Methodology

Torys LLP commissioned Mergermarket to interview 100 senior corporate executives and investment bankers with recent Canadian oil and gas experience to gain insight on 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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Introducción

El pasado año fue un viaje de montaña rusa para los jugadores en la industria del petróleo y gas de Canadá. Los precios del petróleo en el final del 2014 han puesto a la industria del petróleo y gas de Canadá en un estado de flux, con oportunidades únicas y desafíos emergiendo en la misma medida para corporativos e inversores.

Con estas dinámicas en juego, Torys LLP presenta su 2015 Canadian Oil & Gas Outlook, publicada en asociación con Mergermarket. Basado en una serie de encuestas realizadas en noviembre de 2014 con ejecutivos corporativos y banqueros de inversión que trabajan en el mercado del petróleo y gas de Canadá, este informe ofrece un análisis detallado de un sector que se redefine tanto en términos de optimismo sobre oportunidades de negocios futuros como en la cautela sobre el impacto a largo plazo de las declinaciones de precios del crudo, los aumentos de costos y otros factores.

Dealmaking emprendido tanto por corporativos nacionales como internacionales refleja la confianza de que el mercado petrolífero de Canadá ofrece suelo fértil para el crecimiento futuro, especialmente el de shale en particular. El mayor proyecto energético del año de 2014, por ejemplo, vio a España’s Repsol anunciar su intención de adquirir Talisman Energy por US$12.7 billón, una empresa que el CEO de Repsol José María Miranda indicó que era lo que buscaba Repsol en términos de diversificación geográfica y activos de shale. Un invierno frío en Canadá llevó a una subida en los precios del gas natural para los productores de Canadá, y las acciones del petróleo y gas de Canadá recuperaron 11% en el primer trimestre de 2014.

La encuesta, realizada en dos partes en octubre y diciembre de 2014, proporciona dos interesantes instantáneas de las perspectivas de los jugadores de la industria energética. En respuesta a las preguntas de octubre, los participantes fueron partidarios de las perspectivas de negocios futuros del petróleo de Canadá. Sin embargo, esto no era sin ciertas reservas —por ejemplo, el impacto de las nuevas regulaciones medioambientales.

Otra ronda de preguntas en diciembre reveló insight into the precipitous decline of oil prices, one of the big macroeconomic stories of 2014. The collapse in pricing curtailed M&A toward the end of the year, has already heralded calls for less production, and could eventually be a catalyst for increased shareholder activism. Respondents generally agreed that lower oil prices are a long-term reality, a situation that will affect energy producer balance sheets and likely be a depressive influence on new exploration and production (E&P) and distribution projects, such as pipelines. Alongside falling prices, other trends continue to affect the industry, including opportunities for consolidation of Canadian operations by US producers (including Devon and Apache) and potential foreign investment regulatory barriers under the Investment Canada Act, which remain top of mind for global investors interested in the Canadian oil and gas markets.
Key Findings

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

- The majority of respondents predicted an increase in M&A activity in the LNG sector, junior Canadian E&P companies and other energy sectors. They forecasted a rise in company divestitures, private equity investment and foreign investment in Canadian energy. Nearly half of respondents said that private equity (PE) funds will be most active in the junior E&P space, compared with just under 20% in our 2013 report.

- When asked in December 2014 whether the decline in crude oil prices would increase or decrease M&A activity, a majority of respondents remained confident, predicting that there would be either an increase in Canadian energy M&A activity or that levels would remain the same as they had predicted in their responses in October. Only 6% anticipated a decrease.

- Over three quarters of survey respondents expected the overall volume of oil and gas transactions in Canada to increase over the next 12 months. Only 7% said they expected a decline.

Despite price-related concerns, confidence is high for the industry in 2015: a majority of survey respondents maintain that the Canadian energy sector abounds in investment and merger opportunities for global players in a variety of market sectors.

“Despite the potential longstanding ramifications of falling oil prices on energy producers and other regulatory issues that are informing foreign and domestic investments in Canadian energy, opportunities still exist for future growth and activity in the industry, particularly in shale production.”

Neville Jugnauth, Partner, Torys LLP
Rebalancing act: Industry overview

As late as September 2014, there was a sense that the global oil and gas market, while slowly declining in terms of crude prices, was generally stable and that prices would remain high enough to support the construction of new pipelines and E&P projects, and that the sector would continue to attract new acquirers and investors, both domestic and abroad.

Shortly thereafter, crude oil entered a downturn. By early January 2015, international prices had fallen by more than 50% since June 2014, with the global Brent benchmark falling beneath the $50/barrel threshold for the first time since May 2009. There were growing signs of an energy industry slowdown in North America. Rig contractor Helmerich & Payne announced it planned to idle up to 50 rigs by February 2015, cutting its shale drilling activity by roughly 20%.

“As the prices of oil and natural gas are already low in the region, businesses are more prone to be exposed to risks in case of any major events. The best risk management strategies will help in managing all business lines and planning for the future efficiently,” noted a VP of finance at a Canadian junior oil and natural gas firm.

