Price expectations

Despite the majority of respondents in Chart 13 expecting oil prices to remain the same over the next 12 months, 43% anticipate that they will increase somewhat. A slowly rising price curve is in line with IEA projections that the market has bottomed out and supply-demand dynamics will support the oil price again by the second half of 2017.

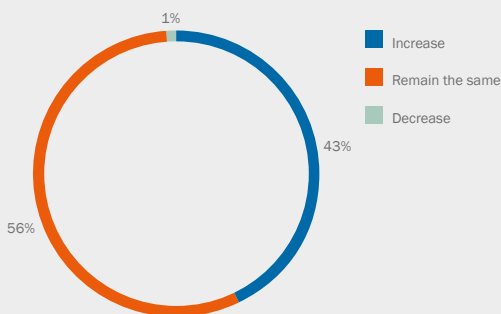
Oil remains the top fuel by demand, according to projections by ExxonMobil, but gas is the fastest growing, with an expected annual growth rate of 1.6% up to 2040. Production from unconventional supply sources, including oil sands, is also expected to grow.

This will apply in particular to the Canadian government's approval of the Kinder Morgan Trans Mountain expansion project at the end of November. The additional pipeline from Alberta to Burnaby in British Columbia will almost triple system capacity to 890,000 barrels per day and will most certainly spur new investment in the oil sands.

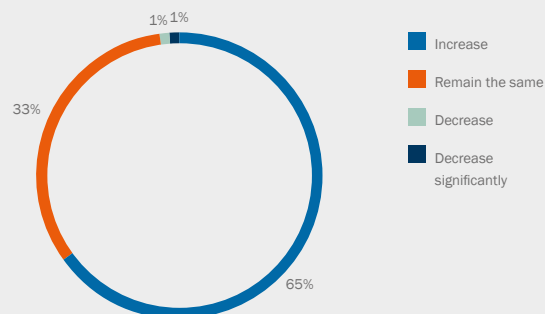
And as one can't have an opinion on oil without having one on gas, our respondents in Chart 14 expressed more optimism regarding gas prices, with 65% saying these will increase somewhat. An increase in domestic gas consumption may underpin the price at home, while much of the export potential remains pegged to permitting LNG export terminals and global gas-demand patterns.

"I expect gas prices to increase somewhat over the next 12 months. The current market scenario shows that supply of gas is slowly coming in sync with the demand of gas. Delay in project approvals has its own drawbacks but it is helping in a way: there is no excess supply of gas in the market from new sources, which in turn is helping push gas prices up," says the managing director and head of energy at a Canadian investment bank.

**C13: What do you expect to happen to oil prices in the next 12 months?**



**C14: What do you expect to happen to gas prices over the next 12 months?**





# Financing deals

## With M&A clearly back on the corporate menu, we reveal how companies are planning to finance their deals

Risk-averse lenders kept the purse strings tight after Brent crude hit rock bottom in January 2016, with credit only available to the top of the crop. To stay afloat during the dramatic downturn with equity capital markets also relatively restrained, many highly leveraged corporates turned to asset sales just to get lifelines to maintain balance sheets and repay existing debt. A combination of debt and equity is now expected to be the preferred financing method for M&A over the next 12 months, according to 60% of respondents (Chart 15).

“To keep debt down, companies will split the way they get their finances. Interest rates are still quite low and debt mechanisms exist for companies to take advantage of,” says the director of strategy and M&A at a US corporate.

Compared to the 2015 survey, a larger percentage of respondents are now prepared to look to debt markets for M&A finance, up from 28% to 37%. This may be due to the bump in price to a stable US\$40/bbl and above—a level at which banks are more comfortable to lend.

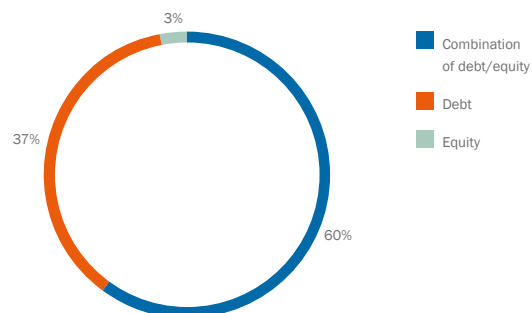
### PE doubles down

Private equity has long been a traditional partner in the US and Canadian oil patch, in particular for junior exploration companies, and indeed 44% of respondents look to partnerships with PE firms to obtain financing for new and existing projects (Chart 16).

