Plenty of foreign interest in Canadian natural gas—for now

Gas extraction projects are free from the foreign ownership restriction imposed on the oil sands. But their future profitability is not guaranteed.

Peter Mazereeuw

British Columbia Premier Christy Clark, centre, visits the Petronas Liquefied Natural Gas Complex in Bintulu, Malaysia on May 5. *BC Government Photo*

Canadian natural gas deposits have become a hot commodity over the past few years, and foreign private and state-owned enterprises have swooped in to claim them.

Gas extraction projects, free of the anti-SOE restrictions imposed on their cousins in the oil sands, are a valuable commodity to resource companies owned by the fast-growing Asian countries in need of cleaner energy, and to the companies that hope to sell to them, said industry watchers and LNG reports from the Canadian Association of Petroleum Producers, the University of Calgary, and Osler, Hoskin and Harcourt LLP.

That demand, combined with a glut in the North American gas market, means the costly liquefaction and shipment of gas overseas has for the first time become more profitable than keeping it within North America, they said.

Thus, the liquefied natural gas sector has been born in Canada.

Canadian gas

The majority of Canada's natural gas is considered "unconventional," meaning advanced drilling techniques are required to access it, according to a Canadian Association of Petroleum Producers report. A large portion of these gas deposits is located in the far east and northeast of British Columbia.

State owned enterprises Korean Gas Corp., Malaysia's Petronas, and PetroChina have bought significant stakes in Canadian natural gas plays in the past four years, the CAPP report said.

Mitsubishi Corp., and INPEX Corp. of Japan; Royal Dutch Shell, of the Netherlands and United Kingdom; BG Group, of the UK; and Chevron of the United States are among the non-SOEs that hold large shares of projects in Canada, according to the industry report.

The British private sector is keen on getting involved in the BC boom, said Rupert Potter, the UK's consul-general for BC, in a phone interview.

"It's a pretty international field, interestingly. If you look at it, there's the US, a lot of Asian companies, but some really good British experience in there as well," he said.

British diplomats are working to help British companies form partnerships with Canadian companies, and to compete not just in the gas sector, but also for the engineering, construction and design work needed to facilitate its growth, he said.

Timing, global competition will dictate success

Whether Canada's LNG boom goes bust depends to a great degree on how quickly and inexpensively extraction projects, pipelines and liquefaction and export facilities are built in Canada, said the industry watchers and reports.

Canada's excess natural gas has, until now, been sold only to the United States, said Geoff Morrison, CAPP's BC manager, in a phone interview.

The recent growth of US natural gas production, thanks to hydraulic fracturing technology, pushed North American prices low in recent years, while growing Asian industry pushed overseas prices high. The price gap grew large enough to make export more attractive for Canadian gas owners, despite the $5 to $7 per thousand cubic foot cost of liquefaction and transportation, he said.

The margins for the future may be thinner. While demand is expected to rise, he said, so will competition, as Australia undergoes its own boom, the US gears up to export, and other countries look to join in.

The full cost of developing Canadian assets is still somewhat unknown, as the province of British Columbia—where most of Canada's natural gas projects are located—is in the process of setting an export tax, said Mary Hemmingsen, a partner in KPMG's Toronto office with expertise in LNG.

That tax will pile onto the province's LNG tax on liquefaction facilities, as well as the standard corporate tax, carbon tax, sales tax, and federal taxes, she said.

The real opportunity in Canada's gas fields is for investors looking to build their own infrastructure and secure gas supplies free from market fluctuations, at least relative to reserves elsewhere, said Warren Brazier, an energy lawyer with Vancouver's Clark Wilson LLP, in a phone interview.

Unlike the United States, Canada does not have the network of pipelines or facilities needed to export gas. Buyers of US gas pay tolls to have their gas moved along each stage of the export process, whereas those that put up money to build infrastructure in Canada would not, said Ms. Hemmingsen.

The location of Canadian gas reserves, and potentially, export facilities, is an even bigger advantage, said Mr. Brazier. Their location in northern BC is not only much closer to Asian markets than reserves routed through the US Gulf Coast, but the cooler local temperature makes the liquefaction process much more efficient than in places such as the Southern United States, Australia or Qatar, he said.

Perhaps for those reasons, there are currently 16 proposals to build liquefaction and export facilities on the BC coast, including 31 partners. Nine proposals have already obtained export licenses from the National Energy Board, according to a BC government website.

There are also several proposed pipeline projects, though foreign investors have generally been more willing to let Canadian companies build the required pipelines, said Mr. Brazier.

The BC government has eagerly embraced the LNG rush in the province. The provincial government set up a website to help residents "learn about LNG and why it is a great opportunity for British Columbians." Premier Christy Clark signed a letter of intent in May with Petronas to begin negotiations regarding "a possible Project Development Agreement to secure mutual interests."