The oil dip

In late December, a majority of respondents (80%) predicted that lower crude oil prices would be long term. Interestingly, however, these respondents didn’t believe this situation presented a serious crisis for energy M&A and investment over the next year. Sixty-one percent of respondents in December said the impact of low oil prices would have no effect on current Canadian energy projects and another 27% said the situation could increase investments.

“Cash-rich corporates are looking for good investment opportunities,” said a managing partner of a US investment bank. “The Canadian oil and gas sector is showing tremendous improvement and great potential for the future with new infrastructure and technology driving the growth.”

Indeed, deal pipelines are still positive. A recent report by investment bank Peters & Co., for instance, predicts that despite falling prices, oil sands products will “represent some of the most significant crude oil additions globally over the next several years.” Of course, falling prices...
have caused some firms—including Suncor Energy, which announced in
January its plans to cut its 2015 capital-spending program by C$1 billion—
to scale back.

Other players’ activities point to continued industry confidence in Canadian
energy production—and its ability to generate substantive M&A activity and
new project financings. For example, Imperial Oil started its US$2 billion Nabiye
Cold Lake oil sands project in January, hoping to achieve daily production of
40,000 barrels of bitumen by year-end.

**Liquid investments**

The subsectors that respondents predict to be the most favourable in terms
of valuations for sellers over the next 12 months are liquefied natural gas
(LNG) with 28%, oilfield services (17%) and oil sands (13%).

“Currently, LNG projects are in significant demand and there is a lot of
support given by the government,” says the finance director of a Canadian
energy producer. “Sellers will be able to reap significant value.” One
example of LNG investment is Exxon Mobil Corp.’s proposed US$21 billion
LNG liquefying/exporting facility in British Columbia, in partnership with
Canada’s Imperial Oil.

In terms of volume, almost all respondents (98%) believe that LNG projects
should increase over the next 12 months, and nearly half of respondents
(49%) anticipate that about six to 15 new projects will kick off. The majority
(56%) of respondents believe that it’s more likely that Canadian, rather than
international firms, will undertake these projects.

Some companies are showing caution in the LNG space, such as British
producer BG Group, which announced in October that it would delay its
proposed LNG export terminal on the Pacific coast. However, generally,
Canadian energy professionals believe that the growth of LNG projects
will continue to be fairly robust. Some respondents cite specific factors
contributing to this growth, including the British Columbia government’s
ongoing work to streamline regulations, offer tax incentives and speed up
the proposal process.

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In which subsector will valuations be
most favourable for sellers over the
next 12 months?

- LNG: 28%
- Oilfield services: 17%
- Oil sands: 13%
- Midstream: 12%
- Offshore: 10%
- Export-related infrastructure: 4%
- Natural gas: 4%
- Alternative energy: 2%
- Oil: 2%

28%
BELIEVE THE LNG
SUBSECTOR WILL PROVIDE
THE MOST FAVOURABLE
VALUATIONS FOR SELLERS
– THE HIGHEST OF
ANY SUBSECTOR
Which of the following Canadian oil and gas industry subsectors will see the greatest increase in domestic and cross-border M&A activity over the next 12 months?

Percentage of respondents

<table>
<thead>
<tr>
<th>Subsector</th>
<th>Domestic</th>
<th>Cross-border</th>
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<tbody>
<tr>
<td>Natural gas</td>
<td>59%</td>
<td>41%</td>
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<tr>
<td>LNG</td>
<td>52%</td>
<td>48%</td>
</tr>
<tr>
<td>Oil sands</td>
<td>41%</td>
<td>59%</td>
</tr>
<tr>
<td>Offshore</td>
<td>33%</td>
<td>67%</td>
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<tr>
<td>Export-related infrastructure</td>
<td>30%</td>
<td>70%</td>
</tr>
<tr>
<td>Alternative energy</td>
<td>39%</td>
<td>61%</td>
</tr>
<tr>
<td>Midstream</td>
<td>26%</td>
<td>74%</td>
</tr>
<tr>
<td>Downstream</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>Oilfield services</td>
<td>13%</td>
<td>87%</td>
</tr>
</tbody>
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Note: Graph does not total 100% as respondents were allowed to select up to three subsectors.

M&A home and away

Respondents were split on which subsectors will see the greatest increase in domestic and cross-border M&A activity over the next 12 months. For domestic deals, the top choices were natural gas (59%), LNG (52%) and oil sands (41%).

“LNG projects will be conducted domestically,” commented a managing director of a Canadian investment bank. “The companies in the sector are looking for growth through domestic expansions and as gas prices are low, they will extensively utilize the opportunities that are available.” Recent localized LNG deals include an agreement signed between BC Hydro and LNG Canada in November, allowing for the connection between the backers’ proposed LNG export plant and British Columbia’s power grid.

Cross-border M&A tells a different story, with the top three sectors identified as offshore (73%), LNG (53%) and oil sands (45%). A much lower percentage of respondents picked oil as a top subsector for cross-border activity (16%, compared to 30% for domestic activity).

“Internationally, oil sands will see demand in Canada as the government has invested handsomely to make sure that productivity increases to enable sustainable development of energy standards,” said a senior VP at an investment bank. “The chances of [these companies] being approached by global giants in the energy industry will increase in the coming years.”

