

ENERGY

A legal guide to exploiting natural resources worldwide

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FINANCIAL
LAW REVIEW

CANADA

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The Canadian oil and gas industry is currently operating under relatively stable and congenial fiscal and regulatory regimes. Since late 1985 there has been a progressive deregulation of oil and gas markets in Canada and a corresponding increase in the direct marketing of natural gas. The implementation of the Canada-US Free Trade Agreement (the FTA) in 1989 assures Canadian energy exporters non-discriminatory access to US markets.

There is also an increased emphasis on operating cost efficiency in the industry and most of the major integrated producers are undertaking large scale divestiture programmes to rationalise their holdings of non-core producing properties. Although special rules apply to foreign acquisitions of producing Canadian oil and gas properties, these rules are applied flexibly and it is usually possible to structure a transaction that will achieve the primary commercial objectives of the parties.

The Canada-US Free Trade Agreement assures Canadian energy exporters non-discriminatory access to US markets

Public securities offerings by Canadian oil and gas issuers are characterised by the streamlining of traditional offering techniques, financial innovation and the continuing rapid internationalisation of capital markets. In Canada, as elsewhere, recent world oil price volatility has led to increased reliance on new risk management tools.

Increased drilling in environmentally sensitive areas, coupled with greater sensitivities and new environmental legislation, are imposing greater responsibilities and potential liabilities on the oil and gas industry.

Principal legislation and regulatory bodies

Each of the producing provinces in Canada regulates the exploration for and the development, conservation and management of non-renewable resources in the province. For example, in Alberta, which is the primary producing province, the Energy Resources Conservation Board administers comprehensive conservation regulations that govern well spacing, pooling, well licensing, maximum production rate limitations, protection of producer equities, processing, transportation and the removal of natural gas from the province.

Within the producing provinces, most new oil and gas exploration takes place on Crown lands which are governed by provincial regimes of Crown licences and leases. Crown leases reserve a Crown royalty and provide for a reversion to the Crown of rights below the deepest zone capable of production in paying quantities after the initial term.

The federal government regulates resources located on federal lands in the northern frontier regions while resources in the continental shelf offshore Newfoundland and Nova Scotia (for example, the Hibernia oil field) are under joint federal-provincial management pursuant to inter-governmental agreements. Parallel federal and provincial statutes provide for the issuance of exploration and production licences, specify the rights and obligations of licence holders, establish general rules governing the conduct of field activities and establish federal-provincial administrative boards.

The Canada Oil and Gas Lands Administration, which has had responsibility for administering those federal lands not being handled by the offshore energy boards or northern territorial governments is being disbanded and its responsibilities are being transferred to the National Energy Board (the NEB) which is relocating to Calgary from Ottawa.

Market deregulation

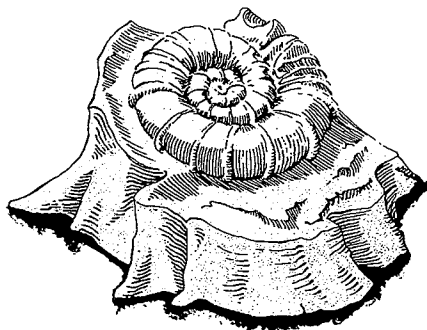
Since 1985, there has been a progressive deregulation of Canadian natural gas markets and a dramatic increase in the number of direct sales negotiated at market prices between aggregators, other gas brokers and producers marketing gas directly to gas users. Prior to late 1985, TransCanada Pipelines Limited (TCPL), which owns Canada's interprovincial natural gas pipeline east of Alberta, was essentially the sole purchaser and carrier of natural gas to Canadian markets east of Alberta, purchasing gas from producers under long-term contracts, and reselling it to local distribution companies in the consuming provinces.

One significant source of new gas markets has been the development of independent power producers and co-generation plants. Typically, gas supply contracts for these projects incorporate innovative terms designed to ensure price and supply certainty for the amortisation period of the project financing (often 15 to 20 years).

