The effective repeal of the flow-through share regime for the oil and gas industry in Western Canada

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"*We will fulfill our G20 commitment and phase out subsidies for the fossil fuel industry over the medium-term.*" *– Liberal Party of Canada Platform*

You can't say Justin Trudeau didn't warn us. He made it very clear during his campaign to become Prime Minister that he planned to introduce legislation that would be damaging to the Western Canadian oil and gas industry.

The flow-through share regime has been a crucial element in the capital markets of Western Canada for oil and gas exploration and production companies (E&P companies). By issuing flow-through shares, and transferring corporate tax benefits of drilling from the corporation to the subscribing shareholders, E&P companies have, firstly, been able to issue shares in this highly risky business to arm's length investors and, secondly, been able to reduce their cost of capital.

In a typical flow-through share agreement, shareholders would invest funds that the issuer would agree to use to drill exploratory wells over a two-year period. Such exploratory drilling costs would be classified as "Canadian exploration expense" (CEE) for Canadian tax purposes and renounced to the subscribing shareholders. Accordingly, if you invested $25,000 you would receive a tax deduction for $25,000 in CEE in the year of your investment. The arrangement provided just enough sweetener for investors to take the plunge and invest in that junior resource company to develop the next big play. Many of Canada's big name E&P companies started out just like this.

In the 2017 federal budget delivered on March 22, 2017, the Liberal government effectively repealed the 30+ year old oil and gas flow through share regime via the introduction of two significant changes in the law.

The first change results in the tax characterization of the drilling costs for a successful exploratory well as "Canadian development expense" (CDE) rather than CEE. CDE is amortized on a 30% declining balance basis rather than the 100% current year deduction afforded to CEE. Nothing like punishing success. As a result, flow-through share investors (if any can be sourced) won't know the value of their tax benefit until the drilling results become known and amounts are renounced. If there's insufficient CEE to renounce because, for example, the E&P company had a small capital raise that was largely flow-through and the drilling program was successful, the balance will be renounced as the less valuable CDE. In the Canadian capital markets, CDE flow-through shares have rarely, if ever, been successfully marketed. No one wants them.

As an aside, it's very interesting that CEE classification for exploratory drilling will be largely unchanged for drilling in the Maritimes and Newfoundland. The reason for this is found in an exception to the new CDE tax classification rule. The exception states that the drilling costs will continue to receive CEE treatment if the well has been abandoned, the well has not produced within 24 months, or the Minister of National Resources has certified that the relevant costs associated with drilling the well are expected to

exceed $5 million and it will not produce within 24 months. Practically speaking, the latter two types of wells only occur in the Atlantic Provinces where very expensive offshore drilling occurs and the initial series of wells rarely become “producing” wells. In Western Canada, a producing well would only be shut-in for 24 months in exceptional and rare circumstances.

The second change introduced in the budget is the elimination of the CDE to CEE re-characterization by small E&P companies. This rule enabled a small E&P company (defined as having taxable capital employed in Canada of not more than $15 million) to treat up to $1 million of CDE as CEE when renounced to shareholders under a flow-through share agreement. Rather than repealing this rule, it should have been modernized by increasing the parameters. For example, increasing the taxable capital limit to $50 or $100 million and increasing the amount eligible for re-characterization from $1 million to $15 or $20 million. This is for two reasons; firstly, as the Western Canadian basin is developed, it is increasingly difficult to find a pure exploration play with a reasonable risk profile that would qualify as CEE. Secondly, with the development of new drilling technologies, the costs per well have skyrocketed. Twenty or thirty years ago, a small E&P company could be formed for $10 million dollars and 30 or 40 wells could be drilled, especially if the costs were shared with partners in the well. Investors were able to spread their risk to multiple wells and plays. Ten million dollars does not go very far in today’s riskier and more costly environment.

The bottom line is that the repeal of the CDE to CEE tax re-characterization rule rather than modernizing it effectively hammers the final nail in the coffin holding the flow-through share regime for the Western Canadian oil and gas business. According to Statistics Canada, the oil and gas industry together with the mining industry represents the third largest contributor to the Canadian economy after real estate selling, managing, renting and leasing (which is, in my humble view, a “support” activity for other businesses rather than an economic driver itself) and manufacturing. If the government had been serious about helping to jump start this very important Canadian industry during its most significant downturn in over a generation, it could have done so. It is abundantly clear that the energy industry is not a priority for the Prime Minister and the Liberal government of the day.

Very disappointing.