59% SEE NATURAL GAS AS THE SUBSECTOR THAT WILL SEE THE BIGGEST INCREASE IN DOMESTIC DEALS

Internationally, oil sands will see demand in Canada as the government has invested handsomely to make sure that productivity increases to enable sustainable development of energy standards. The chances of [these companies] being approached by global giants in the energy industry will increase in the coming years.”

Senior VP, Investment bank
Sales force
Most respondents (62%) expect more oil and gas divestitures in Canadian energy over the next 12 months, while only 9% expect a decrease.

The boom in divestitures is in part due to the long-term declines in oil and gas prices, putting a number of energy producers, particularly junior E&P companies, in a tough situation. With lower prices affecting their bottom lines, these companies will need to consider divesting some assets for cash infusions to improve their balance sheets. Larger firms may look to consolidate Canadian operations as they seek to shift non-core operations from their balance sheets and refocus on core activities. International companies will be their likeliest buyers as evidenced by Swiss giant Glencore’s US$1.35 billion deal to acquire Caracal Energy.

“With low prices, there are some large general players that won’t be able to afford and continue with exploration and development,” stated the CFO of a Canadian E&P company. “And on the other side, there are players that want to grow their production who will find capital and find the opportunities to buy at decent prices. So, there’s a combination of people with money on the buying side and other marginal players with no choice but to sell some assets.”

Another factor others point to as a possible contributor to divestitures is that low oil prices could stir shareholder activism, prompting more energy companies to sell businesses or divisions—or find an acquirer—in response to activist pressure.
Pressure points: Factors affecting oil & gas deal volume

As oil prices continue to trend down, survey respondents considered commodity prices to be the largest factor affecting deal volume. The M&A director of a Canadian investment bank said: “Commodity prices will affect deal volume, as most will consider current conditions and look at any future risks resulting from the deal. Market risks and fluctuations are sure to influence their decisions.”

Deal valuations will also likely be a major factor, given how many energy producers could experience drops in revenue or asset valuations if oil and gas prices keep declining. With the majority of respondents agreeing that valuations will have a key impact on volume, the managing partner of a Canadian investment bank commented that “valuations will be the most important deciding factor for global businesses. Canadian businesses are more likely to accept negotiations based on different strategies like investment of capital in technology or a new site, and they will consider selling off unimportant assets at fair prices.”

When asked in December which Canadian energy subsector would most feel the impact of long-term low oil prices, respondents were somewhat divided. The oil sands subsector was seen by the greatest number of respondents as one that would be hit hardest if the oil price trend continued to remain low long-term. Other popular choices including offshore activity (28%), oilfield services (15%) and midstream operations (12%). LNG was the least chosen option (9%), further reflecting a common industry belief that LNG will continue to be strong in Canada.

Irrespective of decreased pricing, players seem bullish when it comes to dealmaking: 78% said they expect dealmaking to increase, and 25% said it will do so substantially.

There are a number of reasons for this continued confidence, as explained in part by the divestitures-related findings referenced earlier. Many energy companies, facing declining profits due to falling oil prices, will have to ask hard questions in the next 12 months—do I make an acquisition to increase my market holdings? Do I look for a cross-border partner in a market with more favourable valuations? Or, is time to pull up stakes and sell? No matter how companies decide to answer these questions, increasing M&A volume will be a likely result.
RESPONDENTS BELIEVE COMMODITY PRICES WILL BE THE MOST-IMPACTFUL FACTOR FOR M&A OVER THE NEXT 12 MONTHS

“Valuations will be the most important deciding factor for global businesses. Canadian businesses are more likely to accept negotiations based on different strategies like investment of capital in technology or a new site, and they will consider selling off unimportant assets at fair prices.”

Managing partner, investment bank

Earlier surveys found the great majority of respondents predicting energy M&A volume would rise substantially over the next 12 months. Given current market conditions, what are your predictions now?

- Substantially Increase: 53%
- Increase: 16%
- Remain the same: 6%
- Decrease: 15%

Note: earlier surveys were conducted in October of 2014.

36% PREDICT OIL SANDS TO BE IMPACTED THE HARDEST BY LONG-TERM LOW OIL PRICES

78% EXPECT AN OVERALL INCREASE IN ENERGY M&A VOLUME OVER THE NEXT 12 MONTHS
**Fund boom**

Survey respondents believe that PE funds and institutional investors will continue to play substantial roles in Canadian oil and gas. Eighty-two percent of respondents thought there would be an increase in PE involvement in the next year, while 74% thought the same about institutional investors.

For PE funds, the biggest investment opportunities are expected to be junior E&P (46% of respondents) and oilfield services companies (40%) with few predicting any other options (a mere 5% chose oil sands). “PE funds’ involvement will be most active in junior E&P companies since the cost pressures are impacting their overall performance and firms have been struggling due to this,” a managing director of a Canadian investment bank said. “PE firms will invest in these small targets and try to improve their efficiency to derive value from them in the long run.”

Indeed, PE’s involvement with junior E&P goes back to the market decline in 2007-2008, when public investment for the subsector all but dried up. Essentially, PE has been the only game in town for a number of smaller, independent oil and gas producers, a situation that shows no sign of changing in the near term. Both US-based PE funds as well as Calgary-based PE funds, including those marketed by ARC Financial and Kern Partners, have become major providers of funding for Canadian energy start-ups.