A supply warranty may suffice where the producer is sufficiently creditworthy, but in other cases either a dedication of specific reserves or some form of security may be involved. Price escalation formulae are often indexed to regional gas price indices or the cost of alternative fuels.

Transportation regulation

The deregulation of natural gas marketing has been facilitated by a number of regulatory decisions of the NEB which regulates TCPL's tolls and access to the TCPL system. The NEB has eliminated the 'displacement proviso' in TCPL's toll schedules, which had permitted TCPL to refuse to ship direct sale gas in cases where the proposed sale would displace a market previously serviced by TCPL system gas. In addition, the NEB now permits self-displacement by allowing distributors to use direct purchases to displace volumes already contracted by such distributors from TCPL. Finally, the NEB has eliminated the 'double' demand charge situations which arose when both a direct marketer and a distributor whose market was being displaced by a direct sale were required to pay TCPL demand charges.



Natural gas exports

As a result of the FTA, changes have been made to Canada's energy regulatory regime to ensure the FTA's objective of 'the freest possible bilateral trade in energy, including non-discriminatory access for the United States to Canadian energy supplies and secure market access for Canadian energy exports to the United States'. The FTA prohibits export restrictions for crude oil, natural gas, natural gas liquids, coal and electricity, except in limited circumstances defined in relation to pre-existing GATT rules, and then only subject to proportional sharing requirements.

Minimum export and import price requirements are prohibited in similar circumstances, except where required to enforce countervail and anti-dumping orders. Export taxes, duties and charges not applicable to goods destined for domestic consumption are prohibited. Finally, the FTA permits the continuation of current and future Canadian exploration and drilling incentive programmes and implements a consultative mechanism with respect to discriminatory energy regulatory actions.

The NEB now routinely grants short term (under two year) export orders without a public hearing. For longer term export licences, a hearing is required to determine whether the gas proposed to be exported is surplus to reasonably foreseeable Canadian requirements and whether the proposed export is in the national public interest.

The NEB has discarded its cumbersome surplus determination procedures based on reserve ratio analysis and, since July 1987, has adopted a market-based procedure having three components: a complaint procedure which considers any complaints that Canadian users cannot obtain additional gas supply on price and other terms similar to those in the export proposal (no such complaints have been sustained to date), an export impact assessment and a public interest determination.

The export impact assessment is now perfunctory as the NEB supplies the assessment which the applicants are free to rely on. The public interest determination component has also been simplified; the NEB has dropped the requirement that applicants provide a Canadian benefit-cost analysis.

A number of major cross-border pipeline projects have recently been approved by the US Federal Energy Regulatory Commission, including the Iroquois pipeline project which will provide Canadian gas exporters with access to the Northeastern US market by 1992 and the competing Altamont and Pacific Gas Transportation projects which will service the western US

market. Recently, the NEB has approved the application of its traditional 'rolled-in' tolling methodology to distribute the cost of the expansion of the TCPL system required to service the Iroquois project to all of TCPL's system users, rather than 'incremental' tolling which would have imposed the cost of the expansion on Iroquois shippers transporting volumes for export.

Rationalisation programmes

In the past three years, most of the larger Canadian producers have undertaken major rationalisation programmes involving the divestiture of their less strategic producing properties. The volume of Canadian oil and gas mergers and acquisitions was over C\$3bn in 1990, compared to C\$8.4bn in 1989 (including the C\$5bn acquisition of Texaco Canada by Imperial Oil Limited) and C\$3.7bn in 1988. Currently, it is estimated that there are C\$4.1bn of Canadian oil and gas properties for sale.

Most of these divestitures have been structured as direct asset sales, but they typically differ from traditional normal course property sales in at least three ways: the bundling of properties into C\$5m to C\$30m packages attractive to acquisition-minded intermediate sized companies, an orchestration of bids from likely prospective purchasers, and the preparation and dissemination of a detailed property information package, including a pro forma purchase and sale agreement prepared by the vendor.

