OIL AND GAS INDUSTRY FINANCING

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The demand for crude oil and natural gas is constantly increasing. To keep up with this demand the oil and gas industry must spend vast sums of money to find new petroleum deposits to replenish the depleted reserves. Conventional financing techniques are used to finance the transportation, refining and marketing operations of the oil and gas industry, but the financing of oil and gas exploration and production requires special techniques. This paper discusses the common methods of financing the production end of the Canadian oil and gas industry.

Financing for the exploration, development and acquisition of properties in the Canadian oil and gas industry is in a relatively early stage with many arrangements used elsewhere not yet in vogue in Canada. The more common methods of financing consist of borrowing from chartered banks against security given under Section 82 of The Bank Act, borrowing from insurance companies, pension funds and similar institutions by the sale of secured mortgage bonds and, on occasion, by the sale of overriding royalties or production payments. This paper will consider some of the features of the more common methods and then deal briefly with some of the salient features of the less common methods.

I Financing with Canadian Chartered Banks

Due to the bank's inherent obligation to its depositors, bank funds used in financing are not provided as risk capital. While some degree of risk is always present in commercial ventures, the banks generally insist on sufficient collateral to ensure repayment of principal and interest within a reasonable time. The extent of bank advances is invariably determined by the equity capital of the borrower. It is not uncommon for the bank to insist on a commitment that working capital will not be diluted and will be maintained at a given level as substantiated by monthly financial statements of the borrower. An increasingly popular method among banks financing a company's operation on a long term basis is the acceptance of collateral security through the hypothecation of debentures which, through a Deed of Trust, are supported by a fixed and/or floating charge on the company's assets.

Until the introduction of Section 82 in The Bank Act in 1954,[1] Canadian banks were prohibited from lending money against mineral leases but could, under Section 88 of the Act, loan against products of a quarry or mine which, by definition, included hydrocarbons after being reduced to possession at the surface.[2] Little use, however, was made of financing under Section 88 in the oil and gas industry and eventually Section 82 was adopted to facilitate bank financing of in-place reserves.

Sub-section (1) of Section 82 sets forth the various kinds of subject matter upon which Section 82 security may be taken, namely: (a) the

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1 S.C. 1953-54, c. 48, s. 75 specifically prohibited the lending of money directly against the security of land unless the Act specifically provided otherwise and ultimately Section 82 provided otherwise.

2 Bank Act, R.S.C. 1952, c. 12, ss. 88(1)(a) and 88(2)(x).

hydrocarbons themselves, (b) the rights to remove the hydrocarbons, (c) partial interests in any of the foregoing and (d) casing and equipment.

The grant of the security is made in accordance with a statutory form[3] and charges not only the borrower's present interest in the property but also any interest the borrower might subsequently acquire in the property. The form is completed by inserting a full legal description of the lands within, upon or under which the hydrocarbons are located, by describing the leases and the chain of title of the borrower's interest in such hydrocarbons and by describing the nature of the borrower's interest in the casing and equipment located in or on the described lands.

The executed security instruments are registrable by way of caveat at the Land Titles Office against the mineral title of the lands involved and, in the case of leases issued by Her Majesty the Queen in right of the Province of Alberta, are registrable at the Department of Mines and Minerals against the leases involved.[4] Upon due registration the security acquires priority over all rights subsequently acquired in the property[5] and over unpaid vendors' and mechanics' lien holders whose claim was unknown to the lender at the time the security was taken.[6]

The security, being of statutory creation, is governed by the terms of The Bank Act and the lender has only those rights and powers set forth in or permitted by the Act[7] which consist of the right to enter into possession and use, operate and sell upon default in repayment of any loan for which the security was taken or upon failure to preserve and maintain the secured property.[8] If the interest in the leases and equipment represent a partial interest held under an operating or unit operating agreement with a third party operator, it would seem that the bank could not fully use and operate, but rather in such a case must sell or hold as non-operator, as otherwise the bank as security holder would have greater rights *vis-a-vis* the pledged property than the borrower had prior to granting the security. The power of sale, unless otherwise agreed to by the borrower, is by public auction effected after due notice to the borrower and advertising in local papers.[9] If the borrower's title documents contain a first right of refusal provision in favour of third parties, the sale by auction should, it seems, be subject to receiving such third party's waiver or subject to the first offer of purchase to such third party, as otherwise the bank would have greater rights of

3 The form is set forth as Schedule L of the Bank Act, S.C. 1966-67, c. 87. The precise wording of Schedule L need not necessarily be followed but the form used must be to the like effect or otherwise the security may be void. See *Royal Bank* v. *MacKenzie*, [1932] S.C.R. 524 and the Bank Act, s. 82(2).