These investors are also hungry for potential bargains. “They’ll target businesses with depressed market valuations and gain direct control of the operations,” one respondent commented. This tallies with respondents’ views on target valuations, with 53% of respondents expecting PE deals most commonly in the range of US$100 million - US$250 million. Another 30% said the most likely range will be US$50 million - US$100 million. By way of comparison, 34% of respondents believed that the US$250 million - US$500 million bracket would have the most Canadian oil and gas deals in the next year; 26% believed it would be US$500 million - US$1 billion; and 30% believed that US$1 billion-plus deals would see the highest volume.

By contrast, institutional investors will most likely focus their efforts further up the energy pipeline. Fifty-nine percent of respondents predict investors will focus on senior E&P and 67% of respondents estimate such deals to
In which value range do you expect to see the highest volume of PE funds’ and institutional investors’ investment activity in the Canadian oil and gas sector over the next 12 months?

- US$15m to US$50m: 12%
- US$50m to US$100m: 53%
- US$100m to US$250m: 30%
- US$250m to US$500m: 7%

Do you expect an increase in club deals between PE funds in the Canadian oil and gas sector over the next 12 months?

- Yes: 15%
- No: 85%

The abundance of private equity capital dedicated to energy opportunities and the current depressed commodity price environment should create a wealth of buying opportunities at attractive valuations for private equity investors. The appetite for Canadian energy investments should remain strong.”

Neville Jugnauth, Partner, Torys LLP

be in the US$250 million to US$500 million range. “Institutional investors will focus on large E&P firms who are looking for an acquisition in the international markets and have a surety of success,” said a managing director at a Canadian investment bank.

Club deals may also be on the rise in Canadian energy M&A, with 85% of respondents predicting an uptick in activity. This makes sense considering current volatility. Amid wariness about the state of the current market, PE firms may seek to reduce investment risk by partnering with other PE investors.

“I think club deals will increase between PE funds because they’re skeptical about the business environment,” commented a managing director of a Canadian investment bank. “They’ll try to allocate combined capital and share risks in the short term.”
A global field: Foreign investment in oil & gas

China and the US, two of the biggest consumers of the energy in the world, are expected to be where the most acquisitions of Canadian oil and gas companies will originate. For the US, an improving domestic economy, cash-rich corporates and increased PE activity snapping up distressed assets has contributed.

For China, its rapidly increasing energy consumption is giving rise to increased appetite for oil and gas assets; according to the World Bank, energy use per capita increased by over 100% between 2000 and 2010. Respondents noted that China favours Canada, as the CFO of one Canadian corporate put it, for “its rich natural resource power and its lower regulatory requirements.” The VP of finance at a Canadian oil firm also noted that China and other Asia-Pacific countries are “on constant lookout for energy supply to meet their growing consumer and industrial demand. They want to move away from volatile markets such as Middle East and Africa and get their hands on more reliable markets such as Canada.” As a result, we may expect to see more transactions such as China Oil and Gas Group’s US$217 million purchase of Canadian oil and gas producer Baccalieu Energy in June 2014.

US acquirers benefit from both strong ties between the US and Canadian governments as well as the geographic proximity of the markets allowing for streamlined distribution and production. However, as the ongoing controversy around the Keystone XL pipeline shows, US/Canadian operations are not without political complications.

“China and other Asia-Pacific countries are on constant lookout for energy supply to meet their growing consumer and industrial demand. They want to get their hands on a more reliable market such as Canada.”

VP of finance, oil and gas firm

88% see China as the most active buyer in Canadian oil and gas in the next year

30% think PE-backed upstream operators will be the most likely targets in Canadian oil and gas over the next 12 months
Companies based in which regions will be the most acquisitive in the Canadian oil and gas sector over the next 12 months?

- North America: 75%
- China: 88%
- Western Europe: 47%
- Asia-Pacific: 46%
- Eastern Europe (including Russia): 9%
- Latin America: 34%
- Middle East and North Africa: 1%
- Middle East and North Africa: 1%

Note: Respondents could select up to three options.

Junior high
When asked which types of companies would be the most common targets in Canadian oil and gas over the next 12 months, the top responses were junior E&P (41%) and PE-backed upstream operators (30%).

The relatively cheap operations and high risk-adjusted potential of junior E&P firms are an alluring combination for buyers. “Large-cap companies will target junior E&P companies to reduce the cost of operations and to get easy access to Canada’s natural resource reserves,” one managing director of a US investment bank said. Respondents also predicted that difficulty managing rising cost pressures would push some junior E&P firms to sell.

Twenty percent said oilfield services companies would be the most common target. A respondent remarked that “the urge to acquire intellectual assets, machineries and new methodologies of drilling and extraction will be the rationale behind acquisitions of oilfield services.” Indeed, finding more efficient ways to find and procure oil and gas assets has been one of the main issues facing the industry as balance sheets tighten.
Latin bound
For Canadian acquirers, the most promising future appears to lie south of the US border or somewhere overseas. A huge majority (87%) of respondents believe that Canadian outbound cross-border acquisitions will be most common in Latin America, while 74% of respondents believe Canadian buyers will be active in the Middle East and North Africa.