It is estimated that there are C\$4.1bn of Canadian oil and gas properties for sale

Many of the transactions are being structured as 'purchase butterflies' under Canadian federal income tax laws. The structure involves the tax-free transfer of the properties to a newly formed subsidiary and a sale of the shares of the subsidiary to the ultimate purchaser. The technique, which involves a complex capital reorganisation subject to highly technical requirements, is likely to be advantageous only to vendors holding their properties in an operating subsidiary. However, where available, it permits a vendor with a sufficiently high cost basis in the shares of its operating subsidiary to dispose of properties without income recognition while retaining the associated tax pools.

Sellers have begun to incorporate various contingent payment provisions into transactions to bridge the pricing expectation gap between buyers

and sellers. For example, in one recent transaction the purchaser of an oil field from an integrated refiner locked-in field gate prices for two years on production from the field pursuant to a forward sales agreement with the refinery division of the vendor.

Alternatively, oil price indexed debt instruments may be issued by the purchaser as partial consideration for the purchase price; eg a note with periodic payments which are reduced if future price estimates are not obtained or a note giving the holder the right to nominate for and take delivery of a specified volume of crude oil at a scheduled price in each year over the note's term.

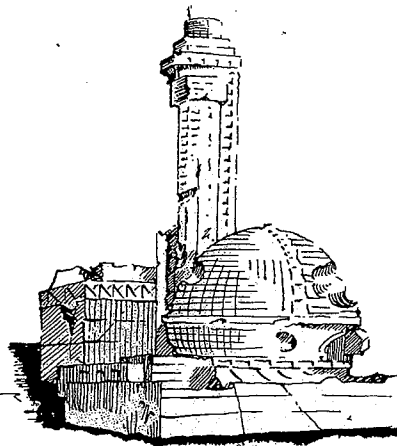
Finally, the vendor may retain a royalty, requiring the purchaser to pay the vendor a portion of the incremental revenue from the property during periods where posted oil prices exceed an agreed upon benchmark price.

Public financing in the energy sector

Most public offerings of securities by Canadian energy issuers are now completed on a bought deal basis. In contrast to the United States and UK, this includes equity deals as well as non-convertible debt offerings. Traditional 'best efforts', long-form prospectus issues have been relegated primarily to initial public offerings, offerings of tax shelter flow-through shares, partnership and mutual fund securities and offerings of other novel or custom-designed securities.

Most public oil and gas offerings are now completed either pursuant to the short-form, prompt offering prospectus (POP) provisions available to issuers with a three year reporting history and a C\$75m market capitalisation (or, in the case of debt offerings, having an investment grade rating) or pursuant to special warrant transactions, a technique developed by intermediate size oil and gas issuers, who do not qualify for the POP system, to issue securities on a reasonably expedited bought deal basis.

Under the special warrant structure, the issuer initially places warrants with institutional investors on an exempt private placement basis. The issuer agrees to file a prospectus to qualify the securities underlying the special warrants, thereby eliminating the resale restrictions which would otherwise apply, and the proceeds from the offering are held in escrow until after a receipt for the



FOREIGN ENERGY INVESTMENT

The Investment Canada Act replaced the more stringent Foreign Investment Review Act in 1985. The Investment Canada Agency (the Agency) continues to review large foreign acquisitions of Canadian businesses to ensure that they are of net benefit to Canada, but the Agency's mandate has been broadened to encourage and facilitate foreign investment.

As a result of the FTA, Canada's foreign investment rules were further relaxed through the phased implementation of enhanced review thresholds. For Americans, the new thresholds are: C\$100m for direct acquisitions in 1991 (and C\$150m thereafter) and C\$500m (non-reviewable beginning next year) for indirect acquisitions of a Canadian subsidiary through acquisition of its foreign parent. These new thresholds also apply to the acquisition by investors from a third country of Canadian business from Americans.

At the time of the FTA, Canada's existing and more restrictive policies pertaining to the acquisition of producing upstream oil and gas assets were retained. These policies disallow the direct foreign acquisition of a financially healthy Canadian-controlled oil and gas business with assets of C\$5m or more. Non-Canadians considering the acquisition of Canadian oil and gas interests should not, however, be overly deterred by these special rules since the rules are administered flexibly and usually, in all but the most politically contentious situations, a transaction can be structured to accommodate the regulatory requirements while at the same time achieving the primary commercial objectives of the parties.

