The Year the Music Stopped – The Precipitous Decline in SOE Investment in Canada's Oil and Gas Sector in 2013

by Frank Turner & Peter Glossop

On December 7, 2012, Prime Minister Harper announced changes to the manner in which investments by state-owned enterprises (SOEs) in Canada would be reviewed under the *Investment Canada Act* (ICA), effectively raising the bar for such investments, as well as placing very significant limitations on acquisitions of control by SOEs of oil sands businesses.

In the wake of the Prime Minister's announcement, there was much speculation as to whether the new rules would have a chilling effect on SOE investment in the Canadian oil and gas sector and impede the growth of our domestic energy industry. As the year end approached, the answer to that question became crystal clear. SOE investment in the Canadian oil and gas sector was practically non-existent in 2013 and the industry generally experienced a shortage of new capital.

- Through to the end of the third quarter of 2013 there had been a single announced SOE deal in the Canadian oil and gas sector worth approximately $320 million, as compared to approximately $28 billion in transactions in the prior year.
- M&A activity in the Canadian energy sector generally was off more than 80% in 2013 as compared to 2012.
- Overall transactional activity in the oil sands in 2013 dropped to its lowest level in a decade.

Osler Represented

Talisman Energy Inc. *in connection with its $1.5 billion sale of British Columbia gas assets to Petroliam Nasional Berhad (PETRONAS)*

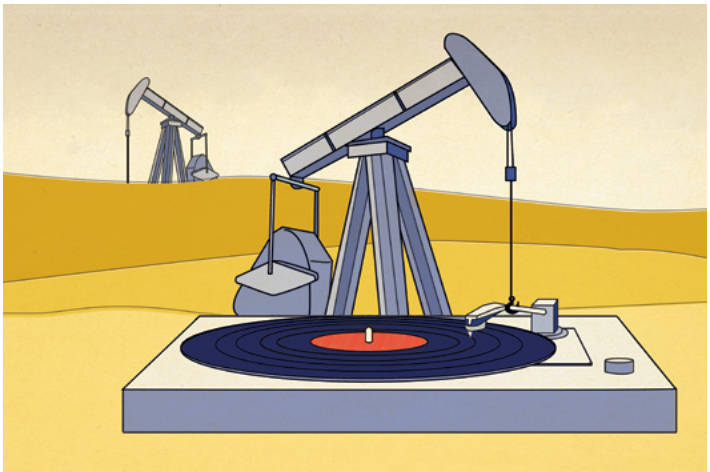
Canadian Pension Plan Investment Board *in connection with the acquisition of Progress Energy Resources Corp. by Petroliam Nasional Berhad (PETRONAS)*

The financial advisor to Nexen Inc. *in connection with its sale to China National Offshore Oil Corp. (CNOOC)*

China Investment Corporation *in connection with its investment in SouthGobi Resources Ltd.*

If the lack of SOE investment in Canada's oil and gas sector experienced in 2013 represents the new normal, it has very significant, and negative, consequences for the growth of our domestic energy industry, especially in respect of non-conventional resources, as well as Canada's ability to diversify its energy export markets by building a seaborne link to Asia.

We believe that uncertainty in the SOE community regarding the federal government's position on SOE investment in Canada is a significant factor in explaining the almost total absence of such investment in 2013. However, other factors, such as the slow pace of infrastructure development as a result of lengthy and controversial regulatory proceedings, and concerns regarding the prices that exported Canadian hydrocarbon products will receive in foreign markets are also relevant. In this paper, we examine some of the reasons underlying the precipitous decline in Asian SOE investment in the oil and gas sector in 2013 and provide our outlook as to what we can expect to see in 2014.



SOE Investment as a Catalyst to Growth in Canada's Non-Conventional Oil & Gas Sector

SOEs, especially those in Asia, have been significant investors in the Canadian non-conventional oil and gas sector, accounting for more than $50 billion of investment over the last 10 years. Over the last five years, foreign direct investment in Canadian energy projects by Asian SOEs has accounted for more than 25% of the total capital invested in those projects and the availability of such capital has been a material factor in the sector's impressive growth. Historically the oil sands have attracted the majority of Asian investment. More recently, there has been significant Asian investment in Canadian shale gas and related liquefied natural gas (LNG) projects.

