Asian Investment in Canada's Resource Sector in 2012

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The first half of 2012 saw significant foreign investment flow into Canada, and as in other years, Asian state-owned enterprises (SOEs) and other Asian investors played a significant role. On average, the size of transaction was larger in comparison to prior years, and Asian investors demonstrated a desire for greater control over the enterprises in which they were investing. The non-conventional oil and gas sector was the principal beneficiary of Asian direct investment in Canada, and within this sector, oil sands, shale gas and LNG projects attracted the bulk of the capital. Asian investors also made significant investments and acquisitions in the mining sector in 2012.

By mid-year, the pace of Asian investment into Canada declined precipitously in light of uncertainty as to whether the federal government would approve Chinese National Offshore Oil Corp.'s (CNOOC) proposed acquisition of Nexen Inc. (Nexen) and the proposed acquisition of Progress Energy Resources Corp. (Progress) by Malaysian-based Petroliam Nasional Berhad (PETRONAS) under the *Investment Canada Act* (ICA). Such uncertainty was resolved on December 7, 2012 when Prime Minister Harper announced that both transactions had been approved. However, at the same time, Prime Minister Harper announced changes to the manner in which SOE investments in Canada would be reviewed under the 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.

Significant transactions in 2012 involving Asian direct investment in Canada, in addition to the transactions noted above, included:

- PetroChina in its proposed partnership with TransCanada Corporation to construct, own and operate the Grand Rapids Pipeline System, its investment in British Columbia shale gas assets owned by Shell Canada and its purchase of the balance of the interests in the McKay River oil sands project;
- the acquisition of Grande Cache Coal Corporation (Grand Cache Coal) by Marubeni Corporation (Marubeni) and Winsway Coking Coal Holdings Limited (Winsway);
- CNOOC's acquisition of a 35% interest in the Long Lake oil sands project through its acquisition of OPTI Canada Inc. (OPTI);
- minority investments by Wuhan Iron & Steel in Adriana Resources and by Heibei Iron & Steel in Alderon Resources, to facilitate the development of iron ore mines in Quebec and Labrador respectively; and
- the announcement by Encana and PetroChina of a $2.1 billion joint venture to explore and develop properties in the Duvernay region of Alberta.

Evolution of Deal Terms

The preferred terms of investment of some Asian enterprises in Canadian companies and projects evolved significantly in 2012. Historically, Asian enterprises tended to acquire Canadian companies with assets outside of Canada or subscribe for minority equity investments in project owners or minority investments in the projects themselves. There were modest governance and

OSLER REPRESENTED THE FOLLOWING CLIENTS IN 2012:

A **subsidiary of PetroChina** on its partnership with TransCanada Corporation to construct, own and operate the Grand Rapids Pipeline System.

Marubeni Corporation and **Winsway Coking Coal Holdings Limited** in their acquisition of Grande Cache Coal Corporation, a metallurgical coal mining company based in Alberta.

PetroChina in connection with the acquisition of an interest in Shell Canada's Groundbirch shale gas assets and the development of their Dover and MacKay River oil sand projects.

A **significant selling shareholder** in connection with the acquisition of Progress Energy Resources Corp. by Petroliam Nasional Berhard (PETRONAS).

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

The **financial advisors** to Nexen in its proposed sale to CNOOC.

Mark Horsfall, Managing Director of CIBC World Markets Inc. and Head of Global Energy, noted recently that *"Asian investors are no longer interested in only contributing capital to the projects in which they invest. They believe that they can make substantial contributions in areas such as management and technology and are looking for opportunities to do that".*

project rights, if any. Thereafter, the size of the investment or project interest being acquired tended to increase with a commensurate increase in governance and project rights. Although larger than earlier investments, these types of investments were for significant minority positions and did not result in an acquisition of control. More recently, however, we have seen Asian SOEs seek outright control of Canadian resource companies such as CNOOC's acquisition of OPTI, China Petroleum and Chemical Corp.'s (Sinopec) acquisition of Daylight Energy Ltd. (Daylight), CNOOC's proposed acquisition of Nexen and PETRONAS' proposed acquisition of Progress.

The apparent desire of some Asian SOEs for increased control, or in some cases, outright control, of the companies and projects in which they invest, became increasingly controversial in the latter half of 2012. Representatives of Canada's domestic energy industry acknowledged the continuing need for foreign capital to fund further development of the sector but expressed concern that outright acquisitions of resource companies precluded Canadians from participating in such development. More generally, ordinary Canadians expressed growing concern about the degree of foreign ownership of domestic natural resources.

Asian Investment in the Canadian Non-Conventional Oil & Gas Sector

Foreign SOEs and other enterprises, especially those from Asia, have been significant investors in Canada's non-conventional resource sector and the availability of such capital has been one of the factors contributing to the sector's impressive growth. We believe that Asian SOEs have been prepared to deploy significant capital into the Canadian non-conventional oil and gas sector because of the potential size of the non-conventional resources, the fact that Canada has actively encouraged foreign investment in this sector and the prospect that these types of investments will help facilitate development of a seaborne export market and thereby secure supply for Asian consumers. It remains to be seen whether the new SOE guidelines under the ICA announced by Prime Minister Harper will have a chilling effect on further SOE investment in such sector.