Acquisitions over the C\$5m threshold will generally be permitted where the properties are already foreign-controlled or where the Canadian vendor is in clear financial difficulty, in each case

subject to satisfactory commitments regarding Canadian equity participation and capital expenditure programmes. Acquisitions of less than one-third of the voting shares of a corporation are deemed not to be acquisitions of control, and hence are not reviewable even if they constitute the acquisition of control in fact or the acquisition of greater than a 50 per cent economic interest (eg through the use of non-voting preferred shares). Similarly, the acquisition of one-third or more of the voting shares, but less than a majority, is not reviewable if it can be established that the target is not controlled in fact by the purchaser through the ownership of shares.

In addition, a number of discrete exemptions can be combined to facilitate a sizeable oil and gas acquisition. Firstly, acquisitions of exploratory properties, regardless of value, are not subject to review. Secondly, any number of producing properties may be acquired, so long as each property has a book value of less than C\$5m and is under a separate operating or unit agreement. Thirdly, up to a 50 per cent working interest in numerous producing properties may be acquired, irrespective of how many other parties hold the balance of the working interests and whether or not the purchaser takes over operation of the property.

In the second and third cases, there is an additional requirement that the acquisition not constitute the acquisition of substantially all of the assets of the vendor. In one recent transaction, these exemptions were relied on to facilitate a C\$260m acquisition of Canadian oil and gas properties by a foreign buyer.

In short, numerous possible structures are available and should be considered by non-Canadians contemplating a Canadian oil and gas acquisition.

prospectus has been issued. Once the prospectus has cleared, the warrants are exercisable without payment of material additional consideration with the result that the purchasers receive freely tradeable securities.

Canadian energy companies were among the first issuers to rely on the new SEC Rule 144A to resell Canadian securities not registered under US securities laws to qualified US institutional buyers on a private placement basis. In addition, by the summer of 1991, the new Canada-US Multijurisdictional Disclosure System (MJDS) should be in place, as well as a Canadian equivalent of the US shelf prospectus system.

Under the MJDS, qualified Canadian issuers will be permitted to comply with Canadian disclosure requirements for certain cross-border securities offerings, issuer bids, rights offerings and cash and securities exchange take-over bids.

Under the recent 'shelf' prospectus proposal, Canadian issuers qualified for the POP system will be permitted to use one short-form prospectus to make a continuous offering or a series of separate, delayed offerings over a two-year period. In addition, they would be permitted to price traditional single tranche prospectus offerings after the issuance by securities regulators of a receipt for the final short-form prospectus.

Trends in energy debt finance

Reserve-based production loans continue to be the primary source of debt finance for the Canadian oil and gas industry. Typically, the terms of such loans provide for the establishment of a floating rate facility with a principal amount not to exceed a percentage (typically, 60 per cent) of the appraised value of the proved producing properties

mortgaged as security for the loan, evaluated using the lender's own price forecasts and discounts rates.

The documentation will usually include a maintenance covenant requiring an annual re-estimate by the lender's engineers of the net present value of proved producing reserves. The value of the properties does not exceed a specified multiple of outstanding indebtedness, the percentage of cash flow dedicated to debt payment will be increased or the borrower will be required to repay a portion of the loan facility or to pledge additional security. In recent years, comprehensive debenture security has replaced short form Bank Act security in popularity.

Typically, the facility will provide for LIBOR, US base rate, fixed rate and bankers' acceptance accommodations in addition to a Canadian prime-based overdraft facility. As in other jurisdictions, however, the phasing-in of the new BIS capital adequacy rules has increased the cost of bankers' acceptances relative to commercial paper and Canadian energy lenders have developed innovative products, such as oil and gas receivables securitisations, to provide indirect access to commercial paper markets for customers without an investment grade rating.