With the aid of Asian investment, over the last 10 years domestic Canadian oil production has increased from 2.35 million to 3.25 million barrels per day. Approximately half of this increase is attributable to expanded production from non-conventional resources. Over the same period, Canadian oil reserves have increased from 4.9 billion barrels to 174 billion barrels, principally as a result of the recognition of reserves from non-conventional sources. Canada is now the sixth largest oil producer in the world with the third largest reserves.

Increasing Asian interest in non-conventional gas projects has, moreover, been a significant factor in the decision to proceed with these projects despite low North American gas prices. Such interest demonstrates growing international confidence that an LNG export market, via Canada's west coast, will develop. Nine western Canadian LNG projects, representing tens of billions of dollars in potential investment, have either commenced or been announced, and foreign SOEs and other foreign enterprises are participating in six of these projects. If a number of these projects were to be completed, Canada would become one of the world's leading gas producers.

Evolving Government Policy

The significant amount of Asian capital invested in Canada's non-conventional oil and gas sector is due in part to concerted efforts by the federal and western Canadian provincial governments to solicit such investment through a variety of trade missions and other trade initiatives including the entering into of a bilateral investment treaty with China in September of 2012 (which has not yet come into force). However, throughout the fall of 2012, it was evident that the federal government was reconsidering its policy on SOE investment in the resource sector. 2012 saw a rapid escalation of the pace of SOE investment in the non-conventional oil and gas sector (approximately $28 billion in 2012 compared to approximately $7 billion in 2011) and an apparent preference of Asian SOEs to seek control of the enterprises in which they were investing. Over this same period, there was growing concern among ordinary Canadians over losing domestic control over our natural resources. We believe these factors precipitated the government's announcement of the ICA rules regarding SOE investment in December of 2012.

The Conservative government, in announcing the SOE rules, attempted to ensure that Canada continued to be viewed as a jurisdiction that was welcoming of foreign investment. In this regard, the government noted the narrow application of the rules and expressly stated that SOE investments that did not amount to acquisitions of control would continue to be welcomed. Asian reaction to

Regulatory Developments

Update on amendments to the *Investment Canada Act*

The threshold for review of investments in 2014 under the ICA is expected to be $354 million of book value of assets of the Canadian business (compared to $344 million in 2013). The federal government has not yet brought into force the proposed higher threshold for review of investments by non-SOE investors. Under amendments to the ICA which are not yet in force, the threshold will increase in annual stages to $1 billion of enterprise value. However, the new threshold for certain non-SOE investors may simply rise to $1.5 billion when the proposed Canada-European Union free trade agreement comes into effect as a result of Canada's most-favoured nation trade commitments under other free trade agreements. Until the new threshold comes into force, investments in 2014 by both SOE and non-SOE investors will be reviewed at the same threshold of $354 million.

the Prime Minister's December 2012 announcement was initially positive, as it focused on the approval of CNOOC's acquisition of Nexen Inc. and the acquisition of Progress Energy Resources Corp. by Malaysian-based Petroliam Nasional Berhad (PETRONAS); however, it quickly turned negative. In commenting on the new SOE rules, Felix Chee, head of the Canadian branch of China Investment Corp., one of that country's largest SOEs and an active minority investor in Canadian resource companies, said the new rules could change the tone of business relations between Canada and China:

> This appears to be stringent. I am pleased to see the [Nexen and Progress] deals approved. But going forward one would expect Chinese companies to re-evaluate their investment plans in Canada to ensure they can still make desirable investments under the new rules.

Criticism of the SOE rules has typically focused on three themes:

- a view by Asian SOEs that they have been specifically targeted;
- a belief that the rules are intentionally ambiguous in order to allow an element of political discretion into the process; and
- observations that the pronouncement of the rules has created significant confusion with respect to the Canadian government's true position on foreign investment and appears to be at odds with earlier efforts by the Canadian government to attract such investment.

In discussing the effect of the new SOE rules, former Conservative Industry Minister Jim Prentice expressed his own reservations in October of 2013:

> Investment by Chinese SOEs in Canada's oil and gas sector… has now essentially stopped. To be sure, one factor is the confusion and diffidence surrounding Canada's ability to access international markets from the west coast. Another, however, is an environment of uncertainty regarding whether Canada really wants foreign investment in the energy sector.