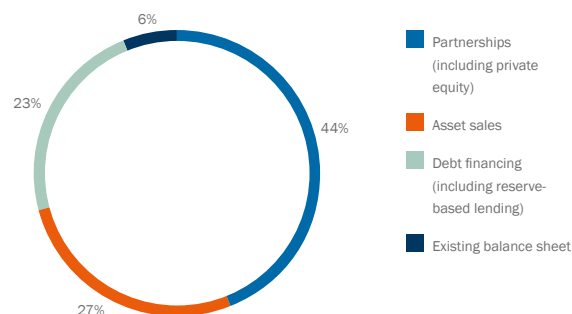
“There is also significant potential for restructuring in the Canadian oil and gas sector and PE firms will not miss the opportunity to invest. They are very confident in managing such strategies and the slight increase in oil and gas prices will enable them to make huge return multiples from investing in such businesses,” says the CFO of a US corporate.

Over the past few years, PE firms have also amassed a significant amount of dry powder to invest in the right target. According to Mergermarket data, PE deals targeting Canadian assets increased from six in 2015 to eight in 2016, and combined deal value jumped from US\$528m to US\$1.4bn.

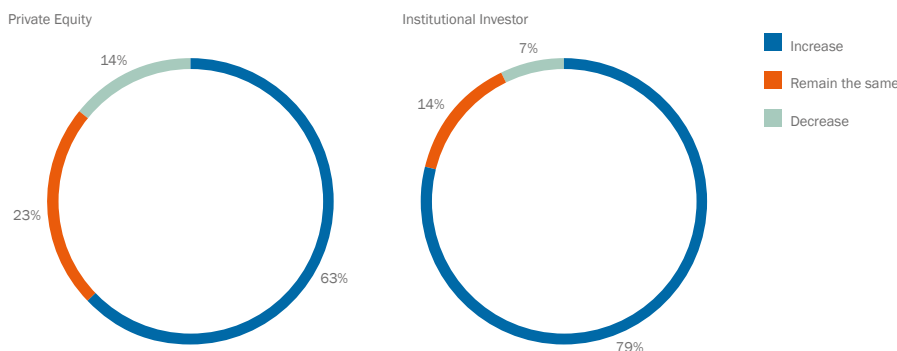
**C15: What is the most likely method that most oil and gas companies will use to finance an M&A transaction in the next 12 months?**



**C16: How do you expect oil and gas companies to obtain financing for new and existing projects over the next 12 months?**



**C17: What do you expect to happen to private equity and institutional investor investment in the Canadian oil and gas sector over the next 12 months?**



US PE funds, for example, made acquisitions in Canada in 2016, such as One Stone Energy Partners' US\$20m bid for Calgary-based emerging junior E&P company Yoho Resources. Canadian energy-focused private equity firms, including ARC Financial, were also very active in 2016.

"PE investors are supporting the oil and gas industry as they see potential for future growth of the business, on anticipation that oil and gas prices will increase and on their ability to turn around business situations and regain performance," says the CFO of a US corporate.

Partnerships with pension funds have also helped Canadian E&Ps weather the downturn: Ontario Teachers' Pension Plan acquired royalties from Cenovus in 2015 and the Canada Pension Plan Investment Board funded Teine Energy's US\$767m acquisition of Saskatchewan assets from the highly leveraged Penn West Petroleum, which had already been paying off debt with proceeds from asset sales.

The Canada Pension Plan Investment Board was also active on the midstream front, having formed Wolf Midstream in 2016 to focus on midstream infrastructure investment opportunities, and which completed the US\$1.07bn acquisition of a 50% interest in the Access Pipeline from Devon Energy in the fall of 2016. Both PE and institutional investor involvement is expected to increase in the oil patch in the next 12 months (Chart 17).