Comprehensive debenture security has replaced short-form Bank Act security in popularity

Some of the more sophisticated and innovative Canadian energy borrowers have entered into complex debt financing structures involving, for example, participating and commodity or index-linked debt instruments, weak currency loans (borrowings denominated in the currency of a high interest rate country with a compensating currency gain locked in through forward exchange contracts or currency swaps) and prepaid interest loans (which, in effect, convert principal payments to tax deductible interest).

Management of oil price risk

Many Canadian producers are hedging oil price risk through trading in commodity futures and options on the New York Mercantile Exchange, but oil price index swaps are also coming to be accepted as a simpler and cheaper way of achieving a longer term oil price hedge, particularly since commodity swaps are generally settled only on a periodic basis whereas futures contracts are marked to market on a daily basis.

TAX INCENTIVES

Under the Canadian Income Tax Act, accelerated write-offs are available permitting the deduction in a taxation year of 100 per cent of 'Canadian exploration expenses' incurred in that year and the deduction of 'Canadian development expenses' on a 30 per cent declining balance basis.

Farm-outs, in many circumstances, are treated as not constituting disposition by the 'farmer', while the 'farmee' is entitled to the accelerated resource write-offs associated with expenditures incurred to earn its interest.

Partnerships are used frequently in oil and gas industry financings, partly because certain resource expenditures incurred by the partnership are allocated to persons who are partners at the partnership's fiscal year end. In addition, specific flow-through share provisions available to resource issuers permit the renunciation to shareholder investors of certain resource expenditures incurred by the resource issuer. Similarly, special joint exploration corporation provisions may permit a parent corporation to establish a resource subsidiary, while at the same time claiming resource write-offs at the parent level.

Although many of the special federal and provincial resource incentive programmes have been permitted to expire as oil prices have risen, the Canadian government has provided an outright contribution of approximately C\$1bn and C\$1.8bn of government guarantees to the Hibernia oil project. Several of the producing provinces provide royalty relief for new wells and for enhanced recovery projects and Alberta provides a refund of a portion, varying with the price of oil, of provincial crown royalties through its royalty tax credit programme.

The initial development of the oil price index swap market in Canada actually preceded the development of analogous products in the United States where initial opposition by the Commodities Futures Trading Commission impeded the involvement of commercial banks in the market.

In Canada, the market developed earlier on the basis of legal opinions to the effect that acting as a fully hedged intermediary in a commodity swap is within the power of a Canadian chartered bank under the federal Bank Act.

Oil price index swap agreements typically take the form of slightly modified versions of the standard International Swap Dealers Association (ISDA) interest rate swap agreements. However, parties not familiar with the ISDA forms have expressed a preference for simpler forms similar to the shorter agreements used for financial swaps prior to the evolution of the ISDA form.

ENVIRONMENTAL ASPECTS

Oil and gas operations in Canada are subject to a variety of federal and provincial environmental laws. For example, in Alberta, the industry is subject to environmental statutes of general application regulating air and water pollution and the reclamation of lands disturbed by surface operations. In addition, a number of industry-specific regulations govern major pipelines, oil sands and waterflood projects, and sour gas wells and plants.

Traditionally, the enforcement of provincial environmental legislation has focused primarily on administrative directives embodying negotiated compliance requirements based on technical discussions with the industry, but tougher new legislation likely to be implemented this summer would establish a legislated environmental impact assessment process, increase enforcement mechanisms and penalty provisions, mandate spill reporting and clean-up and impose a lingering 25 year owner/operator liability for site clean-up and reclamation costs as well as liability of corporate officers and directors for environmental offences.

In addition, as a result of recent court decisions, the environmental implications of any industry project for which the federal government has a decision-making responsibility must be fully considered pursuant to the federal Environmental Assessment and Review Process and draft legislation has been tabled to establish a more formalised federal environmental assessment process.

Under the Canada Environmental Protection Act, the federal government regulates prescribed toxic substances and controls emissions to achieve compliance with international protocols. Generally, federal environmental laws are of more recent vintage than laws in the producing provinces and include provisions for rigorous enforcement, stiffer penalties, liabilities for clean-up costs and director and officer liability.