The environmental protests that have stalled oil sands projects and pipelines in Canada have been more muted in response to the LNG boom, said Mr. Brazier, adding that more work remained to ensure the environmental impact would be minimal.

Those protests may yet build; environmental think tank Pembina Institute said the expected expansion of BC's natural gas sector would make the province's climate change targets "unachievable" in a February report, and a collection of individuals, activists and organizations signed an open letter in June calling on the province to reject an expansion of the industry.

So far, so good for foreign ownership

Large-scale natural resource projects require huge amounts of money, which often only foreign investors can provide. Even large companies prefer to share the risk of such projects, and, since Canadian firms and subsidiaries have a knack for finding and developing those projects, partnerships between companies inside and outside of Canada are commonplace.

Canada's Encana Corporation and Penn West Energy Trust entered into joint ventures with foreign resource companies in the past few years, and Petronas acquired Calgary's Progress Energy in 2012 following a 2011 joint venture in a BC gas deposit. Petronas-Progress then bought up natural gas assets from Canada's Talisman Energy in March.

Canada's federal government initially rejected Petronas's acquisition of Progress, worth more than $5 billion, after then-industry minister Christian Paradis said it did not pass the Investment Canada Act's net benefit test.

The Investment Canada Act requires a federal review of any acquisition of a Canadian company for more than $354 million —a number the government has said it will raise to $1 billion by the end of 2016—in order to determine whether the acquisition is of net benefit to Canada. The threshold is and will remain at $330 million for acquisitions by SOEs, according to Industry Canada. The net benefit test is carried out by the government behind closed doors, and a comprehensive explanation of the decision isn't mandatory.

The federal government approved a second application by Petronas to purchase Progress in late 2012, as well as a deal by the China National Offshore Oil Corporation to buy Canadian oilsands developer Nexen Inc. The same day, Prime Minister Stephen Harper announced that future acquisitions of oilsands companies by SOEs would only be approved in "exceptional circumstances," and that non-oilsands SOE acquisitions would undergo stronger scrutiny.

That scrutiny hasn't stopped foreign interest and investment in Canada's natural gas sector, as proposals have continued to roll in, the BC government's LNG website shows.

Even an oil sands SOE acquisition was approved in May, as Thailand's PTTEP acquired control of oilsands projects from Statoil Canada. That approval was given in large part because Statoil Canada itself is a subsidiary of Norwegian SOE Statoil ASA, said Lawson Hunter, a legal consultant with Stikeman Elliott, in a phone interview.

The Investment Canada Act applies to foreign ownership, not investment, though the definition of ownership is somewhat flexible, Mr. Hunter said. In most cases, taking control of one-third of voting shares is considered to be taking control or ownership of the company, he said.

However, an acquirer is afforded an opportunity to rebut or argue that it is not taking control if it acquires less than 51 per cent of voting shares. On the other hand, the federal government has reserved the right to designate certain acquisitions by SOEs of less than one-third of voting shares as taking control, and therefore submit the deal to a net benefit test, Mr. Hunter said.

The importers and exporters

Japan is currently by far the world's largest importer of LNG, given its developed economy, large population and lack of native resources, said Mr. Morrison. Japanese demand may continue to grow, as the country looks for alternatives to nuclear energy in the wake of the Fukushima disaster, the report said.

South Korea, Spain, China, Taiwan, and the UK were the next largest LNG importers in 2012. China and India are expected to lead the growth in demand going forward, the CAPP report said, and South America and the UK will also increase their demand.

Canada's conventional gas reserves—accessible with traditional drilling techniques—rank only 17th in the world. However, new techniques, including hydraulic fracturing and the ability to drill sideways through rock, have unlocked "vast" deposits of gas around the world considered inaccessible until now, according to the CAPP report. As a result, world gas production is expected to grow from just over 300 billions of cubic feet per day in 2010 to 512 Bcf/d in 2040.

Qatar was by far the world's largest exporter of LNG in 2012, accounting for 10.2 Bcf/d that year, according to the CAPP report. Malaysia, Australia, Nigeria and Indonesia followed at between 3.1 and 2.4 Bcf/d. Just more than 31 Bcf/d of LNG were produced in 2012.

LNG currently accounts for about 10 per cent of all natural gas production, the report said, though that share is expected to grow along with demand for gas in the developing world.

Australia, which has several LNG projects in development, could challenge Qatar as the world's leader in LNG production over the next decade, the CAPP report said.

Canada is projected to be among the world's 10 largest LNG producers by 2019, based on a calculation that includes existing and proposed facilities, the CAPP report said. In addition to Qatar and Australia, Russia, the United States, Nigeria, Algeria, Indonesia and Malaysia are expected to produce more than Canada.

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