With respect to these top two responses, Canadian energy firms will be seeking lower costs and less fevered competition for assets. “The untapped markets in the Latin American region are more viable to approach,” one respondent said. “I think firms will target the resource value and potential synergies yet to be utilized in the growing markets to increase their production volumes and drilling and exploration capabilities.”

In the past few years, energy has been one of the strongest M&A sectors in Latin America. According to Mergermarket data, energy dealmaking in Latin America almost doubled in 2013 compared with 2009. And this has been driven in part by Canadian interest—for instance, in November 2014 Brookfield Renewable Energy Partners bought a Brazil-based portfolio of 488 MW renewable operating assets from Energisa.

“A growing number of Latin American governments have effectively reduced macroeconomic concerns and have formed a solid regulatory foundation, which is sufficient for Canadian businesses to be confident in acquisitions.”

Finance director, oil and gas firm
Latin America, like many other regions, is moving toward energy independence and continued exploration and production of oil and gas. As a result, home-grown energy producers are becoming increasingly competitive. And while some countries still suffer from perceived corruption and opacity in their regulatory systems (39% of respondents cited regulations as the largest potential obstacle to a cross-border deal), a growing number of Latin American governments “have effectively reduced macroeconomic concerns and have formed a solid regulatory foundation which is sufficient for Canadian businesses to be confident in acquisitions,” observed a finance director at a Canadian oil and gas firm.

For example, Colombia has been active in recent years in promoting PE investment. Since 2009, the Colombian government has established a stronger, more systemized antitrust regulatory body and M&A agreements are generally negotiated in English, following established common law. Colombia has also been active in promoting PE investment of late. The finance director, referenced above, added: “Colombia is a good target, as [conditions] are improving at a rapid pace, giving rise to faster economic growth.”
In focus: What drives Canadian exploration and production companies?

While the top goals of senior and junior Canadian E&P companies are to grow through acquisition (52% and 44% respectively) over the next 12 months, the predictions differed in whether that growth would come from farm-in agreements or partnerships. Far more respondents said acquisition-based growth would be a priority for senior E&P instead of junior (32% compared with 9%). By contrast, 29% of respondents predicted that asset sales would be a priority for junior E&P, compared to the near-negligible 5% of respondents who said the same for senior companies.

Getting credit
When asked what will be the most likely methods Canadian oil and gas companies will utilize to finance M&A in the next 12 months, 68% of respondents said they believed deals would be financed by a combination of debt and equity. Far fewer (28%) believed debt deals would be paramount, and only a handful (4%) said equity would be the primary funding method.

Respondents were also asked how these companies would most likely obtain financing for both new and existing projects. Forty-eight percent said firms would most likely use joint venture partnerships including those with PE firms. “Partnerships will be common for obtaining financing as oil and gas companies will want to develop their business and are most likely to use partners for enhancement of their strategic vision and business,” said the CFO of a US E&P firm. These types of partnerships are already in play: in November 2014, Canadian Non-Operated Resources signed a joint venture with Tourmaline Oil for C$400 million, a deal which will help Tourmaline accelerate its planned exploration and development program in the Peace River oil sands.

Other means included debt financing (23%) and asset sales (18%). An energy solutions firm CFO commented that asset sales “would be the most preferred source of finance for businesses. Foreign investors have become highly active in the Canadian markets, and generating large capital through the sale of assets will be possible with zero or low complexities.”

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

It’s a difficult time in the energy business—but with the decline of oil prices, deal volume may well increase. We are seeing a greater number of interested investors and buyers than when prices were high. The challenge, however, will likely be reaching agreement on value.”

Ron Deyholos, Partner, Torys LLP
What is the most likely method most oil and gas companies will use to finance an M&A transaction in the next 12 months?

- Combination of debt/equity: 68%
- Debt: 28%
- Equity: 4%

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

- Joint venture partnerships (including PE): 48%
- Debt financing: 23%
- Asset sales: 18%
- Existing balance sheet: 9%
- IPOs: 2%
Navigating regulation

Respondents are divided on whether the Canadian energy M&A market will be hit heavily by regulations. While 54% said they don’t expect regulatory risk related to foreign investment in Canadian oil and gas to impede deal activity over the next 12 months, a substantial 46% believe that regulatory risk will be an issue.

For the majority, the current Canadian regulatory regime is not seen as overly burdensome. A partner at a Canadian investment bank commented that “the laws in Canada are suitable for a healthy business undertaking, and the government understands the business challenges well.” Canada’s regime is often seen as having less potential risk compared to that of the US. Consider the high-profile example of the Keystone pipeline: although it has Canadian support, the Obama administration has warned that it will veto legislation permitting the project.

Despite some respondents acknowledging certain comparative benefits of Canada’s regulatory regime, nearly half see regulations as a potential factor affecting energy M&A, particularly cross-border deals. For example, the Investment Canada Act, which gives the Canadian government authority to reject foreign bidders based on whether the deal will provide a “net benefit” to Canada, remains a concern. Dealmakers still recall how BHP Billiton was blocked from bidding for Potash Corp. in 2010, and fear that if market

“The regulatory risks associated with foreign investments will be an obstacle. Firms now are looking to expand in Canada due to [a perceived] regulatory advantage, but if situations change, deal activity will definitely fall.”

