EXPLORER

Spring 2012 Issue

Canada's Oil & Gas Entrepreneurs™

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Executive Director's Report: Spring 2012

Gary Leach, Executive Director, SEPAC

The oil and gas industry has been grappling the last two years with a growing divide between natural gas weighted companies, who are suffering from diminished cash flows, low valuations and unreceptive capital markets versus their oil and liquids weighted competitors, who have been relatively healthy (even though Canadian crude prices are suffering significant discounts to global benchmarks). Additionally, the junior sector is enduring a 'size discount' due to impaired market valuations relative to intermediates.

As a result of these challenging fundamentals, a number of producers have announced in recent months they are launching a 'strategic review' process and many more are understood to be in a 'soft' sale process. Whether the solution is a quick sale or a slow motion transformation of the business platform, the challenges imposed by the commodity price divergence mentioned above will, over time, change the face of the junior and intermediate sector.

"In Alberta, we have just completed a provincial election…. An initiative SEPAC is planning for mid- 2012 is to co-sponsor a seminar for the elected members of the Alberta Legislature on an "introduction to the oil and gas industry".

In light of the rapidly changing profile of our sector, we thought it would be an interesting exercise to ask a group of five expert participants and observers of the junior sector to provide their opinions on where they think this sector will be in five years and what it will look like. Our panel included: George Fink, Founder, Chairman and CEO of Bonterra Energy; Bruce Edgelow, VP Energy Group at ATB Financial; Alan Tambosso, President of Sayer Energy Advisors; Geoff Vanderburg, Editor, the iQ Report; and Robert Fitzmartyn, First Energy Capital. You will find their insight on these trends and how it will affect the junior sector inside this edition of your SEPAC Explorer magazine.

"SEPAC is hosting its Spring Investor Showcase on June 11th at the Westin Calgary under the supervision of our Event & Communications Director, Michelle Chidley. This event will be the only E&P investment conference in Calgary this year."

In Alberta, we have just completed a provincial election. Because Alberta is a leading supplier of crude oil, natural gas, bitumen, refined products and petrochemicals to the North American market, the energy policies of this province, including its regulatory and fiscal competitiveness, are of major importance to the nation's economy and North America's energy security. An initiative SEPAC is planning for mid- 2012 is to co-sponsor a seminar for the elected members of the Alberta Legislature on an "introduction to the oil and gas industry". The funding for this is courtesy of the CAPP- SEPAC "Broad Industry Initiative Fund" supported by Alberta producers. The idea is to give new and returning MLAs a basic overview of the scale and complexity of the industry as well as some exposure to issues of topical interest thus providing a basis for dialog with theses MLAs in the future.

SEPAC is hosting its Spring Investor Showcase on June 11th at the Westin Calgary under the supervision of our Event & Communications Director, Michelle Chidley. This event will be the only E&P investment conference in Calgary this year. In addition to opening the doors to retail investors, SEPAC invites a targeted audience of analysts, fund managers and local news media to this event. With some 20 junior and intermediate member companies signed up to present, and a great group of sponsors, this will continue to be a premier event on Calgary's business calendar in 2012.

I close with thanks to the volunteers who contribute to making SEPAC the voice of "Canada's Oil and Gas Entrepreneurs™" our Board of Governors as well as the volunteers on our various industry committees and working groups. ■

Gary Leach
Executive Director

Where will the Junior Sector be in Five Years?

The oil and gas industry is no stranger to change and uncertainty: from volatile commodity prices, opposition to energy development and even international politics…there is no shortage of issues to derail the business plans of junior oil and gas producers. We thought it timely to ask a panel of well- known industry experts and observers to offer their insight on the road ahead for the junior sector. Maybe you'll find some comfort here or, if not, at least you can't say you weren't forewarned….

Geoffrey Vanderburg, Editor, iQ Report
Managing Director, Bryan Mills Iradesso

Depressed natural gas prices. Stingy lenders. Tight-fisted investors. The challenges facing today's junior oil and gas explorers and producers are real. But equally real are the solutions. And the same solutions that will help to ensure the survival of the sector today will contribute to its success for years to come.

At Bryan Mills Iradesso, we've been helping publicly traded junior oil and gas companies communicate with investors since 2001. As one of our services, we publish a quarterly iQ Report comparing the financial and operating results of Western Canada's junior and intermediate public oil and gas explorers and producers. We use the iQ Report to help companies benchmark themselves against their peers and to increase the profile of the industry. For the purpose of our report, we define juniors as companies with production between 500 and 10,000 barrels of oil equivalent per day (boe/d) and intermediates as companies with production from 10,000 to 100,000 boe/d. Companies with production below 500 boe/d are emerging players while companies with production greater than 100,000 boe/d are seniors.

In our view, the success of the junior sector depends on the ability of companies to stay one step ahead of the crowd, to be nimble and to be inspirational.