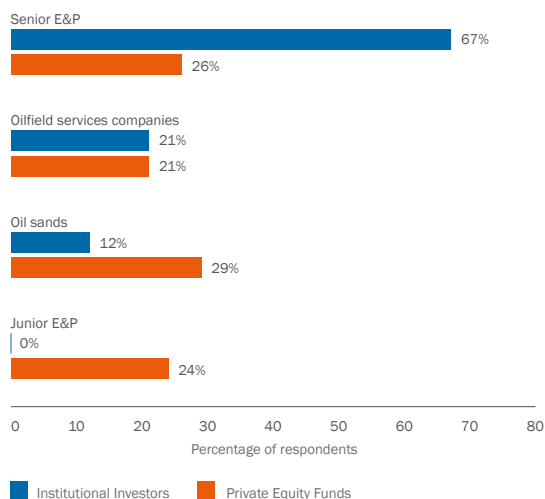
“Private equity has continued to find successful opportunities to deploy capital in the Canadian energy industry while capital markets have remained relatively constrained for many industry participants during the low commodity price cycle.”

Neville Jugnauth, Partner, Torys

**79%**  
EXPECT INSTITUTIONAL INVESTOR ACTIVITY IN THE CANADIAN OIL AND GAS SECTOR TO PICK UP IN 2017

**67%**  
ANTICIPATE A FOCUS ON SENIOR E&P COMPANIES BY INSTITUTIONAL INVESTORS

**C18: Where do you expect involvement from private equity funds and institutional investors to be most active in the Canadian oil and gas sector over the next 12 months?**



One respondent, the CFO and VP of finance of a Canadian corporate, says: “State-owned enterprises where majority shareholders are institutional investors have begun investing in the Canadian oil and gas market. However, the increase is going to take some time as there is an attempt to draft a national policy on carbon pricing and other related policies.”

Institutional investors are expected to show a clear preference for dealing with senior E&P companies, according to 67% of respondents (Chart 18). Private equity is expected to be interested in all sectors.

“Private equity funds and institutional investors will be playing a substantial role in the Canadian oil and gas sector. PE funds would largely be concentrating on junior E&P companies along with oilfield services as they present bigger investment opportunities. On the other end, institutional investors are most likely to focus their efforts further up on the energy chain and will have greater interest in investing in senior E&P companies,” comments the managing director of a US investment bank.

**Private equity’s focus on energy**

There is a general consensus that there will be a recovery in the Canadian oil and gas industry supported by relative oil price stability above US\$50/barrel and political support for pipeline projects to address market access concerns. As such, conditions are expected to be conducive to strong levels of M&A and investment activity in Canada’s upstream and midstream sectors. This continues to be a trend from the latter half of 2016 when senior Canadian producers were actively consolidating upstream assets; a number of significant midstream infrastructure transactions were completed; and activity in the oil sands sector significantly increased.

Private equity fundraising has outstripped investment in Canadian oil and gas over the past few years. And there are significant amounts of capital looking for opportunities at an attractive part of the industry investment cycle from a valuations standpoint. Private equity has been active in all areas including acquiring distressed assets through junior and mid-cap E&P restructurings and partnering through investment in both start-up management teams as well as senior issuers.

Midstream infrastructure assets continue to provide monetization strategies for producers and attract investment from both financial buyers and well-capitalized strategic buyers. As industry conditions continue to improve, consolidation in the oilfield services sector is also expected.

— Neville Jugnauth, Partner, Torys

# Regulatory insights

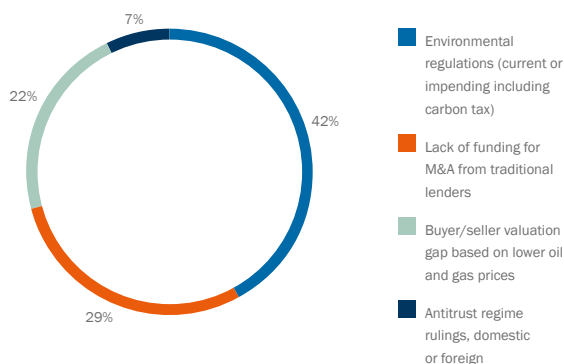
## Environmental regulations are likely to become stricter, pushing up the costs of extraction

The heavy carbon footprint of the oil sands and new LNG projects looms large. And as the global oil and gas industry is increasingly factoring in environmental cost in the form of carbon taxes, the price of emissions will increase for Canadian producers. A liberal Trudeau administration is pressured by environmental and citizen concerns, having to balance these with the huge economic importance of extractive industries.