As in the case of interest rate and currency swaps, a bank or dealer intermediary will usually be involved. The intermediary will usually call upon the assistance of an experienced energy lender to provide credit enhancement through the issuance of a letter of credit in support of the payment obligations of the oil producer under the swap agreement. The energy lender assumes not only the normal credit risk of the oil producer, but also various additional risks inherent in oil price index swaps:

- oil price index volatility is generally greater than the volatility of either interest rates or exchange rates;

- since the market for oil price index swaps is less developed and less liquid than the market for financial swaps, there is less assurance that a replacement transaction will be available if one party defaults;

- production quotas or price controls may be imposed on the producer's output causing a divergence between the prices received by the producer for its output and the movement of the oil price index used in the swap agreement (unlikely under the constraints of the FTA); and
- the producer's royalty burden (based on actual market prices) may be disproportionate to the net price received by it after giving effect to the hedging arrangements.

At the same time, however, the risk is in some respects less. This is because the producer's ability to settle under the swap agreement, if oil prices rise, will be enhanced by the increase in its operating cash flow provided it has not hedged all of its production.

Electricity

The generation and distribution of electricity is under provincial jurisdiction and each of the major Canadian suppliers of electrical energy for export is a provincially owned or regulated utility. Currently there are significant electricity export opportunities, particularly to the Northeastern and Midwest United States. Typically, electricity export contracts are negotiated pursuant to bulk purchase arrangements incorporating terms with respect to price, quantity, reliability, duration and product type (eg interruptible energy, seasonal energy, fixed capacity term).

Exports of Canadian electricity are regulated by the NEB which has a general mandate to ensure that exports are in the Canadian public interest. In deciding whether an export application is to be subjected to a public hearing, the NEB must consider whether there is any preliminary evidence to suggest that the export would:

- have unacceptable impacts outside the sponsoring provinces;
- contravene environmental guidelines; or
- deny Canadians fair market access to the electricity proposed for export.

The FTA extended to electricity the pre-existing GATT trading rules applicable to other energy goods, as well as the more stringent proportional sharing obligations contained in the FTA itself. In particular, Canada's 'least cost alternative test', which required a demonstration that electricity exports would not result in prices in the importing country being materially less than the least cost alternative for energy at the same location in that country, was eliminated under the FTA.

Uranium

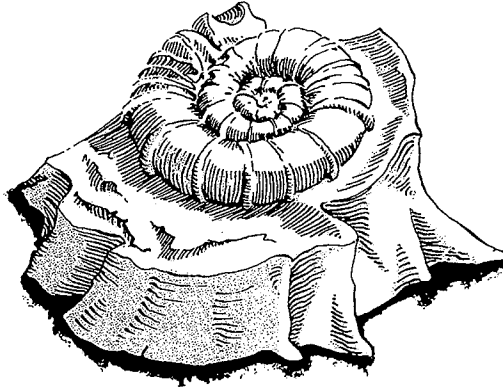
Canada has significant high grade, internationally cost competitive uranium deposits, particularly those at Key Lake, Cluff Lake and Cigar Lake in Saskatchewan. These resources have been regulated federally since 1946 when the federal government used its constitutional declaratory powers to shift from provincial to federal jurisdiction all works and undertakings 'for the production, refining or treatment' of uranium.

The federal Atomic Energy Control Board has regulatory power, primarily through a licensing procedure, over the prospecting for, mining, refining and handling of uranium. In addition, pursuant to the Canadian Uranium Upgrading Policy, announced in 1985, all Canadian uranium ore (except uranium exported to the US, which has been exempted pursuant to the FTA) must be upgraded in Canada.

Pursuant to Canadian uranium ownership policies which were grandfathered for the general relaxation of foreign investment restrictions under the FTA, Canada continues to limit non-resident ownership of Canadian uranium mines to 49 per

cent at the first stage of production, provided that higher levels of non-resident ownership will be permitted if it can be established that the producing entity is, in fact, Canadian-controlled as defined in the Investment Canada Act.

From the above report, it can be seen that Canada's very significant energy resources and its hospitable fiscal and regulatory environment continue to provide attractive investment opportunities for international investors.



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