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Bruce Edgelow, VP Energy Group,
ATB Financial

The landscape of the junior oil and gas industry has changed significantly over the last 5 years. Which begs the following questions: What will the junior sector of the oil and gas industry look like 5 years from now? What trends will still be dominant in the junior oil and gas space in 5 years? Will juniors have to be larger to survive? What kind of business model will attract capital market support? What business models will lead to success over the next 5 years? Unfortunately none of us has a crystal ball to provide absolute answers to these questions. The only constant we can expect is change.

Juniors have begun to transition from drilling moderately priced individual vertical wells to drilling much more capital intensive resource plays. For example, in 2000 the cost to drill and complete one well in Pembina was ~$330 thousand. By 2010, the cost had ballooned to ~$2.75 million due to horizontal drilling and more complex completion techniques. This trend is expected to continue as resource plays become increasingly more dominant as larger budgets, bigger capital bases and higher production become more commonplace. As such, access to capital will be more vital for juniors than in the past. We expect consolidation to occur as a result of a need for critical mass to meet these increased capital requirements. Liquidity challenged small producers may be attractive targets for larger well-capitalized companies looking to expand their asset base.

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George Fink, Founder, Chairman & CEO
Bonterra Energy

It will likely be a volatile five year period that will provide some great opportunities, but will also have some substantial areas of concern.

As in past five year periods there will be large price swings in both oil and natural gas. My prediction during the five year period is that Edmonton par oil prices will more often be in the $95 to $110 Cdn. range than in the $70 to $85 range. Natural gas prices will likely be in a somewhat depressed price range between $3.50 to $5.00 for a major portion of the five year period, but will likely continue to lag at much lower prices during the early phase of this period. The low prices will result in natural gas replacing other sources of energy, resulting in more demand on a long term basis.

One major issue that must be dealt with in the next few years is arranging sufficient capacity to deliver the increased oil production that is taking place in Canada. Canada presently produces approximately 2.8 million barrels (bbls.) of oil per day (conventional about 900,000 bbls. and oil sands about 1.9 million bbls.). This number will increase to approximately 4 million bbls. in the next five years, with the major increase coming from oil sands. At the present time Canada only has one buyer for its oil and natural gas, that being the United States. It is imperative that Canada develops or

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Robert J. Fitzmartyn
Managing Director, Institutional Research
FirstEnergy Capital Corp.

As far as I can remember, predictions for the demise of the Canadian Junior E&P business model have been frequent and longstanding. This is largely predicated on the death of the Western Canadian Sedimentary Basin, citing a dwindling opportunity inventory and an inflationary, uncompetitive cost environment relative to other basins. Despite a renaissance in the WCSB recently, attributable largely to advances in well completions, the view for smaller entrepreneurial oil & gas producers looks particularly challenging from here over the next 5 years.

Intense market focus on identifying and supporting companies targeting unconventional “resource plays”, characterized by reservoirs amenable to scalable, repeatable drilling opportunities, and benefiting from evolving technological advancements such as multistage fracturing techniques in horizontal wells, has led the rush to secure leverage to bad rock instead of good rock. This has been an established trend for more than three years now, with many smaller E&Ps, consistent with a faster, more responsive structure, able to profit from these developments in the Bakken, Montney, and Cardium to name a few. Early identification of a new play concept, land aggregation, drilling to prove up the play, and eventual monetization to a

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Alan W. Tambosso
President, Sayer Energy Advisors

With capital intensive resource plays recently dominating the landscape of the Canadian oil industry, the public markets have generally been non-supportive of junior oil and natural gas companies. This lack of support has left many industry pundits wondering if the day of the junior is done, and if we will even have a junior sector five years from now.

Our neighbours to the south witnessed the near-death of the juniors many years ago, as larger, expensive prospects in the US Gulf Coast and in the deeper basins in the continental US caused the public markets to focus capital almost exclusively on larger companies. Recent advances in technology have strengthened the focus on larger companies, and development of deep shale basins with expensive horizontal wells has all but shut the juniors out of the public US markets.

In Canada, the recent focus on capital intensive opportunities such as horizontal development of resource plays has had a similar effect. The public markets are currently generally non-supportive of junior oil companies which hold conventional oil and natural gas assets. As most of these companies do not have the financial capability of competing for the larger, deeper more expensive resource plays, many analysts have read the last rites over this sector of our industry.

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The New Alberta Government

Michelle Chidley, Event & Communications Director, SEPAC

With the Alberta election finally behind us, the political climate in this province is expected to remain stable for the next four years. In a hotly contested race, the Progressive Conservatives pulled off another majority. However, the same governing party does not necessarily mean we should expect to experience any déjà vu.

The next four years are shaping up to be fundamentally different than the last four. We have a Premier who is proud of our oil and gas industry and wants to position us as a Global Energy Capital. What will also make this sitting of the legislature different is that we have a conservative party in place as the Official Opposition primed to hold the more centrist government to account on fiscal and economic issues. Further contributing to a different government experience is the fact that almost half of the legislature is composed of brand new MLAs.