4 The Mines and Minerals Act, S.A. 1962, c. 49, s. 180.

5 A subsequent advance made after notice of an intervening mortgage may not have priority unless the statute changes the general rule to the effect that such an advance would be secured by a third mortgage rather than by the first mortgage. *W. H. Fraser* v. *The Imperial Bank of Canada* (1912), 47 S.C.R. 313; *Hopkins* v. *Role* (1861), 9 H.L.C. 514; 11 E.R. 829; *West* v. *Williams*, [1899] 1 Ch. 132; *Marshall Wells* v. *Alliance Trust Co.*, [1920] 1 W.W.R. 368 and 907; *Deily* v. *Lloyds Bank, Limited*, [1912] A.C. 756, 761 to 768 inclusive; and *Robinson* v. *Ford* (1914), 7 W.W.R. 747. A subsearch to confirm that there are no intervening encumbrances should be made prior to effecting subsequent advances on the strength of the existing security granted to the bank.

6 Bank Act, s. 82(3), (4) and (5).

7 It should be noted that The Bank Act, a federal statute, and not The Mines and Minerals Act, a provincial statute, establishes the rights, privileges and priorities of the Section 82 security and decisions dealing with Section 88 of The Bank Act with respect to constitutionality and conflicts with other provincial and federal legislation may be of assistance. See *Tennant* v. *Union Bank of Canada*, [1894] A.C. 31.

8 Bank Act, s. 82(3).

9 Bank Act, s. 82(3). The statute sets forth the requirements as to the sale by public auction including notices and publication of advertisements.

sale than the borrower had at the time of granting the security and the third party would be deprived of its contractual rights.

Under The Bank Act the charge is on the interests then owned or subsequently acquired by the borrower. Any charge under Section 82 would, it seems, be subject to prior agreements creating overriding royalties, production payments and like interests; and the bank's title is not capable of being fully checked, particularly if Crown Petroleum and Natural Gas leases are involved, due to the short-comings of the system of registry in Alberta referred to in part II of this paper.

With the recent liberalization of the provisions of the Act permitting the making of loans directly against the security of real and personal property, Canadian chartered banks are able to make advances on current account against the deposit, as security, of a bearer debenture secured by a mortgage of oil and gas leases and equipment. The deposit of the debenture covers all loans and indebtedness howsoever arising, and the debenture stands as security for fluctuating amounts on current account.[10] Unlike Section 82 securities where the only rights and remedies of the bank are those set forth in the statute, the debenture can contain such rights and remedies as are required by the bank and as are permitted under the laws of the jurisdiction where the secured property is located. The type of assets subject to a charge in a debenture can include not only the assets referred to in Section 82 (1) of the Act, but also vehicles, gathering systems, surface leases, pipelines, processing plants and non-hydrocarbon mineral interests.

For the operator who has a substantial investment in equipment not used to produce or store hydrocarbons, such as drilling, service and pipeline companies, or has a valuable cash royalty which gives no interest in hydrocarbons in, upon or under the ground, in place or in storage, the grant of a secured debenture to the bank as security for advances on current account may be more acceptable to the bank. The salient features of such debenture security are similar to those of bonds secured by a mortgage contained in a Trust Deed hereafter discussed under that heading.

Bank financing under Section 82 of the Act against proven developed reserves or pursuant to the debenture route is, under present competitive conditions, generally for short terms not exceeding five to seven years. For the party with wildcat acreage and few producing properties the probability of a successful bank financing is, under current conditions, unlikely, and such a party must resort to one or more of the other methods of raising funds for development or operations.

II Financing with Long Term Secured Bonds

The resource company which wishes to finance on a basis of repayment over an extended period in excess of five to seven years will find

10 The Companies Act, R.S.A. 1955, c. 53, s. 111(4) provides that:
> Where a company has, either before or after the commencement of this Act, deposited any of its debentures to secure advances from time to time on current account or otherwise, the debentures shall not be deemed to have been redeemed by reason only of the account of the company having ceased to be in debt whilst the debentures remained so deposited.