VP of finance, oil and gas exploration company
conditions become rockier for energy companies, the government could be quick to act in the defense of a Canadian energy producer that becomes a target for a foreign company. Also, the federal government’s state-owned enterprise (SOE) guidelines, announced at the time of CNOOC/Nexen Investment Canada approval, have certainly impaired investment by SOEs in the oil sands subsector.

“The regulatory risks associated with foreign investments will be an obstacle,” remarked one VP of finance at a Canadian oil and gas exploration company. “Firms now are looking to expand in Canada due to [a perceived] regulatory advantage, but if situations change, deal activity will definitely fall.”

In any event, the prospect of increased regulatory obstacles is, for the present moment, just another factor that foreign bidders in Canada will want to accommodate as they fine-tune their dealmaking strategies.

**Future uncertainty**

Respondents noted some wariness about current and future environment-related legislation affecting Canadian energy projects deals. For instance, in September 2014, Nova Scotia’s provincial government banned high-volume onshore hydraulic fracturing (with exceptions for testing or research). New Brunswick soon followed suit with a fracking moratorium, which Sheri Somerville of the Canadian Association of Petroleum Producers observed “could certainly have a detrimental impact on future investment and industry progress for the province.”

Fifty-six percent of respondents said these legislative actions have “moderately decreased” the appetite of foreign companies to acquire Canadian energy providers. And an overwhelming majority (88%) of respondents believe that new LNG projects are going to face future opposition and delays, primarily because of aboriginal or environmental issues. “The proposed ban on fracking will have an effect on certain business areas within the Canadian oil and gas sector, and the foreign deals that are in the pipeline will take an exit and redirect their investments into different economies, so the impact can be significant,” said a director of finance at a Canadian oil and gas company.
Responses to regulation

Canadian energy players’ concerns about the potential of regulations to derail deals are not impacting their approach to structuring transactions, for example, to make them more palatable to energy regulators.

When asked if they’d change their material contractual terms or deal structure to avoid regulatory risk in a Canadian oil and gas investment, a large majority of respondents (72%) said they would not. “It would not be needed,” a partner at a Canadian investment bank said, adding they were confident “the government understands the local business challenges and has created a healthy environment that will promise growth and development of firms within Canada.”

Of the 28% of respondents who are ready to change their material contract terms or deal structure, a managing director of a Canadian investment bank said that “yes, we would consider changing material contractual terms, as we will have a few things we want from the deal and we will compromise on them as our ultimate aim needs to be met.”

In terms of what actions they would take to improve a deal’s regulatory chances in Canada, a majority of respondents (54%) said they’d be willing to do an “inversion” deal in which the acquirer is re-domiciled in the target’s country (a structure common to US buyers and Canadian sellers, though recent and proposed legislation in the US may curb some inversion deals). Thirty-two percent of respondents said they’d do an inversion deal and would divest any pertinent asset or business and do a Canadian listing if it meant the deal would get approved.
Conclusion

The results of our survey illustrate a Canadian energy market whose players are highly conscious of developing global energy trends. The continued resilience of Canadian energy M&A in the face of falling oil prices offers opportunities for PE and institutional investors, domestic companies on the hunt for targets at home and abroad, as well as for inbound acquirers looking to invest in Canadian projects, acquisitions of Canadian E&P firms and divested assets from Canadian producers.

Of course, the ongoing decline in crude oil prices across the globe continues to change the landscape of the industry, with significant implications for deal valuations, future E&P projects and the financial health of the energy industry as a whole. The industry is also keeping a close watch on potential domestic and cross-border regulatory complications that could throw a wrench in acquisitions or investments with respect to a range of issues including foreign investment/antitrust and environmental concerns.

The sector is responding to this paradigm shift in oil and gas—a shift that has been macroeconomic, regulatory and financial—by rebalancing and adjusting. As 2015 gets into full swing, here are three key trends to look for in the Canadian oil and gas sector:

- **Strength in adversity.** While corporates are neither blind nor unwilling to react to the macro-level challenges they face, the underlying strength of Canadian oil and gas is giving industry players a belief that investment, not cutting spending, is the play.

- **Latin American dream.** As oil prices fall and margins continue to wilt, Canadian oil and gas firms looking to expand outwards will need to combine hitting growing markets with synergy generation and cost-cutting. Latin America’s countries could provide that combination.

- **A private era.** Private equity funds, while already active, will become even more so in the coming year for Canadian oil and gas. This is particularly true for junior E&P firms as well as start-ups and firms generally in SME space. On top of this, companies added to the PE portfolio could become primed for foreign investors in a few years’ time when funds reach the exit stage of their life cycles.

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There is currently significant demand on the part of well capitalized investors, particularly PE funds, for acquisitions of quality western Canadian petroleum assets. However, it is likely that the onset of major M&A activity will not occur until late Q2 given that many potential vendors are not currently willing to conclusively accept the new commodity pricing environment. Over the course of the next few months, it is expected that the bid-ask spread should narrow with the result that the second half of 2015 should see significant M&A activity in the oilpatch.”

