From scarcity to abundance

Oil and gas transactions in review 2014—Canada
From scarcity to abundance

We believe that a structural shift is underway in the oil and gas business as the industry transitions from a “resource scarcity” model to a “resource abundance” model. For the Canadian industry, three key implications result from this structural shift:

- **Costs matter** - In a “resource abundance” world, future commodity prices will not preserve or rescue high-cost projects as the industry grapples with structural cost pressures. Capital-intensive unconventional resource development, increasing regulatory and environmental costs, and the growing technology and service costs of unlocking abundant yet complex plays will drive new business models and a renewed focus on operational excellence resulting in a bifurcation of winners and losers – those able to adapt and those who fail to adjust.

- **Globalization** - The global nature of the industry continues to change. Growing unconventional production has challenged old market dynamics, with new competition at a global level (for example, liquefied natural gas (LNG) can be viewed as an effort to globalize the Canadian natural gas business). Capital continues to flow to projects with little regard for borders, while players continue to evolve strategies and structures in ways to best address and succeed in the global energy marketplace.

- **Innovation** - Essential to realizing the massive resource potential of the Canadian industry, innovation – in technology, business processes, structures, operating and funding models – will be required to offset high structural costs (e.g., the oil sands and unconventional plays). Innovation will be a key driver of success.

In many ways, transaction activity in 2014 in Canada and involving Canadian companies reflected reactions to the implications of the structural shift currently underway with executives and investors trying to reposition their companies and capitalize on emerging opportunities.

Supported by a host of significant transformative business transactions, favourable commodity prices and strong capital markets in early 2014, aggregate Canadian transaction levels (excluding oilfield services) grew significantly in total dollar terms in 2014. The total deal value of US$42.2 billion in 2014 was more than three times the 2013 total of US$14.0 billion.

Despite these robust transaction figures, total publicly announced transactions completed in Canada in 2014 continued a downward trend, declining 17% compared to 2013 (with 281 deals vs. 337 deals). Some of this decline in completed transactions is likely attributable to lingering sector uncertainties at the start of the year, coupled with a pronounced decline in overall transaction activity in the final months of 2014 as the oil price collapse took hold.
Canadian oil and gas transaction activity
(excludes oilfield services)

Source: EY analysis of data from Derrick Petroleum

* Canadian transaction values and deal volumes represent only reported Canadian assets and companies bought and sold within a given calendar year.

Across the major components of the Canadian energy industry (namely oil, natural gas, LNG, oil sands, midstream and oilfield services), a number of telltale transactions and critical business themes played out throughout 2014. Notable transactions in Canada focused on a variety of rationales, including creative farm-outs to “share” exploration, development or project costs; carve-outs to monetize non-core assets; transactions to strategically reposition a business (selling gas and buying oil); and those done to stave off activist investor threats. And all these transactions took place in an environment of increasing levels of new private capital intent on pursuing Canadian energy assets.
Oil (conventional, tight and shale oil)

Oil transactions in 2014 represented a number of big bets on reshaped corporate strategies, ongoing play consolidation and continued asset rationalizations, with companies aggressively pursuing what were perceived to be “lucrative” oil assets. Some of the most significant oil-focused Canadian transactions in 2014 were:

- Spain-based Repsol SA agreed to acquire Calgary-based Talisman Energy Inc. for approximately CAD$15.1 billion.
- Crescent Point Energy Corp. acquired Calgary-based CanEra Energy Corp. for approximately CAD$1.1 billion.
- Encana Corporation completed the IPO and secondary sale of its royalty interests through the creation of PrairieSky Royalty Ltd. for combined proceeds of approximately CAD$4.06 billion.
- Calgary-based Whitecap Resources Ltd. acquired certain Western Canadian oil and gas assets with 15,000 BOE/day of production from Imperial Oil Ltd. for approximately CAD$855 million.
- Calgary-based Vermilion Energy Inc. acquired southeast Saskatchewan-focused Elkhorn Resources Inc. from a group of private equity-backers for approximately CAD$427 million.

Natural gas

Similar to many Canadian oil assets, Canadian natural gas assets continued to attract international attention, with notable transactions creating significant new players and reflecting the ongoing evolution of different production strategies and focuses.