The oil sands have historically attracted the majority of foreign investment in the Canadian non-conventional oil and gas sector. However, more recently, there has been significant foreign investment in Canadian shale gas and LNG projects including:

- The acquisition by PETRONAS of a 50% interest in shale gas formations in North Montney, British Columbia and the announcement of its plans to build a LNG export facility at Prince Rupert, British Columbia;
- The acquisition by a consortium led by INPEX Corp. of Japan of a 40% interest in certain Horn River, Cordova and Laird shale gas formations; and
- The announcement by a consortium including Mitsubishi, PetroChina and Korea Gas of a $12 billion LNG facility at Kitimat, British Columbia.

The increasing ability of non-conventional gas projects to attract foreign capital has been a significant factor in the decision to proceed with such projects in the face of low North American gas prices caused by over-supply. Such interest demonstrates growing international confidence that an LNG export market, via Canada's west coast, will develop. Five 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 all five of these projects.

Asian Investment in the Canadian Mining Sector

Global M&A and investment activity in mining, by volume, eased substantially in 2012 and Canada was no exception. Much of the foreign direct investment activity into the Canadian mining sector in 2012 involved the completion of transactions announced in late 2011 and was focused primarily on base metals, particularly raw materials for steel making such as metallurgical coal and iron ore. By way of example, Osler acted for the Asian-based consortium of Marubeni and Winsway Coal in their $1 billion acquisition of Grande Cache Coal. Asian enterprises made a number of minority investments in Canadian mining companies in 2012, often to fund the development of iron ore projects. However, as the year progressed, completing mining transactions became more difficult as a result of commodity price fluctuations (with re-pricing not uncommon) and a global rise in resource nationalism. For example, Chinalco's bid for an interest in SouthGobi Resources, a Canadian company with assets in Mongolia, was withdrawn when Mongolian government approvals were not forthcoming.

ICA Review of CNOOC and PETRONAS Transactions

The lengthy review of the PETRONAS and CNOOC cases under the ICA created a level of uncertainty over the criteria required to be met to obtain regulatory approval of reviewable foreign investments. Such uncertainty last surfaced two years ago when BHP Billiton's offer for Potash Corporation of Saskatchewan was not approved. However, the level of anxiety around the PETRONAS and CNOOC cases appeared to be more acute.

The PETRONAS transaction, announced on June 28, 2012, was initially rejected on October 19, 2012. However, PETRONAS re-engaged with the federal government and the transaction was approved on December 7, 2012. The CNOOC transaction, which was announced on July 23, 2012, had its review under the ICA extended twice. It was also approved on December 7, 2012. However, since these transactions were approved under the rules applicable to SOEs prior to December 7, 2012 they are of limited value in predicting the outcome of future proposed investments. Indeed, Minister of Natural Resources Joe Oliver indicated shortly after the December 7 announcement that CNOOC's bid for Nexen likely would not have been approved under the new SOE regime. In addition, neither CNOOC, PETRONAS nor the government has published in any detail the actual commitments given by the investors to secure approval under the ICA.

Outlook

We believe that the CNOOC-Nexen and PETRONAS-Progress transactions represent a tipping point in terms of SOE investment in the Canadian resource sector. The combined value of the CNOOC-Nexen and PETRONAS-Progress transactions is approximately $20 billion which exceeds some estimates of total Asian investment to date in the Canadian non-conventional oil and gas sector, and the announcement of such deals became a catalyst for public debate. By the fourth quarter, it was clear that Canadians were increasingly concerned about the outright acquisition of large Canadian resource companies by foreign SOEs and the degree of foreign ownership in the resource sector. This presented an issue for the federal government which had been actively courting Asian investment in Canada and had particularly emphasized the need for foreign investment in the oil sands and non-conventional gas sectors. The "carefully calibrated" solution announced by Prime Minister Harper was to approve the CNOOC-Nexen and PETRONAS-Progress transactions on the basis that the net benefit test in place at the time those transactions were announced had been met, but significantly raise the bar on future SOE investments and limit acquisitions of control of oil sands businesses to "exceptional circumstances".

We had expected that the government's announcement of the new SOE guidelines would seek to mollify Canadians with respect to SOE investment in Canada, but on a basis that did not deter future SOE investment. In large measure, the new SOE guidelines have been well received by Canadians. The initial reaction from Asia has also been positive and, thus far, the official Chinese press has elected to focus on the approval of the CNOOC-Nexen transaction following a string of disapprovals in the United States. However, it is not a certainty that the resource sector will continue to attract the significant volumes of foreign capital it requires in order to fully realize the value of Canadian natural resources. While the fundamentals of the Canadian resource sector remain sound, going forward, SOEs will need to reset their expectations in terms of their ability to influence the enterprises in which they are investing. Whether they are prepared to invest significant amounts on this basis is an open question at present, although the recently announced Encana-PetroChina joint venture suggests that there may be reasons to be optimistic.

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