Premier Alison Redford

Alison Redford possesses a number of attributes that should make her a capable leader for Alberta and an effective advocate for this industry. Frustration over the royalty changes in Alberta influenced Redford to run for MLA in 2008. Since then, she has worked hard to learn the complexities of the oil and gas industry as well as the issues that affect its competitiveness. A lawyer by profession, Redford spent a number of years working internationally, bringing a global view to her policies for this province. Bilingual and articulate, Premier Redford is able to communicate our messages to all Canadians, our American neighbours and the rest of the world.

At the SEPAC Speaker Series in February, Premier Alison Redford said, "Energy is Alberta's lifeblood and we are committed to doing everything we can to keep oil companies of all sizes healthy and viable. You will always be my highest economic priority." Such statements indicate that she appreciates and understands the importance of oil and gas to this province's prosperity. Also, in the same speech, the Premier vowed not only to support the industry but to be a proud and vocal advocate for our energy sector. When mentioning the message she planned to take to the United States Congress, she said "Alberta's energy and the Keystone pipeline are vital to American energy security. Our stringent environmental standards, democratic transparency and willingness to innovate make us the ideal foreign supplier. I will communicate this in no uncertain terms."

> "Energy is Alberta's lifeblood and we are committed to doing everything we can to keep oil companies of all sizes healthy and viable. You will always be my highest economic priority."
>
> **Premier Alison Redford**

Hon. Alison Redford, Premier of Alberta

In the early days of Redford's Premiership, she spearheaded the Canadian Energy Strategy, a national dialogue to encourage cooperation in energy. Premier Redford has said that a pan-Canadian strategy would help provinces and territories understand how all of Canada benefits from the resources in Alberta. Redford has forged strong relationships with her colleagues in the New West Partnership, the Premiers of British Columbia and Saskatchewan, who are working together to further Western Canada's energy interests in Ottawa. On day 1 of her new mandate, the Premier talked to Prime Minister Stephen Harper about ways the federal and Alberta governments can work together to better defend our natural resource development, promote our environmental record and open new markets for Alberta's oil and gas. She has revealed plans to work more closely with the federal government going forward.

Premier Redford has demonstrated that she wants to be an advocate for Alberta's oil and gas industry. She understands the key issues and is able to communicate these messages to the rest of the world, but most importantly, she is positioned to have those messages heard, understood and accepted. We support her in her mission to raise the level of understanding and change perceptions of our industry outside our provincial border.

SEPAC developed a relationship with Alison Redford over the past three years through various lobby initiatives. We have a positive relationship with the Premier and are pleased that some of our messages have influenced a number of her energy policies. We look forward to continuing to work with Premier Redford to ensure she is always aware of how our members are impacted by government policy.

Official Opposition: Wildrose Alliance

On April 23, the Wildrose Alliance Party became the Official Opposition, winning 17 seats in the Alberta Legislature. While not the number of seats predicted for the Wildrose, we expect them to be a formidable opponent of the PCs in the legislature, holding the government to account on fiscal and economic issues.

Danielle Smith, Leader of the Official Opposition

SEPAC met with Wildrose Leader, Danielle Smith, and her energy policy advisors prior to the election when the party was creating their oil and gas platform. Ms. Smith has demonstrated an astute awareness of oil and gas issues and has a few members of the oil and gas community in her caucus. When settled in Edmonton, we plan to visit with Ms. Smith to continue the dialogue on issues facing junior and mid-sized producers.

One issue that will be on the agenda when we meet with the Wildrose Alliance leader is property rights. A policy born in rural Alberta, property rights was the key issue that won the Wildrose a majority of seats in the southern part of the province. We fear that their policy could raise questions about surface rights access and compensation, concerns we voiced to the party prior to the election.

39 New Faces

The election produced 39 new MLAs of all party stripes. This turnover should breathe new life into the legislature. SEPAC has already begun introducing the association to the new MLAs and are working with our industry colleagues to organize an Oil and Gas 101 to educate all members of the legislative assembly – new and old – on the industry that fuels Alberta's economy.

Over the last 4 years, we made incredible strides in bringing our messages to the Alberta government. We plan to continue to build on the relationships already established with the 48 returning incumbents. Key in our discussions with government will be the single regulator, regulatory reform, land use, municipal taxation, well abandonment, property rights and surface access.

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At time of writing, a new cabinet has not yet been appointed so we do not yet know who the energy minister will be. Regardless of the choice, SEPAC will work to develop a strong relationship with this key minister as well as all others with portfolios that impact our members. ■

Michelle Chidley

KEY ENERGY POLICIES IN ALBERTA

Oil and Gas Royalties

Having absorbed the lessons of the Stelmach years, the Redford Government says it will preserve the current regime on royalties and promises to consult with industry before any future changes are considered.

Canadian Energy Strategy

This initiative broadly expresses a desire to get the provinces to collaborate on common goals and priorities related to energy but attempts to cover a very diverse range of issues from cooperation on monitoring cumulative impacts, creating “cleaner” energy technologies, securing new energy markets and pipelines, streamlining regulatory systems, developing cleaner energy technology, etc.