Similarly, in commenting on the "drastic drop" in foreign M&A activity in the Canadian oil and gas sector in 2013, Alberta Premier Alison Redford publicly addressed the uncertainty created by the new SOE rules in November:

> There is too much uncertainty right now. This isn't just about state-owned enterprises in China. Unfortunately many of us who are looking to equity firms in different parts of the world have heard commentary that there's so much uncertainty right now with respect to the rules in Canada that it's giving them pause; sophisticated investors who understand that there's always going to be a little give and take. But the rules have been changing so quickly and so unilaterally in Canada for far too long.

The foregoing views are consistent with the experience of Canadian advisors who work with SOEs on investments and acquisitions in Canada. Many of these advisors have noted a significant uptick in concern among SOEs regarding their ability to have a deal approved by the Canadian regulatory authorities in light of the new rules and this has led to a reticence to transact.

It should be noted that the foregoing views are at odds with public statements made by the federal government that the SOE rules have not deterred investment in Canada by state-owned enterprises. For example, federal Natural Resources Minister, Joe Oliver, dismissed the notion that the SOE rules were creating a measure of uncertainty in October, 2013, following his return from a trade mission to China and South Korea:

> I didn't encounter any confusion about the rules; I wasn't asked for clarity. Nobody said to me directly or indirectly that the decline in SOE investment [in the Canadian energy sector] was the result of those rules... I certainly got no sense from anybody that they are turned off the prospect of investing in the Canadian industry.

Moreover, Prime Minister Harper has said publicly that the ambiguity embedded in the SOE rules reflects prudent policy:

> In my opinion, when you are dealing with large state investors, foreign governments as the investor, I think it would be foolish for the Canadian government to provide absolute clarity. It is absolutely necessary, when the investor is a foreign government, for the government of Canada to be able to exercise its discretion and have direct conversations with those foreign investors.

Other Factors

As set forth above, we view the uncertainty regarding Canada's receptiveness to SOE investment, especially in the resource sector, as a significant factor underlying the decline in such investment in 2013. However, there are clearly other reasons that have contributed to such decline including:

- concerns regarding the slow pace of construction of the infrastructure necessary to link western Canadian hydrocarbons to Asian markets, as a result of lengthy and controversial regulatory proceedings;
- uncertainty regarding the price that Canadian producers will receive for LNG products in Asian markets; and
- a sense that some Asian countries that have been significant acquirors of resource assets need a period of time to digest those acquisitions and perhaps divest under-performing assets or de-risk some of those investments by bringing in partners, prior to commencing a further acquisition program.

Concerns Regarding the Pace of Infrastructure Development and Pricing of Gas Exports

One of the drivers of SOE investment in the Canadian oil and gas sector has been a desire to secure a supply of hydrocarbon products for their home markets which are often high growth economies. However, transporting Canadian hydrocarbon products to Asia and other off-shore markets requires the construction of a comprehensive network of extraction and upgrading facilities, gathering systems, pipelines, LNG trains and ports, most of which has yet to be constructed or is in

the early phase of its development. Further, some announced projects, such as the Northern Gateway Pipeline, have encountered significant opposition from environmental and Aboriginal groups and this has resulted in delays in securing key regulatory approvals. At the same time, other energy producing nations, such as Australia, are much further advanced in developing an export market for their LNG products. There is concern that if a significant portion of announced LNG projects come on line, the global supply of gas will exceed total world demand by a significant margin, disadvantaging projects that are currently at an earlier stage of development. The foregoing has led to concern that Canada will miss its window of opportunity to develop its own seaborne LNG export market.

There is also uncertainty regarding the price that Canadian gas exports could obtain in Asian markets. The price of LNG in those markets has typically been linked to the price of oil which has resulted in prices in Asia for imported gas reaching $19.50 per Mcf as compared to $3.80 per Mcf in North American markets. In part, it is the significantly higher gas prices available in Asia that are fuelling the development of Canada's LNG industry. However, some LNG importers, such as Japan and India, have publicly said that it is "unreasonable" to maintain such linkage in a world flush with gas. Such pricing uncertainty creates issues as to the commercial viability of the LNG projects that have been proposed for Canada's west coast and acts as a further deterrent to investment therein.

Asian SOEs have been prodigious acquirors of oil and gas assets. Chinese companies have completed more than 80 transactions over the last five years. In 2012, Chinese buyers of oil and gas assets paid an average premium of 49% against an industry average of 31%. SOEs from South Korea and Malaysia have also been significant acquirors of Canadian oil and gas assets. Some observers have noted that it is likely that Asian SOEs will need to pause following a lengthy buying spree to digest what they have purchased, integrate the acquired assets into their national energy companies and generally "improve their competitiveness in the global energy market" prior to resuming the previous pace of acquisition. We also expect to see some divestitures of underperforming assets by SOEs and de-risking of significant acquisitions by bringing in partners.