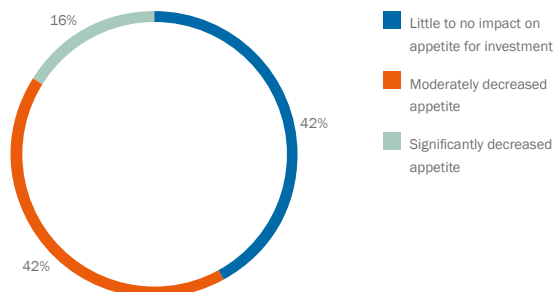
At the end of November 2016, the government made four key decisions that hugely impact current and future projects and indicate the direction the Canadian oil and gas sector will take for years to come. The moratorium on crude oil tankers in northern B.C. is effectively in line with the rejection of Enbridge's proposed Northern Gateway Pipeline from Alberta to Kitimat, B.C.

However, recognizing the significance of the oil and gas industry and getting product to market, the government approved Enbridge's Line 3 replacement and the Kinder Morgan Trans Mountain Pipeline expansion project.

**C19: Which of the following factors are the greatest challenge(s) to Canadian oil and gas M&A over the next 12 months? Respondents were asked to select the most important factor.**



**C20: How do you think the recent approval of the Pacific NorthWest LNG project has impacted foreign investor appetite for LNG projects?**



### Reducing the footprint

Pressure to transform extractive industries and energy generation is exerted on a global level. As the Paris Agreement on climate change (COP 21) enters into force in the winter of 2016, Canada will seek to reduce greenhouse gas emissions to 30% below the levels of 2005 by 2030.

“Keeping in mind [that with] climate change policies being framed and the gradual shift towards clean fuel across the globe, there will be more emphasis on reduction of environmental impacts. This will require tremendous capital funding to bring in the necessary technological changes,” says the CFO and VP of finance of a Canadian producer.

In October, the incumbent government levied a national carbon price, or a cap-and-trade scheme as an alternative, in an attempt to align the provinces into a cohesive carbon policy. Read more about this topic in our “Spotlight on carbon pricing in Canada” article on page 24.

“We expect environmental regulations to change, which will impact the amount we will be allowed to extract. This will raise extraction cost, and returns are already low and added taxes contribute to problems that oil companies will face when trying to remain operational,” comments a senior director of strategy and business development at a US corporate.

But uncertainty on new project approvals prevails despite concrete reform efforts, as well as rising anti-pipeline activism by environmental protesters and concerned Indigenous groups.

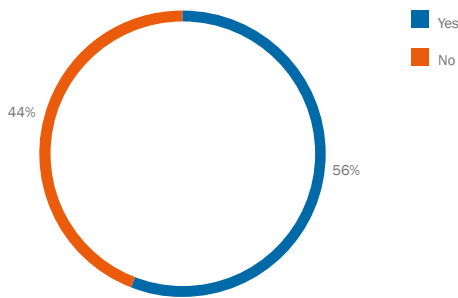
Indeed, 42% of respondents expect environmental regulations to be the greatest challenge to Canadian oil and gas M&A in the coming months, as the oil patch is already feeling the squeeze in a low oil price environment (Chart 19).

Trudeau’s administration sent a positive signal to the market with the approval of Petronas’ Pacific NorthWest LNG. A project with considerable compliance hurdles still to overcome, 42% of respondents believe the approval has not sparked foreign investor appetite for Canadian LNG projects, likely due to the lengthy approvals and compliance process (Chart 20).

More than half of respondents, however, are optimistic about the approval of new greenfield projects in Canada over the next 12 months (Chart 21). One of



**C21: Do you expect an increase in any new greenfield projects / final investment decisions for such projects including LNG in Canada in the next 12-24 months?**



the recent approvals made by the government, the Trans Mountain expansion pipeline from Alberta to a port near Vancouver, has sent a positive signal to investors as new pipeline infrastructure will encourage new exploration and production activity given the anticipated increase in transport capacity.