Carbon Capture & Storage

The last $440 million of the total $2 billion in funding commitments made by the former Stelmach government will likely be frozen by the Redford government.

Single Energy Regulator

The Redford government will be going forward in 2012-13 with plans to unite the ERCB and the regulatory functions of the departments of Environment and Sustainable Resource Development under a single regulatory agency. A joint policy development office will be created to unite policy development across the government ministries.

Joint Oil Sands Monitoring System

The federal and Alberta governments will set up a bio-diversity, water and air monitoring system to collect and publish data related to the environmental impact of oil sands development. The annual expense of this program will get passed on to oil sands operators.

Support for Pipeline Expansion & Market Diversification

Expect to see Premier Redford touting Alberta’s energy resources and the high level of environmental stewardship practised in Alberta to audiences across Canada as well as outside the country.

Next Step in Land Use Framework

The broad outlines of this policy having been developed for the Lower Athabasca region and following some backtracking on property rights legislation to provide increased assurance to land owners we should expect to see more detailed rules in 2012.

Juniors will need to be nimble, early movers into niche emerging resource plays and pioneer a skill that makes them economic and viable as a going concern. Development plays such as the Cardium, Viking, and Bakken should continue to dominate the oil and gas landscape. These repeatable development style plays require ample land inventory to provide sufficient drilling opportunities. Given increasing prices, juniors will require enough capital to fund full cycle economics. Moreover, drilling and completion costs are likely to further increase as even more advanced technology will be required to unlock the full resource potential.

The full cycle growth story will be the preeminent method whereby juniors thrive in a changing marketplace. This includes organic growth, acquisitions, farm-ins and joint ventures.

Demand for conventional plays with smaller pools bearing exploration risk is reducing. The appetite to fund natural gas activity is virtually non-existent unless the producer is in a niche play that can still be economic at current depressed prices. Investor and capital providers will need an increasingly keen eye toward overall corporate economics and foresight to determine if a company has the scale, talent and asset profile to exploit the opportunities available.

The industry is reporting fewer dry holes. Technological innovation has made previously uneconomic plays much more viable. Five years from now, one can expect significant advances in fracturing technology to have further increased economies of scale. It is expected that there will be a significant uptick in the number of plays that are not even on the radar screen at this time. Going forward the industry will likely find that larger pools are repeatable and that the technology being deployed is increasingly efficient.

The full cycle growth story will be the preeminent method whereby juniors thrive in a changing marketplace. This includes organic growth, acquisitions, farm-ins and joint ventures. As in the past, juniors will continue to drill using cash flow, available debt and equity to grow with the end goal being a corporate sale to a larger company with excess capital looking to diversify.

A land accumulation strategy could be a viable and successful method for a junior company over the coming years. For

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McMillan's Energy group consists of leading professionals with a wide breadth of experience and recognized expertise providing legal services and advice to the oil and gas industry.
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SEPAC Speaker Series Luncheon at Calgary's Fairmount Palliser Hotel featured Alberta's Premier Alison Redford

On February 24th, SEPAC held the latest Speaker Series event with the Honorable Alison Redford, Premier of Alberta. Following lunch, Alberta's Premier described to the audience the current government's policy and plans for the future of the energy sector. At the end of the discourse, the Premier took time to answer questions from the attendees. ■

1. Premier Redford is greeted by Doug Kay SEPAC Chair, Dan McFadyen Chairman of Alberta's ERCB, Neil Smith SEPAC Vice Chair, Aidan Walsh SEPAC Past Chair, and Gary Leach SEPAC Executive Director
2. Premier Redford

Photos by Charles Hope Photography

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CSUR Canadian Society for Unconventional Resources

1. *Conversations flow around the head table*
2. *The Premier is introduced by Mike Thackray of McMillian LLP*
3. *Premier Redford*
4. *Questions are taken from the floor*
5. *Sepac Chair Doug Kay thanks the Premier for her speech.*
6. *From Left to Right: SEPAC Past Chair Aidan Walsh, SEPAC Vice Chair Neil Smith, Premier Redford, former Energy Minister Ted Morton, SEPAC Chair Doug Kay and SEPAC Executive Director Gary Leach*

Photos by Charles Hope Photography

modifies pipeline systems so that it has the ability to access ocean transportation to Asia and pipeline systems that can deliver to Quebec, the Maritime Provinces, and access Europe and South America. Unfortunately, small and intermediate companies cannot influence the pipeline issues on an individual basis and we have to approach it on a unified basis through associations like SEPAC. My feelings are that the delivery situation will be resolved, but there will be short periods when supply will exceed capacity to deliver, and that during these periods there will be a negative impact on prices.

Juniors will likely have to be larger to survive in this changing environment. Two predominant factors in this matter are: firstly, that there is now a huge overload in dealing with hundreds of regulatory requirements; and secondly, with regard to access to investment funds as much larger capital budgets are required today compared to even five years ago and also investors more and more are investing in dividend paying entities which takes funds away from investments for growth only companies. The business model of the future may be a combination of growth and a small quarterly dividend.