Regulatory Developments

National security issues

On October 7, 2013, the federal government turned down Accelero Capital Holdings' proposed acquisition of the Allstream division of Manitoba Telecom Services Inc. (MTS) under the national security provisions of the ICA. The decision, which came more than four months after Accelero announced its proposed $520 million acquisition of Allstream, took the market by surprise. Other than noting that "MTS Allstream operates a national fibre optic network that provides critical telecommunications services to businesses and governments, including the Government of Canada" no reasons were given for the decision. While sending a strong signal that national security will be invoked to block a transaction, it should be appreciated that this is only the third transaction that the government has blocked under the ICA (outside the cultural area) since the legislation was enacted in 1985.

In addition, the governments of China and South Korea have both launched investigations into whether representatives of certain SOEs that completed significant foreign acquisitions, or their family members, personally benefitted from those transactions. Some commentators have suggested that these investigations could dampen the pace of further SOE foreign direct investment while they are ongoing.

Outlook for 2014

Notwithstanding the almost total lack of SOE investment in the Canadian oil and gas sector through the first three quarters of 2013, events occurring in the fourth quarter have provided some reason to be optimistic that SOE investment sentiment towards the sector is changing.

First, concerted efforts undertaken by the provincial governments of Alberta and British Columbia and the federal government to persuade Asian SOEs and other foreign investors that Canada continues to welcome their investment in the oil and gas sector appeared to be gaining some traction. In October, Alberta signed a framework agreement with China's National Energy Administration to give the province "unprecedented access" to Chinese decision makers. In commenting on the agreement, Alberta Energy Minister Ken Hughes said:

> In the eyes of China I believe we represent a tremendous supply of energy that they would be very pleased to have access to.

He further noted that the agreement:

> strengthened ties with what we believe will become one of our key markets for energy products.

B.C. Minister of Natural Gas Rich Coleman also reported receiving very positive reactions from potential Asian investors in west coast LNG projects

A number of Canadian oil sands producers struggled to attract additional funding in 2013 and several were forced to engage in strategic alternative processes at distressed valuations. The beneficiaries of this environment are multi-national enterprises, and not Canadian companies, who no longer need to compete for assets with SOEs. A competitive environment which includes multi-national enterprises, Canadian companies and SOEs gives assurance of a competitive landscape with effective Canadian participation. The federal government needs to explicitly encourage SOE participation to reverse an outcome which has clearly harmed Canadian participation.

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following a B.C. trade mission to the region in November. This trip was one of a series of missions by BC officials to "further LNG prospects by strengthening the government's connection to key stakeholders in Asia."

In commenting on his discussions with such stakeholders, Mr. Coleman noted that: "[t]he buzz was that we were moving in the right direction."

Other notable developments in the fourth quarter included:

- public statements by representatives of the Chinese government that China was aiming to double the share of natural gas in its energy mix by 2020;
- the announcement by Malaysia's Prime Minister Mohd Najib of his government's intentions to spend $36 billion on the Pacific Northwest LNG facility proposed for the Prince Rupert area; and
- the announcement of the acquisition by Malaysian state-owned PETRONAS of $1.5 billion of natural gas holdings in the Montney region of British Columbia from Talisman Energy Inc., marking the first significant SOE investment in the Canadian oil and gas sector in 2013 despite PETRONAS' difficult approval process in 2012 when it acquired Progress Energy. Osler acted as lead counsel to Talisman.

Further, concerns about the pace of infrastructure development appeared to be lessening somewhat at year-end in light of the approval of the Northern Gateway project and the advancement of Kinder Morgan's expansion of its TransMountain Pipeline system. Positive movement in public support for infrastructure projects and government's commitment to shorter timelines for regulatory approvals also contributed to increased optimism.

Accordingly, we believe that there is reason to be optimistic that there will be significantly more SOE investment in the Canadian oil and gas sector in 2014, albeit not at the levels seen in 2012. We also believe that there will be greater SOE interest in LNG and other non-conventional gas assets as opposed to other types of energy assets, and we expect that SOEs will pursue joint ventures with other parties in connection with such investments, or invest by way of a royalty purchase or through debt instruments, as opposed to seeking outright acquisitions of control of Canadian energy companies.

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