Those who believe that no new greenfield projects and final investment decisions will receive the green light in Canada over the next 12 months mostly attribute this to exceedingly high project development costs and changes in global supply and demand patterns. However, small-scale LNG terminals could be a solution to bypass these concerns.

**42%**  
 SAY ENVIRONMENTAL REGULATION IS THE GREATEST CHALLENGE TO M&A IN THE SECTOR

**42%**  
 SAY THE APPROVAL OF PACIFIC NORTHWEST LNG HAS NOT SPARKED FOREIGN INVESTOR APPETITE FOR CANADIAN LNG

**56%**  
 EXPECT AN INCREASE IN GREENFIELD PROJECTS IN CANADA

**Responding to regulation**  
 There is no question that the federal government's increased focus on environmental stewardship has and will continue to place pressure on the oil and gas industry. Our clients face increasing uncertainty and therefore risk regarding facility approvals, costs and future growth.

And it should be noted that some provinces are also focused on climate change. Alberta, for example, has embarked upon an aggressive climate change initiative of its own. Industry players will be called upon to be forward thinking and innovative as they attempt to grow, compete and satisfy investors' return expectations.

— Luigi Cusano, Partner, Torys

## Conclusion: Turning tides

With the decision to enhance tidewater access for Canadian producers through the Trans Mountain pipeline and to US markets through the Line 3 expansion and the newly revived Keystone XL, the government has signaled its support to the oil and gas industry at a time when many are struggling with the prolonged low price of oil.

This will ease some of the uncertainty in the market and provide a much-needed boost of confidence to investors. Nevertheless, the dismissal of Enbridge's Northern Gateway has moderately decreased investment appetite in Canada's infrastructure, say 55% of respondents. According to 42% of respondents, even the recent approval of the Pacific Northwest LNG project has somewhat cooled foreign investor appetite due to the lengthy approvals process. Now the owner of Malaysian national oil company Petronas has placed the project under review.

Smaller-scale LNG projects may hold the key to market revival. Our survey shows that the majority of respondents (56%) anticipate an increase in LNG projects. This is much in line with the expectation that gas demand globally will increase. Asian buyers for example are looking to Canada to secure supply of both oil and gas amid a globally expanding LNG market.

Our data shows that 67% of respondents are more optimistic about the volume and 54% about the combined value of Canadian M&A for the year ahead—particularly senior E&P companies, which are likely to be the most acquisitive.

However, Canada is also moving towards a lighter carbon footprint and this will put additional costs on producers—42% of respondents feel that environmental regulation, including changes to carbon pricing, is one of the greatest challenges to Canadian M&A. Factoring in environmental costs is nothing new for Canadian producers, but a uniform policy would bring greater certainty to investment planning. Upstream companies globally now have to contend with climate change policies and reposition their corporate strategies in line with new regulation.

PE firms sitting on vast amounts of dry powder are also set to capitalize on their knowledge of the industry. For struggling junior producers, PE firms can throw a lifeline and help them optimize both geology and geography by assembling complementary portfolios. If the oil price improves further and remains stable above the break-even price for oil sands producers, then the dynamic Canadian oil market will maintain its attractiveness as a safe and stable investment destination.



“There are certainly reasons to be more optimistic about 2017 than 2016. That being said, the industry still faces considerable challenges on a number of fronts. This optimism, albeit very guarded optimism, and the existing challenges facing many companies may well both help to drive an increase in M&A activity in 2017.”

Derek Flaman, Partner, Torys

# Spotlight on carbon pricing in Canada

By Tyson Dyck, Henry Ren and Renée Matthews

As 2017 begins to take shape, the Canadian government and several provinces are implementing significant new measures to mitigate climate change. These initiatives seek to establish an escalating price on greenhouse gas emissions. We explore how they will work and ask what the impact of a carbon price on the cost of energy will be in an emissions-constrained environment.