"Juniors will likely have to be larger to survive in this changing environment. Two predominant factors in this matter are: firstly, that there is now a huge overload in dealing with hundreds of regulatory requirements; and secondly, with regard to access to investment funds as much larger capital budgets are required today compared to even five years ago and also investors more and more are investing in dividend paying entities which takes funds away from investments for growth only companies. The business model of the future may be a combination of growth and a small quarterly dividend."

If natural gas prices continue to be on the low side, it will likely result in more activity in the merger and acquisition part of the business in 2012 and 2013, especially for gas weighted companies. Low prices are forcing lending institutions to reduce lending amounts and depressed share prices are extremely dilutive for raising funds by equity methods. Cash flows are substantially reduced and in some cases may even be negative. Mergers may provide relief in some cases because of the benefits of economy of size of the merged entities.

In summary, the next five years will have some periods of prosperity and some periods when there will be big challenges. This is no different from all five year periods. A real strong feature for the junior and intermediate companies is that companies tend to be very innovative and adaptable and always figure out ways to handle difficult issues. SEPAC has very much become of part of dealing with issues. I have been involved with SEPAC since its inception and over the years it has been an ideal entity to allow juniors and intermediates to deal with matters on a unified basis, which is so important in dealing with politicians and regulators. Even more importantly, SEPAC provides a venue for all of its members to learn from each other and which makes us better companies and an ideal format to develop good contacts and friendships. ■

better capitalized entity needing growth prospects is a seasoned formula that has been employed in the sector for decades. Coral Hill, a private company, is looking to replicate this in the emerging Beaverhill Lake trend.

That is the principal advantage of the smaller, more nimble exploration growth vehicle, and we do not see this trend changing. Expanding inventories on rock never thought to be profitable has grown however in the stables of the Majors and Large Caps, so Juniors are effectively competing in the acquisition decision with the in-house projects of these potential acquirers. An increasing supply of opportunities means that demand will fall, and within that context, the great equalizer is price – Junior E&P should reduce its value expectations.

> "Early identification of a new play concept, land aggregation, drilling to prove up the play, and eventual monetization to a better capitalized entity needing growth prospects is a seasoned formula that has been employed in the sector for decades ... That is the principal advantage of the smaller, more nimble exploration growth vehicle, and we do not see this trend changing."

Commodity prices, particularly in the North American natural gas complex, are brutal right now, exacerbated by an abnormally warm winter, likely placing prices below the marginal cost of replacement. We understand and appreciate the feeling that size matters, that the push to get bigger to generate sufficient cash flow to support drills that are 5x-10x the cost of a decade ago is critical, although realistically think this is misguided. Many larger producers cannot keep up – look at Encana attempting to strike joint ventures or otherwise monetize assets right now. Diversification used to be a good thing in our industry prior to the concept of the pure play. A divergent crude oil-natural gas pricing tape, and even going back to the New Royalty Framework, show that diversification, both on the revenue stream and geographically, can be a good thing. Other risk mitigation measures such as business plans employing reasonable levels of debt and focusing on minimizing costs are fundamentals that are not rendered obsolete with disruptive completion technology advances.

Junior E&P has traditionally been a consumer of capital – it spends far more than it generates in cash flow. As such, it relies heavily on capital markets, and to that end, the broader picture right now is challenging. Investors dip into Junior E&P to participate in growth, not necessarily the commodity, although a stronger commodity helps buoy growth. As such, Junior E&P competes for capital here at home with other sectors in both domestic and international markets. The broader macro environment has been decidedly "risk off" for 9 months now. In Canada, an aging demographic has exhibited a thirst for yield, with stocks distributing a dividend currently commanding favour. Equities have taken a back seat to capital flows into bonds, although this has shown signs of reversing. As such, funds that generally invest in Junior E&P have seen outflows of capital as investors realign priorities, whether it is associated with a shortened investment time horizon, a willingness to move away for longer term capital appreciation strategies and more predictable income streams, or some other risk aversion reason.

While business models built to last will always sell, and those built to sell might not last, the pursuit of basic and sound business fundamentals should always be paramount. Accomplishing this might entail reducing growth expectations, and lengthening the time associated with building and managing Juniors E&Ps. The ability to create and sustainably fund a dividend position in 5 years is likely a winning strategy. This has worked immensely well for Bonterra Energy Corp., predicated on low risk, longer life Cardium light oil development, proving that smaller entities can still enjoy success, although Crescent Point has not fared too badly either. ■

As this has been unfolding, I keep hearing the voice of a wealthy, wise old sage I once knew. Shortly after the market crash of October 1987, he told me “Get up off the mat and go do something. Times of stress are times of tremendous opportunity”. He understood his own words better than anyone, as the roots of his fortune were planted in the Great Depression, when he took advantage of some unique opportunities to position himself for better times ahead.

> “The current focus of companies on resource plays is leading to large mergers and acquisitions. Out of these deals will fall unwanted conventional oil and natural gas assets which have upside remaining.”