Some significant Canadian natural gas transactions in 2014 were:

- Canadian Natural Resources Limited (CNRL) acquired the Canadian conventional oil and gas assets (excluding certain Horn River and heavy oil assets) of Devon Energy Corp. for approximately CAD$3.125 billion.
- Jupiter Resources Ltd., a newly formed portfolio company of Apollo Global Management, acquired the Bighorn gas assets (acreage, pipelines and facilities) of Encana Corporation for approximately CAD$2.0 billion.
- Chevron Corporation sold a 30% interest in its liquids-rich Duvernay shale assets to Kuwait Foreign Petroleum Exploration Company (KUFPEC) for approximately CAD$1.67 billion.
- Ember Resources Inc., a portfolio company of Brookfield Capital Partners, acquired the Clearwater CBM assets of Encana Corporation for approximately CAD$610 million.
- Canadian Natural Resources Limited (CNRL) agreed to acquire the Deep Basin assets of Apache Corporation for approximately CAD$419 million.

LNG

The “slow” advance of Canadian LNG projects continues to represent a significant opportunity and challenge for Canada, where a world-class asset base is at risk of becoming “stranded” without the export capacity represented by these projects.

Multiple proponents – most of whom are global LNG players – continue to advance projects but face a range of hurdles, including global capital allocation choices, significant up-front capital commitments on long-term market calls, growing competition (especially from pending US LNG export projects) and continued domestic negotiations in Canada to set the right industry framework.

Most notable Canadian LNG-related transaction activity in 2014 was principally focused on partnership building to share project development costs and portfolio rationalization to refocus operations on “core” opportunities.

- PETRONAS sold a 15% interest in its Pacific NorthWest LNG project to Sinopec and China Huadian Corporation for an undisclosed amount and a 20-year, 1.8-million tonne annual offtake agreement.
- PETRONAS sold a 10% interest in its Pacific NorthWest LNG project to Indian Oil Corporation Ltd. for approximately CAD$1 billion and a 1.2-million tonne annual offtake agreement.
- Apache agreed to sell its 13% interest in Wheatstone LNG (Australia) and 50% interest in Kitimat LNG (Canada), along with certain upstream oil and gas assets (including Horn River and Liard basin acreage) to Woodside Petroleum Limited for approximately CAD$3.18 billion plus an estimated CAD$1.6 billion in cost reimbursements.
- Korea Gas Corp. sold 5% of its 20% interest in the LNG Canada project to Royal Dutch Shell PLC for an undisclosed amount, with additional efforts being made to further sell down its remaining interest in the project as part of a corporate debt reduction plan.
**Oil sands**

The significant capital necessary to advance oil sands projects continues to pose an issue for many players. Junior oil sands players continue to be challenged to secure necessary project funding due to the broad range of energy investment alternatives and the restrictions on foreign investment in the oil sands imposed by the Investment Canada rules.

Most oil sands projects now underway are steam-assisted gravity drainage projects, where no mining is involved and where the top projects have economics that rival the best plays elsewhere in North America, with the benefit of very long, minimal-decline reserve lives. Capital will continue to flow to these projects.

- Athabasca Oil Corp. sold its remaining 40% interest in the Dover oil sands project to PetroChina for approximately CAD$1.184 billion.
- Osum Oil Sands Corp. acquired the Orion oil sands project in Cold Lake from Royal Dutch Shell PLC for approximately CAD$325 million.
- Statoil ASA and PTTEP Group agreed to split their respective interests in the Alberta Kai Kos Dehseh oil sands project. As part of the transaction, Statoil received 100% ownership of the Leismer and Corner projects and PTTEP received 100% ownership of the Thornbury, Hangingstone and South Leismer projects, in addition to a payment of approximately CAD$220 million.

**Midstream**

The dramatic growth in North American oil and natural gas production has been a boon to the midstream sector, with substantial infrastructure investments required in every basin. Significant project activity in Canada has mirrored this demand, with much of the growth being organically driven by existing players.

The Canadian midstream space has not been directly impacted by the MLP (tax advantaged) model that has recently been driving the US midstream space, but the yield and fee-for-services models of Canadian midstream players continues to provide more plentiful access to lower cost capital than for Canadian upstream players. Midstream transaction activity in 2014 highlighted creative transactions reflecting the larger repositioning occurring across the industry.