## Alberta's Climate Leadership Plan

Alberta's new legislation is a multi-faceted strategy to reduce carbon emissions and diversify the economy.

The four cornerstones of this plan are:

- An accelerated phase-out of coal
- An economy-wide carbon levy
- An absolute cap on oil sands emissions
- A methane gas emissions reduction plan

While Alberta already has legislation in place to regulate carbon emissions, the *Climate Change and Emissions Management Act (CCEMA)*, the Climate Leadership Plan will have a much broader provincial impact on emissions reductions.

As of January 1, 2017, a carbon levy of \$20/tonne is being charged on all fuels that emit greenhouse gas emissions when combusted. This will increase to \$30/tonne in 2018. The levy applies to transportation and heating fuels such as diesel, gasoline, natural gas and propane. Marked gas and diesel used on farms are exempt from the levy, and the levy does not apply to electricity.

To reduce oil sands emissions, Alberta has implemented a \$30/tonne carbon price for oil sands facilities. Additionally, the province has implemented a legislated maximum emissions limit of 100 megatonnes per year,

with provisions for cogeneration and new upgrading capacity in hopes of stimulating technological investment.

By 2025, the province intends to cut methane emissions from oil and gas operations by 45% by applying new emissions design standards to new facilities and improving the measurement and reporting of methane emissions.

## Pan-Canadian Framework on Clean Growth and Climate Change

Meanwhile, after months of negotiation, the federal government, eight provinces and three territories signed the Pan-Canadian Framework on Clean Growth and Climate Change (the Framework) on December 9, 2016.

The agreement outlines a federal standard for carbon pricing. The essential feature of the Framework is a federal benchmark for pricing greenhouse gas emissions. To meet the benchmark, jurisdictions can implement either:

- An explicit price-based system, or
- A cap-and-trade system

For price-based systems, the benchmark carbon price would start at a minimum of \$10 per tonne in 2018, rising by \$10 per year to \$50 per tonne in 2022.

In contrast, jurisdictions that adopt cap-and-trade are expected to achieve (i) emissions reductions of at least 30% below 2005 levels by 2030, and (ii) declining annual caps to at least 2022 that correspond, at a minimum,



to the projected emissions reductions resulting from the carbon price that year in price-based systems.

The governments of Saskatchewan and Manitoba have indicated that they will not adopt the Framework.

## Impact on the Oil and Gas Sector

### Oil sands producers

Since 2007, Alberta has had legislation in place that regulates emissions from large industrial facilities across all sectors, including the oil and gas sector. The CCEMA and the related *Specified Gas Emitters Regulation (SGER)* established an intensity-based limit on industrial GHG emissions (as opposed to an overall cap on the province's aggregate emissions).

Pursuant to this legislation, large industrial facilities are currently required to reduce their emissions intensity by 20% per year, or else rely upon earned emission offsets and emission performance credits.

As a further alternative, facilities that are unable to meet their intensity requirements can fund credits at a price of \$30/tonne of GHG emissions in excess of their facility emission limit, which is paid into the provincial Climate Change and Emissions Management Fund. Alberta's new carbon levy under the Climate Leadership Plan, together with the SGER limits, will apply to 78-90% of the province's GHG emissions.

Alberta's Climate Leadership Plan adds a further layer of legislation and regulation that will apply to the oil and gas sector specifically. Pursuant to the newly enacted *Oil Sands Emissions Limit Act (OSELA)*, the government has introduced a cap on total oil sands emissions at 100,000 megatonnes per year, with specific exemptions for certain producers and facilities (e.g., upgraders, cogeneration facilities).

The oil and gas sector in Alberta has largely supported the government's climate plan initiatives, including the carbon levy and emissions cap. However, the sector recognizes that ongoing consultation and cooperation with government policy makers will be key to determining the economic and competitive path forward for all members of the industry.

There is some discourse within the industry that predicts a curtailing of future oil sands growth as a result of the emissions cap. Predictably, some producers will hold assets that remain underdeveloped or stranded, without the implementation of operational efficiencies that allow them to grow production, but at a lower carbon intensity.