The current focus of companies on resource plays is leading to large mergers and acquisitions. Out of these deals will fall unwanted conventional oil and natural gas assets which have upside remaining. Juniors with access to capital will be able to acquire these assets, assets which otherwise may not have been made available, and they will then be able to exploit the upside.

This situation is in many ways similar to the one seen in the early 1990’s when juniors began acquiring properties from larger companies, putting capital into intensive development of the properties, shortening reserve life and quickly turning reserves in the ground into cash flow.

The financial community, always looking out for an investment which could rapidly increase in value, took notice. Public market support for these ventures gave life to a brisk public market for the shares of junior companies which could turn reserves in the ground into money in the bank. This ultimately changed the face of the business.

Following this, the royalty trust era saw acquisitions with little in the way of subsequent dispositions. Trusts were highly focused on retaining all production in order to maintain monthly cash distributions. For several years the resulting M&A landscape was dominated by corporate and large property transactions, with few crumbs falling off the table as unwanted properties available for acquisition by juniors.

For a short time after the trust game died there was an increase in property deals; however, the rapid emergence of the focus on resource plays has led to a return of a dominance of corporate transactions. Ultimately, this should lead to a rationalization of conventional properties, which will create opportunities for junior companies and which will breathe new life into the publicly-traded junior sector.

Transactions such as Sinopec International Petroleum and Production Corp.’s purchase of Daylight Energy Ltd. and Pengrowth Energy Corp.’s pending acquisition of NAL Energy Corp. should ultimately lead to the disposition of conventional oil and natural gas assets which will not be pursued by the resulting entities.

Concurrent with the announcement of the acquisition of NAL, Pengrowth announced its plan to focus on oil-based resource plays. As former royalty trusts, you can be sure that NAL and Pengrowth each had in their portfolios assets which were being kept for no purpose other than retention of production, cash flow and value. Pengrowth also recently announced its intention to make some of these now non-core properties available to the M&A market, and, if so, the likely buyers of these assets will be junior companies, as no larger company which is focusing on resource plays would have an interest in acquiring them.

> "While the public markets are not currently supportive of junior companies which might acquire such assets, this will change over the next few years once the investment community realizes the opportunity to profit by financially supporting a company which can make money from such an acquisition."

While the public markets are not currently supportive of junior companies which might acquire such assets, this will change over the next few years once the investment community realizes the opportunity to profit by financially supporting a company which can make money from such an acquisition. Within a few years the situation could be similar to that which unfolded in the early 1990's.

With natural gas prices at ten-year lows and many companies focusing on oil properties, some junior companies are already beginning to make their move to use a longer-term view to opportunistically acquire natural gas assets for future development.

In January, Guide Exploration Ltd. acquired a 100% interest in a shallow natural gas pool covering approximately 1,000 sections of land on which only approximately 1,000 wells have been drilled. Guide was able to purchase the property because the vendor, a major company, made a strategic decision to focus its efforts on its oil prospects.

There was some financial support for this deal, as Guide paid for the acquisition with a $36.6 million bought-deal financing; however, the price of Guide's shares dropped significantly subsequent to the acquisition. The public market appears to have little interest in the fact that Guide has in its prospect inventory a property which it can extensively develop at minimal risk when natural gas prices improve. While the market has not been kind to Guide subsequent to this counter-cyclical acquisition, watch how fast the sentiment turns once natural gas prices improve and the company accelerates development of the property.

As larger companies make properties available, other juniors will follow Guide's lead, acquiring under-developed conventional oil and natural gas properties. This is exactly the type of activity which will ultimately lead to the rebirth of the interest in the publicly-traded juniors. As this unfolds over the next few years, the markets will return with strong support as soon as such companies show an ability to give a superior return on investment. ■

Staying one step ahead of the crowd sometimes involves proving up resources that are adjacent to a bigger player. This is what happened in March 2012 when Crescent Point Energy snapped up production and reserves from Wild Stream Exploration. Staying one step ahead sometimes involves a combination of brainpower and a blessing by being in the right place at the right time before land prices escalate due to a discovery in the area or a prospective geological formation.

"Juniors are big enough to get on the radar of investors but small enough to react quickly to negative influences. And that's exactly what the juniors have been doing for the past three years as they've been able to move faster than the seniors to kick their natural gas habit."

Some emerging companies are too small to attract investor interest. Some seniors are too big to move quickly. But the size of the juniors is just right. Juniors are big enough to get on the radar of investors but small enough to react quickly to negative influences. And that's exactly what the juniors have been doing for the past three years as they've been able to move faster than the seniors to kick their natural gas habit. Based on the juniors trading on the TSX and TSX Venture Exchange, the median natural gas weighting of the group declined from 76 per cent of production in the second quarter of 2009 to 56 per cent of production in the third quarter of 2011. The move to produce more oil during a time of weak natural gas prices has been steady and strategic. By comparison, the median natural gas weighting of the intermediates was almost unchanged over the same period, moving from 67 per cent of production in Q2 2009 to 65 per cent in Q3 2011. You could compare this transition from oil to natural gas to the process of turning around a cruise ship versus turning around a speed boat.