Similar provisions are present in the legislation of the other western provinces and under the Act governing companies incorporated under the laws of the Dominion of Canada. The statutory provision referred to above was passed to overcome the ruling in *Russian Petroleum & Liquid Fuel Company Limited* [1907] 2 Ch. 540.

the chartered banks rather unreceptive and, accordingly, must look for alternative sources of capital. One source which may be available is the private placement of secured bonds with pension funds or insurance companies in Canada or the United States.

The governing statute for Canadian insurance companies, the Canadian and British Insurance Companies Act,[11] sets forth various types of assets in which such company may invest its funds. There is included in the list of permissive investments, bonds of a company which are secured by a mortgage on real estate, leaseholds or the plant and equipment of a corporation that is used in the transaction of its business.[12] The production equipment and plant facilities owned by a producing oil company, pipeline company or drilling company and used in its business would clearly qualify as a permissive asset to mortgage. Interests in oil and gas leases of the standard type would qualify as real estate[13] and rights-of-way and surface leases would qualify as leaseholds. The borrower then could mortgage its interest in the substances in place, under the mineral and surface leases, and in all production equipment and related facilities, under a Trust Deed securing bonds which are sold to Canadian insurance companies. While variations exist under the governing laws of jurisdictions in the United States, United States' insurance companies can generally invest their funds in bonds secured by the foregoing as can most pension, charity and other group funds.

The borrower having settled on the institutional lender and the assets to be used to secure the bonds must, in conjunction with the lender, settle the terms of the Trust Deed pursuant to which the bonds are issued. The Trust Deed will, to comply with the statutes governing permissive investments for the lender, provide for a specific fixed charge on designated properties and assets, may contain provisions for serial maturity or sinking fund payment and will contain elaborate covenants of the company as to its operations, the mortgaged property and related matters and may contain restrictions on the power of the company, during the period the bonds are outstanding, to declare dividends or create or assume other indebtedness whether secured or unsecured.

Prior to closing the sale of the bonds, if freehold leases are involved, copies of the Trust Deed are registered at all applicable Land Titles Offices, at the offices of the Registrar of Companies pursuant to The Companies Act,[14] and, if Crown leases are involved, the practice is to file a copy with the Department of Mines and Minerals, but little solace can, under existing legislation, be taken in the fact that such filing with the Department of Mines and Minerals has been effected.[15] The company's titles to the mortgaged assets are checked and solicitors for the lender and the borrower provide the lender with opinions as to the company's title and the extent and validity of the security granted to secure the bonds. If the assets subject to the mortgage consist of Crown Petroleum and Natural Gas Leases issued by the Province of Alberta,

11 R.S.C. 1952, c. 31.
12 *Id.*, s. 63 (10)(h).
13 The typical oil and gas lease has, in Canada, been characterized as a *profit à prendre*. See *Berkheiser* v. *Berkheiser*, [1957] S.C.R. 387.
14 R.S.A. 1955, c. 53, s. 99.
15 No statutory provisions exist outlining the effect, if any, of a filing with the Department of Mines and Minerals. The Department issues a letter of receipt containing the following, or words to the like effect: "The Indenture is a matter between the parties thereto only and will not be otherwise recognized by the Department."

the opinion must be qualified, as the registry system in Alberta with respect to Alberta Crown Petroleum and Natural Gas Leases is, to say the least, rather deficient.[16]

Under the Mines and Minerals Act[17] the only instruments which can be registered are (a) transfers of Crown leases, permits or licences[18] and (b) securities granted to a Canadian chartered bank under Section 82 of The Bank Act. Section 176(6) of the Act provides that "a transfer registered under this part is valid against and prior to any unregistered transfer." It is common for the Trustee, under the Trust Deed, to receive, at the time the bonds are issued, registrable transfers of the borrower's interest in Crown leases which the Trustee either registers immediately or holds pending default by the borrower under the Trust Deed. If the Trustee effects registration immediately, he may subject himself to liability to the surface owner and other parties if the leased substances escape or other damage occurs. The Trustee, if registered as owner, will receive all notices under the lease in the place and stead of the borrower, and the borrower will resist immediate registration of the transfer into the name of the Trustee to avoid this result. The Trustee, in order to more fully protect its security, must register the transfer or, at least, put beyond the power of the borrower the possibility of the borrower or its assignee registering a second transfer, which transfer, by virtue of clause 176(6) of the Act, would have priority over the then unregistered transfer in the hands of the Trustee.