Derek Flaman, Partner, Torys LLP
The Supreme Court of Canada’s Historic Aboriginal Title Case

John A. Terry | Valerie Helbronner | T. Ryan Lax

On June 26, 2014, the Supreme Court of Canada (SCC) released its unanimous decision in Tsilhqot’in Nation v. British Columbia. Though this decision marks the first time the SCC has upheld a specific Aboriginal title claim, the SCC largely applied its existing legal framework developed over the last 40 years. Canadian oil and gas M&A in 2015 will be in part shaped by the potential impact of this decision: investors in Canadian oil and gas assets will assess the quality of their diligence, consultation and accommodation with affected local Aboriginal communities, particularly those with existing or potential title claims.

This decision is expected to have significant, but variable, implications beyond oil and gas activity, including for infrastructure and other energy projects across Canada, depending on the geographic area at issue in a specific project. If a project involves lands where Aboriginal treaties have clearly extinguished Aboriginal title rights, the Tsilhqot’in decision will likely not change the applicable law. In contrast, if a project involves lands where existing Aboriginal treaties have not clearly extinguished Aboriginal title rights, or where treaties between the Crown and Aboriginal peoples do not exist, the decision raises important considerations.

In general, the Crown is subject to a duty to consult and potentially accommodate Aboriginal interests before authorizing a project to proceed on lands that are subject to an Aboriginal title claim, even if that claim has not been recognized by treaty or court order. The degree of consultation or accommodation required depends on the strength of the Aboriginal title claim and the severity of potential adverse impacts of the project. In the Tsilhqot’in decision, the SCC confirmed that proposals to use or develop land before Aboriginal title is recognized can avoid allegations of infringement or failure to adequately consult by obtaining the consent of any interested Aboriginal groups.

Once an Aboriginal title claim has been recognized, infringements on that title can only be justified in narrow circumstances whether either (i) consent from the Aboriginal title-holder is obtained or (ii) a stringent public interest test is satisfied, as discussed in parts 4 and 5 below. As such, the recognition of Aboriginal title confers a significant, although not an absolute, set of rights in respect of use and management of land.

Given the significance of these rights once Aboriginal title is established, the SCC noted in Tsilhqot’in that obtaining consent of interested Aboriginal groups who have pending or possible Aboriginal title claims, although not a legal requirement, may avoid a charge of undue infringement if Aboriginal title is later established. According to the SCC, if the Crown authorizes a project without Aboriginal consent, “it may be required to cancel the project upon establishment of [Aboriginal] title if continuation of the project would be unjustifiably infringing.”

Background

Throughout most of Canada, the Crown has entered into treaties with indigenous peoples whereby those peoples gave up their claim to land in exchange for reservations and other promises, but this largely did
not occur in British Columbia. This issue with respect to the Tsilhqot’in Nation lay dormant until 1983 when the B.C. government granted a logging licence for part of the territory at issue. Roger William, former Chief of the Xeni Gwet’in First Nations government, one of the six bands that make up the Tsilhqot’in Nation, commenced a claim seeking a declaration prohibiting commercial logging. When the ensuing negotiations reached an impasse in 1998, the original claim was amended to include a claim for Aboriginal title on behalf of all Tsilhqot’in people. The Aboriginal title claim was confined to approximately five percent of what the Tsilhqot’in regard as their traditional territory.

In 2007, after 339 days of trial spanning five years, the British Columbia Supreme Court held that the Tsilhqot’in’s semi-nomadic uses of a portion of the territory at issue were sufficient to demonstrate exclusive occupation for the purpose of proving Aboriginal title. The trial judge thus found that the Tsilhqot’in people were entitled to a declaration of Aboriginal title to a portion of the claim area as well as to a small area outside the claim area.

The British Columbia Court of Appeal (BCCA) adopted a narrower construction of the test for Aboriginal title. The BCCA held that that the Tsilhqot’in claim to title had not been established, but that title may be proven in the future with respect to smaller specific sites that the Tsilhqot’in had intensively used at the time of the assertion of European sovereignty. For the rest of the claimed territory, the Tsilhqot’in were confined to other Aboriginal rights, including rights to hunt, trap and harvest.

The Supreme Court of Canada’s Decision
The SCC rejected the BCCA’s narrow approach to Aboriginal title. In so doing, the SCC awarded the Tsilhqot’in Nation title over the claim area identified by the trial judge. Though this is the first case to recognize a specific Aboriginal title right, it builds on and applies existing Aboriginal title jurisprudence that has developed over the last 40 years, since Calder.2

The SCC’s judgment confirms four key points, expanded on below: 1. Aboriginal title will be recognized where exclusive occupation prior to the assertion of European sovereignty can be demonstrated; 2. the duty to consult and accommodate in cases in which Aboriginal title or other rights have yet to be proved continues to apply; 3. Aboriginal title gives the right to exclusive use and occupation of the land; and 4. where Aboriginal title has been proven, incursions can only be justified in narrow circumstances on the basis of the broader public good.