To attract capital market support, the juniors of tomorrow will not only have to stay one step ahead of the crowd by having enviable assets or the flexibility to seize opportunities, they'll also have to be inspirational.

To be inspirational means to build momentum. In the first quarter of 2012, companies that captured the imagination of investors through their promising assets, their financial strength or their track record experienced the best return. These outperformers included DeeThree Exploration (117 per cent return), TriOil Resources (35 per cent return), Novus Energy (33 per cent return) and Vero Energy (33 per cent).

In order to survive periods of low natural gas prices or high costs, juniors also need to demonstrate their fundraising abilities and the willingness to form joint-venture partnerships to share the risks and rewards with bigger players. This willingness demonstrated by the triad of Trilogy Energy, Celtic Exploration and Yoho Resources made it possible for Yoho to drill a third horizontal well into the Duvernay formation. Multi-stage horizontal fracturing is pricy.

These and other techniques will ensure the survival of the junior oil and gas sector despite the challenges. The survival of the sector is not to be confused with the survival of individual companies. Individual juniors are not designed to survive. In fact, only two of the 68 companies that made up the peer group in 2003 are still in the same peer group eight years later, namely Delphi Energy and Zargon Oil and Gas. All the other companies have disappeared, merged, changed their focus or expanded their way into a different peer group. Both Delphi and Zargon are on the cusp of becoming intermediate players themselves.

Despite the near-term challenges for the juniors, we're confident there will always be an audience for the junior oil and gas sector. And as long as there are investors, there will be juniors. Admittedly, the number of public juniors has fallen sharply over the last few years. But after a steady decline from about 87 juniors in the third quarter of 2005, the number of juniors reached a level of support three years ago at about 55 companies. This stabilization is another sign that the sector is here to stay.

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While it's possible there will be more consolidation within the sector over the next few years, new juniors will enter the fray to fill the voids. And we do not think it will take production of 5,000 or 10,000 boe/d for the juniors to be viable. What it will take is a strong balance sheet, production increasing on a per-share basis, an asset base with upside and a management team with a track record of success.

As the capital markets search for investment opportunities, the juniors must be seen as leaders. The risks of trying to stay ahead of the crowd are great, but so too are the potential rewards. The strongest players will be able to build on their own success by consistently under promising and over delivering. Despite the challenges facing the industry, the juniors have what it takes to inspire investors. The climate is harsh, but the survival guide stays the same. ■

instance, with the Duvernay in its infancy and largely unproven at this time, a junior might choose to assemble a strong land base and sit on it without expending the large capital requirements to drill. They may be able to wait for better capitalized players to prove up the regional play with the exit strategy to sell their land at higher values.

Junior oil and gas companies will still be very active in this space in 5 years. However, there will likely be fewer of them as a result of consolidation and incrementally higher entry costs. We expect that the overall environment for juniors will be made more difficult as significant equity support will be imperative for juniors to remain a going concern. We expect a $10 million starter kit will not meet the capital needs of a junior going forward. To have a greater probability of success, a junior may require $100 million or more to sustain an adequate capital program for 1 to 2 years. To receive this backing, juniors will need to deliver investors top quartile reserve, production and cash flow growth on a per share basis. If they don't perform at these levels, investors will be much more likely to deploy their capital to more stable mid-cap companies that yield a higher risk adjusted return including dividend income.

The table below shows that the number of juniors in the defined universe has increased nominally in recent years in comparison to significant growth in revenue and capital spending. As alluded to earlier we expect this number to reduce due to consolidation and further increased capital requirements.

"For a junior oil and gas company to be successful and to thrive in an increasingly competitive market, numerous attributes will be critical. A quality, experienced management team will be more important than ever before. It is crucial that management maintain a strong balance sheet and keep capital spending within board approved budgets. Furthermore, maintaining an optimal capital structure with reasonable and serviceable debt levels will be of the utmost importance."

For a junior oil and gas company to be successful and to thrive in an increasingly competitive market, numerous attributes will be critical. A quality, experienced management team will be more important than ever before. It is crucial that management maintain a strong balance sheet and keep capital spending within board approved budgets. Furthermore, maintaining an optimal capital structure with reasonable and serviceable debt levels will be of the utmost importance. We expect to see a greater number of juniors succumb to high debt, while others will risk the company on the success of a few high risk wells.

