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Canada's Upstream Giants Cash In on Royalty Lands

With Cenovus Energy's C\$3.3 billion (US\$2.6 billion) sale of its royalty interest and mineral fee title lands earlier this month, Canada's upstream giants are moving fast to part with these cost-advantaged assets in exchange for big funds. Encana announced a similar move last year, while Canadian Natural Resources has signaled its intention to follow suit as low oil and gas prices continue to pinch operating cash flows.

The Ontario Teachers' Pension Plan is picking up Cenovus' Heritage Royalty unit, which holds about 3.1 million net acres of the mineral fee title lands in Alberta, Manitoba and Saskatchewan. Cenovus owns the mineral rights to these fee title lands, which means it does not pay royalties to the government and instead pays a mineral tax that is generally lower. Much of the property dates back to railway grants that were awarded to a predecessor company of Encana in the 19th century. Cenovus, which was spun out of Encana in 2009, is free to lease the land to third parties to develop, generating royalty income ([EIF Sep.23'09](#)). Roughly two-thirds of the fee lands were leased at the end of 2014, and generated 7,800 barrels of oil equivalent per day in third-party royalty interest production during the first quarter, boosting Cenovus' operating cash flow by C\$30 million.

Alan Tambosso, with Calgary-based Sayer Energy Advisors, says royalty lands are unique because they generate revenue but incur no operating expenses. "As well, there is no direct ownership of the hard asset [like wellbores and facilities] so there are no future abandonment, reclamation or environmental issues to deal with if you are a royalty owner," Tambosso told *EI Finance*. Cenovus consequently only had to cover freehold mineral taxes and administrative expenses on its royalty lands, while benefiting from the stable source of revenue they provide.

Despite those advantages, Cenovus sweetened its divestment to Ontario Teachers further by including royalty interests not in its Heritage unit: working interest production with implied first-quarter volumes of 5,400 boe/d, a gross overriding royalty interest on its Pelican Lake heavy oil property in Alberta, and an enhanced oil recovery project in Saskatchewan with implied first-quarter volumes of 1,600 boe/d. Ontario Teachers views the assets as a way to diversify its investment portfolio and provide a hedge against inflation, since royalty cash flows are correlated to the price of oil and gas.

But why would Cenovus sell off a low-maintenance, almost passive revenue stream in the first place? With depressed oil and gas prices sharply cutting revenues, the billions in dollars Cenovus could raise through their sale proved too tempting to pass up. Indeed, the firm's first-quarter cash flow of C\$495 million was 45% below year-earlier levels as higher oil sands production and lower operating costs were offset by reduced oil and gas prices and weaker refining margins. Cenovus cut its annual capital spending budget C\$700 million this year in the weakened price environment, to C\$2.6 billion, and raised C\$1.5 billion in a share offering ([EIF Feb.18'15](#)). But the royalty land sale will firm up its balance sheet even further by exchanging a trickle of future royalty revenues for a one-time cash infusion. Also, Cenovus did retain an option to acquire leases at predetermined rates and lease terms for up to 10 years on more than 800,000 acres in zones of the fee lands that it is currently developing.

The Cenovus deal echoes recent moves by Encana, which last year netted C\$1.67 billion in an initial public offering (IPO) of its royalty lands business PrairieSky Royalty, then picked up another C\$2.6 billion several months later by shedding its remaining 54% stake in the entity ([EIF Sep.10'14](#)). Encana used part of the proceeds to snap up stakes

in major US tight oil plays ([EIF Oct.1'14](#)).

Canadian Natural is likewise gearing up for a potential sale or IPO of its fee title and royalty land business later this year. The firm's third-party royalty volumes averaged 7,400 boe/d in the fourth quarter of 2014. Weak commodity prices prompted the company to set its 2015 capital budget at C\$6 billion -- C\$2.6 billion below spending levels initially penciled in back in November -- and in June the firm raised C\$500 million in a long-term debt offering. Canadian Natural meanwhile delayed Phase 1 of its Kirby North steam-assisted gravity drainage scheme ([EIF Jul.1'15](#)).

Tambosso says there are other Canadian companies that could pursue similar deals, but Canadian Natural is the most obvious seller given the size and scale of its position. Still, with commodity price weakness continuing to pressure the balance sheet of Canadian E&Ps and fall borrowing base redeterminations around the corner, more deals may shake out in the coming months.