1. What is required to demonstrate Aboriginal title?
The SCC applied the test for Aboriginal title to land, set out in Delgamuukw.3 Aboriginal title is based on “occupation” prior to the assertion of European sovereignty. To make a finding of Aboriginal title, three characteristics are necessary: 1. occupation must be of sufficient intensity, in light of the context-specific carrying capacity of the land and the customs and characteristics of the specific Aboriginal group; 2. if present occupation is relied on as proof of occupation pre-sovereignty, the occupation between pre-sovereignty and the present must be continuous; and 3. occupation must have been

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exclusive at the time of sovereignty, in the sense of demonstrated intention and capacity to control the land.

2. The Crown is subject to a duty to consult and potentially accommodate before Aboriginal title is recognized

The duty to consult is a procedural duty that arises from the honour of the Crown prior to confirmation of Aboriginal title, as set out in *Haida Nation*. The degree of consultation or accommodation required lies on a spectrum, depending on the strength of the Aboriginal title claim and the severity of potential adverse impacts of the contemplated government action. At the high end of this spectrum, accommodation may be necessary.

3. Once recognized, Aboriginal title confers a substantial set of rights

Once recognized, Aboriginal title encompasses the collective right of the Aboriginal group to exclusively use and occupy land, including the right to benefit from its economic development. Land use is not limited to traditional purposes, provided that non-traditional uses can be reconciled with the communal and ongoing nature of the group’s attachment to the land. This means that Aboriginal title land cannot be used in a manner that would prevent subsequent generations from enjoying it. The SCC noted that once Aboriginal title has been recognized, the Crown may have to reassess its prior conduct in light of the new title rights in order to faithfully discharge its fiduciary duty to the Aboriginal group.

4. Incursions on Aboriginal title can only be justified in narrow circumstances

To justify an infringement on Aboriginal title where consent of the Aboriginal group possessing title has not been obtained, the government must show: 1. that it discharged its procedural duty to consult and accommodate, which is highest in cases where Aboriginal title has been established; 2. that its actions were backed by a compelling and substantial objective; and 3. that the government action is consistent with the Crown’s fiduciary obligation to the Aboriginal group.

The SCC affirmed its decision in *Delgamuukw*, which stated that government objectives that reconcile the prior occupation of North America by Aboriginal peoples with the assertion of Crown sovereignty may be considered compelling and substantial, and therefore capable of justifying an incursion on Aboriginal title. Government objectives that may satisfy this purpose include the development of agriculture, forestry, mining, and hydroelectric power, general regional economic development, protection of the environment, and the construction of infrastructure and settlement of people to support those aims. Whether these or other objectives are found to be compelling and substantial will depend on the context of the specific project at issue and its potential benefits for the Aboriginal group possessing title, Canada, and the degree to which it furthers the goal of reconciliation between the two.

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4 2004 SCC 73.
For example, in the *Tsilhqot’in* decision, the SCC found that the proposed logging sites were not economically viable, and as a result, the economic benefits of logging could not be considered a compelling and substantial objective. It will therefore be important for companies developing projects in areas subject to Aboriginal title claims to bear in mind that courts in subsequent cases may similarly analyze the economic viability of a project in assessing whether the objective served by developing the project is sufficiently compelling and substantial to satisfy the test for an incursion.

Where a compelling and substantial public purpose is established, the government must show the proposed incursion on Aboriginal title is consistent with the Crown’s fiduciary obligation toward Aboriginal people. This obligation includes two facets. First, the government must act in a manner that respects the fact that Aboriginal title is a group interest that inheres in present and future generations. Incursions cannot be justified if they would substantially deprive future generations of the benefit of the land. Second, the Crown’s fiduciary duty infuses an obligation of proportionality into the justification process: the incursion must be rationally connected to achieving the government’s objective; the incursion must go no further than necessary to achieve the government objective; and the benefits expected to flow from the government objective must not be outweighed by the adverse effects on the Aboriginal interest.

5. When does an incursion on Aboriginal title arise?

In the *Tsilhqot’in* decision, the SCC also discussed the province’s powers in respect of Aboriginal title lands, and the circumstances in which an infringement will arise. Provincial governments have the power to regulate the use of all lands within the province, whether they are held by the Crown, private owners, or holders of Aboriginal title; as a result, provincial laws of general application will usually apply. However, the SCC affirmed its decision in *Sparrow*, which held that laws of general application unconstitutionally diminish an Aboriginal right where: 1. the limitation imposed by legislation is unreasonable; 2. where the legislation imposes undue hardship on the Aboriginal group; or 3. where the legislation denies the holder of Aboriginal title their preferred means of exercising the right.

In this case, the SCC held that granting rights to harvest timber from the Tsilhqot’in’s lands is a serious incursion that will not be lightly justified. Should the government wish to grant such harvesting rights in the future, it will need to establish that this harvesting furthers a compelling and substantial objective, which was not present in this case. In the alternative, the government may grant such harvesting rights with the consent of the Tsilhqot’in. An infringement does not arise where the title-holding Aboriginal group consents. It is important to note that an Aboriginal group cannot consent to an act that abrogates to the communal and ongoing nature of the title right.

The court’s emphasis on compensation and meaningful consultation with indigenous communities point to how, now more than ever, good relationship building with affected Aboriginal communities will be crucial for players in oil and gas projects around the world.

To discuss these issues, please contact the authors.
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