Executives will need to manage risk appropriately in terms of effective deployment of capital as well as hedging commodity price fluctuations. They will also need to attend to the potential for higher interest cost on debt and manage same through a standalone interest rate hedging program. The commodity pricing environment will likely dictate that these plays be oil focused with strong netbacks. Notwithstanding, juniors will likely require multiple core areas of strong assets that each add economic value and the ability to increase reserves, production and cash flow on per share basis. In order for growth to occur, shareholder support and access to capital will remain paramount. Finally, a company must not fall in love with their assets but be willing to adapt quickly to changing market conditions. Who knows, with all the conversion to oil activity and some recent positive signs on the NG demand side, it may not be too soon before there is a swing back into the currently abandoned natural gas space. Time will tell. ■

Junior E&P Companies

(< 10,000 boed production)

	2007	2011	Change
Number of Juniors	142	156	9.9%
Gross Revenue ($MM)	2,933	4,937	68.3%
Net Capital Spending ($MM)	5,191	7,477	44.0%
% Oil Production Weighting	44%	54%	22.7%

Source: CanOils

Alberta Premier Redford appoints ministers to key portfolios affecting the energy industry

Following the Spring 2012 provincial election that saw former Energy Minister, Ted Morton, defeated by a Wildrose candidate, Premier Alison Redford appointed Ken Hughes, a first time Calgary MLA to the Energy portfolio. Mr. Hughes has had a significant career in public service, having earned a Masters degree in Public Administration at Harvard University in 1983 and served as an Alberta Conservative Member of Parliament in Ottawa from 1988-93. Most recently he was Chair of the Alberta Health Services Board which oversees the province's health care system. He comes with an impressive business background having founded a successful insurance brokerage operating in rural areas of the province and has sat on a wide variety of corporate and not-for-profit boards.

Hon. Ken Hughes, Minister of Energy

Given that the Premier herself intends to play a large role in promoting Alberta's energy sector and advocating for market diversification, the key area of focus for the new Energy Minister may be to stick-handle the single regulator project through to completion by 2013.

Premier Redford kept Diana McQueen in the Environment portfolio but increased her responsibility to also include Sustainable Resources Development. Ms. McQueen was first elected as an MLA in 2008. Hailing from the Drayton Valley area, a hotbed of oil and gas industry activity, she had a long career with Amoco Canada and served as the Mayor of the town of Drayton Valley. The combined Environment & SRD Ministry will have significant policy making influence on Alberta's oil and gas industry. ■

Hon. Diana McQueen, Minister of Environment and Sustainable Resources Development

About SEPAC

SEPAC, Canada's Oil and Gas Entrepreneurs™, advocates on behalf of its member companies for sound government policy that promotes a thriving independent oil and gas sector.

SEPAC was founded in 1986 as the Small Explorers and Producers Association of Canada. Today the Association represents a wide spectrum of independent oil and gas companies ranging from start-ups to junior and mid-sized producers operating in Canada, the United States and around the world.

SEPAC's core Producer Members are supported by a strong contingent of Associate Member companies supplying technology, products and services to the upstream oil and gas industry.

Keeping our promises to Alberta's kids

Every family, every business and every community in Alberta benefits when we keep our promises to young people. Alberta's Promise can help you invest in children in the communities where you work!

Inspiring partnerships for kids

Alberta's Promise inspires ideas, actions and investment through the active involvement of over 1,300 Partners. These Partners include: Promise Builders made up of businesses, foundations and community funding organizations; Promise Agencies such as registered charities and not-for-profit organizations; and Promise Communities including cities, towns, Métis settlements and municipalities.

In bringing together builders and agencies to meet the needs of Alberta communities, Alberta's Promise facilitates partnerships that benefit children and youth. Alberta's Promise makes it easy for businesses to make informed, practical decisions about where best to invest their resources (volunteer, in-kind and financial) by providing relevant research and community information. Through consultation, Alberta's Promise helps businesses to align their company goals and interests with the priorities of the communities in which they live and work.

Benefiting all Albertans

By working together children and youth have: greater support – allowing them to do better in school, access to mentors and role models who can positively influence their lives and increased options to make a difference – in their families, schools and communities.

ALBERTA'S PROMISE

Inspiring Partnerships for Kids

Alberta businesses will have access to current information on community priorities. This information can assist them with determining where their resources can have the greatest impact for children and youth in their communities. By investing in young people today, businesses will benefit from greater access to a home-grown, talented future workforce and an increased profile within their communities – positioning them as an employer of choice.

The benefits to communities will be realized for decades to come as young people choose to stay in the province, become engaged citizens, conduct their work and raise their own families.

Starting with a promise

Alberta's Promise Partners provide support for young people by committing to Five Promises which provide key building blocks for children and youth to achieve their full potential.

A Healthy Start: I promise to nurture the growth and well-being of children in their early years and to support parents

Caring Adults: I promise to provide support and guidance to children and youth through mentoring, coaching and volunteering

Child and Youth Friendly Communities: I promise to help provide safe, caring communities in which children and youth can grow

Lifelong Learning: I promise to inspire a passion for knowledge and skill development throughout life; in the classroom, in the workplace, in the community

Opportunity to Contribute: I promise to support children and youth to become active citizens, innovators and leaders in their communities

Alberta is the only province in Canada to enshrine a promise to children and youth into legislation. The Premier's Council on Alberta's Promise Act articulates a vision for Alberta as a province where children and youth are valued, nurtured and given the opportunity to reach their full potential. Alberta's Promise is led by the Premier of Alberta and a Premier's Council comprised of over 50 community leaders from across Alberta.

Making a difference

To become a Partner or for more information please visit www.albertaspromise.org or contact us at 1-866-313-7500. ■