- Enbridge Inc. announced plans to financially restructure its CAD$16-billion Canadian liquids pipeline business - transferring these assets to its affiliate, Enbridge Income Fund, to optimize its financial and capital structures.
- Veresen Inc. and KKR & Co. LP agreed to acquire certain midstream pipeline and processing assets in the Montney from Encana Corporation and Mitsubishi Corp. via a newly formed joint venture, Veresen Midstream LP, for approximately CAD$412 million and a commitment to invest up to CAD$5 billion in additional capital to further develop Montney midstream assets.
- Calgary-based Whitecap Resources Inc. sold certain west central Alberta gas processing assets to Keyera Corp. for approximately CAD$113 million, with proceed used to fund Whitecap's purchase of certain Imperial Oil assets.

**Oilfield services**

The Canadian oilfield services segment is highly fragmented and consists of several hundred entities, many of which are private. The growth in service-intensive, “unconnected” resource development has led to a service renaissance in Canada. For example, some analysis suggests the average multi-stage fracked horizontal well drilled in North America is now seven times more service intensive and 2.5 times more expensive than the average well was less than 10 years ago.

Transaction activity in the Canadian oilfield services space was very robust in the first nine months of 2014, driven by aggressive consolidation efforts by some global and US-based strategic buyers and strong interest from private equity groups, who often invest on the services side of the oil and gas space as opposed to making direct investments in oil and natural gas reserves. In many cases, know-how and access to innovative and proprietary technologies, tools or processes developed to address the operational challenges of the Canadian environment drove transaction activity – with consolidation, geographic entry and service expansion driving additional activity.

A very entrepreneurial sector, transaction success in oilfield services has required buyers to be careful to align interests in order to retain key people, while a renewed focus on cost control and the pending threat of excess services capacity – due to lower activity levels driven by commodity price declines – are at risk of significantly and negatively impacting the broader oilfield services sector in 2015.

Notable Canadian oilfield service transactions in 2014 included:

- NCSG Crane & Heavy Haul Corporation, a North American provider of crane and heavy haul services, was acquired by TriWest Capital Partners, Energy Capital Partners and Alberta Teachers’ Retirement Fund from Northwest Capital Appreciation Partners.
- CWC Well Services Corp. acquired Ironhand Drilling Inc., a Western Canadian oil and gas drilling contractor, for approximately CAD$106 million.
- Stuart Olson Inc. agreed to acquire Red Deer-based Studon Electric & Controls Inc., a Western Canadian electrical and instrumentation service provider, for approximately CAD$102 million.
- Canyon Services Group Inc. acquired Fraction Energy Services Ltd., a Western Canadian water and fracturing fluid logistics, containment, transfer and storage management company, for approximately CAD$102 million.
- WSP Global Inc. acquired Calgary-based Focus Group Holding Inc., an 1,800 person engineering and geomatics business focused on facilities engineering, geomatics, pipeline and civil engineering projects for the Canadian energy industry, for approximately CAD$366 million.
Looking forward

Since mid-2014, the transaction market has been stalled by a dramatic plunge in oil prices, with natural gas and all other natural gas liquids also being severely pressured. At current prices and with current market conditions, few new oil or gas projects globally appear to be economical, and the Canadian industry is not immune.

In addition, Canadian producers now have to face the fact that our largest customer for oil and gas production, the US, is now also our greatest competitor. As low energy prices persist, transaction activity will stall until companies, investors and funders are able to develop a clearer sense of when the global oil supply/demand balance has come into equilibrium - and how equilibrium will be achieved - whether by way of demand growth, supply reductions (achieved through either reduced capital investment, cuts by Saudi Arabia or US shale production declines) or some combination of these levers. Only at that point can a clearer call on future prices be made.

Once the current market shock has worn off, we expect that 2015 will see a continuation of 2014’s portfolio rationalization efforts. In Canada, we expect these transactions to be driven by a variety of factors, including the need for incremental cash to fund other operations or shareholder requirements, to remove non-core assets to streamline operations and reduce costs, to continue repositioning the business and, increasingly, to address balance sheet necessities.

Capital preservation will be a key theme in 2015, and we expect current market challenges to create unique opportunities for well-positioned and well-financed companies. Unlike during the financial crisis in 2008-09, when transaction activity effectively ceased, we believe transactions will accelerate through 2015. In the meantime, Canadian companies are focused on actions to enhance their resilience - from an operational, financial and portfolio perspective.

Contact us

Barry Munro
Canadian Oil & Gas Leader
+1 403 206 5017 | barry.munro@ca.ey.com

Chris Hibberd
Transaction Advisory Services
+1 403 206 5176 | christopher.hibberd@ca.ey.com
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