Consequently, there is an industry focus on investing in new innovations and utilizing new technologies that can help Alberta's oil and gas companies meet the new regulatory requirements, while remaining financially and operationally competitive in the North American (and global) commodity market. Companies seeking to maintain and secure their future market position across jurisdictions with unequal (or simply differentiated) regulatory policies have been incentivized to invest in and adopt technologies that give them a competitive edge.

The Canadian Oil Sands Innovation Alliance (a voluntary group of some of the largest oil sands producers) is an example of this, having committed \$1.3 billion in investment funding since 2012 to develop over 800 patents related to enhancing environmental performance and mitigating the carbon footprint of their operations. This type of financial commitment is indicative of the sector's long-term view on the importance of integrating leading technology and innovation in corporate operations as a means of remaining competitive in a shifting, uncertain and often unequal regulatory world.



### **Natural gas producers**

Alberta's climate change initiatives also have consequences for natural gas producers. The government's plan to phase out coal-fired power by 2030 necessitates a significant reallocation of the provincial fuel supply mix. In particular, the government's goal is to have 30% of electricity supply sourced from renewable power, and the remaining 70% sourced from natural gas.

The forecast is that an additional 1.5 billion cubic feet of gas per day will be required to meet this new supply mix, which presents a huge opportunity for natural gas producers to contribute to and benefit from Alberta's climate change goals. The Climate Leadership Plan also calls for a reduction in methane gas emissions by 45% by 2025. The oil and gas sector is the largest source of methane gas emissions, accounting for 70% of Alberta's methane emissions in 2014.

The government plans to reach this objective through the implementation of new design standards for gas production facilities, improving monitoring, detection

and reporting protocols, and by introducing regulated standards by 2020 to reduce methane emissions from oil and gas operations.

### **Ontario's Cap-and-Trade Program**

On January 1 this year, Ontario's new cap-and-trade program came into effect, covering the emissions of around 85% of the province's economy. The program limits the greenhouse gas emissions of major emitters in the province. Under the program, those emitters must cover their emissions in each compliance period (the first runs from January 1, 2017, to the end of 2020) with an equivalent amount of emissions credits. These credits can be procured in auctions, the secondary market or reserve sales, and can be traded among emitters and other market participants. Some emitters will also receive free allowances from the province — this is intended to provide transition assistance and minimize carbon leakage.

### **Emitters covered by the program**

- Large industrial emitters with 25,000 tonnes or more of carbon dioxide equivalent (CO<sub>2</sub>e) emissions per year

- Natural gas distributors with attributed emissions of 25,000 tonnes or more of CO<sub>2</sub>e per year
- Petroleum product suppliers that supply 200 litres or more of petroleum products in the province per year
- Importers of more than zero megawatt hours of electricity into the province per year

Approximately 150 large industrial emitters will be registered under the cap-and-trade program, in addition to the covered natural gas distributors, petroleum product suppliers and electricity importers.

The price of carbon in the Ontario cap-and-trade program reflects the costs of emissions allowances sold at auction and in the secondary market. In 2017, Ontario will release into the system, whether through auction or free allocation, an amount of allowances roughly equal to the expected emissions for that year, which is meant as a “soft start” to compliance obligations. The cap would then decline between approximately 4-5% each year during the first compliance period, reducing the number of allowances available, thereby incentivizing emissions reductions.

Ontario intends to link its cap-and-trade market with that of California and Québec as early as 2018. Market linkage will result in the three markets holding joint auctions of emissions allowances. It will also allow emitters in Ontario to purchase credits on the secondary market from covered emitters in these other markets and vice versa. This in turn will equalize the effective carbon price (i.e., the price of allowances) in these jurisdictions.

## Conclusion

The combined effects of federal and provincial programs to price greenhouse gas emissions are likely to reach well beyond the price of fossil-based energy, and it will be interesting to watch how these effects manifest as companies in Canada enter this new era of carbon pricing in 2017. With the Canadian oil and gas sector slowly recovering from the significant economic downturn over the past 18 months, we will continue to observe and assess how provincial and federal climate change policies will either enhance or undermine the progress of that recovery.

**For more information on the impact of carbon pricing on energy costs, please visit: [www.torys.com/oilandgas](http://www.torys.com/oilandgas)**

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