ANALYSIS

Are Flow-Through Share Financings Heading Toward Extinction?

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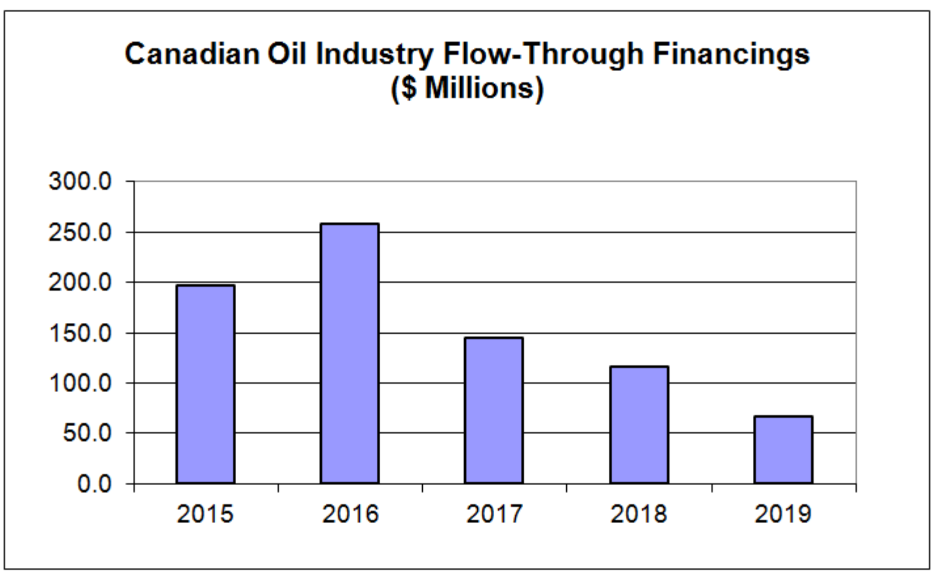
The total amount of equity raised through flow-through share equity financings to date in 2019 in the Canadian oil and natural gas industry, as illustrated in the graph below, is approximately $67 million, down 43 per cent from the $118 million completed in 2018 and 74 per cent lower than the $258 million raised in 2016. The decline in the amount of flow-through equity raised over the last number of years can be attributed to a few factors, namely, less junior oil and natural gas exploration and production ("E&P") companies pursuing exploration, a general lack of capital and investor appetite for the Canadian oil and natural gas industry and lastly changes to the tax treatment of flow-through shares made by the federal government in 2017.



Historically, the flow-through share equity financing structure was a very convenient tool for many E&P companies in the past to raise much needed capital to explore for and develop oil and natural gas reserves and production. By issuing flow-through equity shares along with passing on the tax benefits of drilling from the E&P company to the flow-through investor, the E&P company was able to raise the capital to go after the "next big play".

Recently most of the drilling and development of oil and natural gas in the Western Canadian Sedimentary Basin ("WCSB") has been on resource plays instead of exploration. Over the last number of years, the E&P companies that have been able to raise any capital have done it based on resource plays from a formation which has already been proven to be productive. The general sentiment is that the WCSB has been "picked over" and that there is really nothing left to explore and that all of the previous E&P companies that were successful explorers are either no longer active in the Canadian oil and natural gas industry or are focused on the development of the aforementioned resource plays.

Another factor which can be attributed to the decline in the amount of flow-through equity financings is a general lack of capital and investor interest in the Canadian oil and natural gas industry. According to our statistics, there has been approximately $675 million in equity raised in the Canadian oil and natural gas industry to date in 2019 compared to $1.9 billion which was raised in 2018 and the $12.6 billion of total equity financings completed in 2016. Considering the numbers above it is not surprising that total flow-through equity financings have also followed suit.

The changes made in 2017 by the federal government to the tax treatment of flow-through shares have also negatively affected the amount of flow-through equity financings. Prior to the changes implemented by the federal government, a typical flow-through share equity financing involved shareholders investing funds that the E&P company would use to drill exploratory wells. The exploratory costs would be classified as Canadian Exploration Expense ("CEE") and renounced to the subscribing shareholder. As an example, if a shareholder invested $10,000, that shareholder would receive a tax deduction of $10,000 in CEE in the year of the investment or in other words a 100 per cent deduction in the first year.

Under the new rules, using the example above the E&P company would first have to drill the exploratory well to determine if it results in a producing oil and/or natural gas well. If the well does result in a producing oil and/or natural gas well then it is no longer classified as CEE but rather as Canadian Development Expense ("CDE"). In which case the shareholder above, instead of being able to renounce $10,000 would only be able to renounce $3,000 of the total $10,000 invested or in other words a 30 per cent deduction in the first year. However, if the exploratory well drilled does not result in a producing oil and/or natural gas well it is then classified as CEE and would be eligible for a 100 per cent deduction.

These changes to the tax treatment of flow-through equity shares have introduced significant forecasting and budgeting uncertainty for both E&P companies and investors. When an E&P company commences drilling an exploratory well it will not be sure whether the well will be characterized as CEE or CDE until the well result is known. This makes planning more difficult and the investor is unsure if its initial investment will be either classified as CEE or CDE.

The above factors have led to a significant decline in the amount of flow-through equity financings completed over the last couple of years. Even though flow-through equity financings have been diminishing there is a possibility that flow-through equity financings may not be done yet and could be reincarnated in a new type of structure.

Recent reports in the media have suggested that the Alberta provincial government has been lobbying the Canadian federal government to allow a flow-through equity type of investment structure to be used to raise money for the abandonment and reclamation of oil and natural gas wells. The proceeds raised would be specifically used to abandon and reclaim oil and natural gas wells, wherein the amounts invested by shareholders will be renounced by the E&P company to the shareholders presumably similar to how flow-through equity financings were structured in the past. If the Alberta government is successful in its lobbying effort, it may lead to a comeback of sorts for flow-through equity financings but obviously not as it was initially structured to be.

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