A method sometimes employed is to have the borrower lodge with the Trustee the registrable transfer of the lease plus the lessee's copy of the Crown lease. This procedure is designed to enable the Trustee to refer to Section 176(4) of the Act which provides that before a transfer may be registered, the lessee's copy of the agreement shall be submitted to the Department. This may afford some protection to the Trustee but the borrower may, by an appropriate affidavit of loss of lessee's copy, be able to procure a duplicate copy of the lease which can be submitted with a second transfer and thereby comply with Section 176 of the Act and gain priority over the Trustee's unregistered transfer.[19]

Another method sometimes used to overcome the problem outlined above is for the Trustee to have a company incorporated and transfer the mortgaged leases into the name of this company, which company would have signing officers in whom the Trustee has confidence and would hold the leases in trust for the lender and the borrower, as their interests may appear. This procedure retains some of the practical problems existing when the Trustee itself becomes registered as owner[20] as outlined above but may be preferable, in certain cases, to the middle

16 The Mines and Minerals Act contains three short sections relating to registration, whereas the Land Titles Act, R.S.A. 1955, c. 170 has over 200 sections establishing a system of registration, which may suggest that the registry system in The Mines and Minerals Act is, by no means, a complete system of registration.

17 S.A. 1962, c. 49.

18 *Id.*, s. 176.

19 In addition the borrower may have a small leasehold interest and the lessee's copy may be in the possession of the other participants in the lease so that the borrower may not have the right to acquire possession of the lessee's copy and deposit this with the lender. In these cases the lender, on occasion, will procure an undertaking from the person having possession of the lease to the effect that they will not release or give up possession of the lessee's copy of the lease without first giving notice to the lender.

20 Such as receiving all notices under the lease and subjecting itself to liability, as owner, for escaping substances and damages to surface, reservoir, etc. A further difficulty is the fact that legal title is in the shell company but all operating agreements, unit agreements and production sale agreements may be in the name of the beneficial owner, the borrower.

position of lodging the lessee's copy of the lease with the Trustee and leaving the transfer unregistered pending default by the borrower.

The lender under the secured bond form of financing wishes to receive an opinion that the mortgage of the assets contained in the Trust Deed is a first, fixed and specific charge. When Alberta Crown leases are involved, this type of an opinion is rather difficult to give to the Trustee or the institutional lender because of the provisions of The Mines and Minerals Act.

Section 32 of The Mines and Minerals Act provides for a lien in favour of the Crown with respect to overdue royalty and such lien attaches to all goods and chattels at or below the surface of the land included in the lease. The statute specifically provides that the Crown royalty lien has priority over all mortgages, sales, bills of sale and other liens regardless of whether the royalty lien was in existence at the time the mortgage, sale or disposition was effected. Under the section, the lien attaches to all goods and chattels on the land and if the borrower jointly owns the lease with others and diligently pays its share of the royalty, its interests in the goods and chattels may still be subject to the overriding lien, if one or more of its participants in the lease fails to timely pay their share of the royalty. In short, the prior lien under the Act may not exist at the time the bonds are issued but may arise later through no fault of the borrower.[21]

Section 176(6) of the Act gives priority to a registered transfer over prior unregistered transfers but the Act is silent on the effect of registration of a transfer with respect to prior conveyances or dispositions which are not capable of registration under the Act. If ABC Oil is the registered owner of an undivided 50% interest in an Alberta Crown lease and on June 1, 1968, sells to XYZ Oil a 20% overriding royalty chargeable to ABC Oil's 50% interest, XYZ Oil is unable to effect registration of this interest under the Act or at any other office.[22] If on September 1, 1968, ABC Oil grants a mortgage of its 50% unregistered interest to a Trustee to secure bonds, there is no way the lender can determine that a 20% royalty was granted to XYZ Oil unless the files of ABC Oil indicate its existence or, by chance, information of its existence is obtained from other sources.[23]

The failure of the Act to permit registration of mortgages, royalties, production payments and similar carved-out or reserved interests creates numerous problems for lenders and indeed purchasers of leases as it is unclear what the effect of Section 176 of the Act is in such cases. Section 176(6) refers only to transfers which are registered as having priority over prior unregistered transfers and, it can be argued, that a registered transfer does not take priority over prior interests in the lands

21 The Mines and Minerals Act, *supra*, n. 4, s. 32. The lien under the Act should be confined to the interest of the defaulting party in the goods and chattels used in the winning, working, recovery or production of minerals, and the words "irrespective of who may be the owner of the goods or chattels" now in section 32(2) should be deleted. Lenders, as a rule, insist on a covenant in the Trust Deed to the effect that the borrower will maintain the mortgaged property free of liens and, with such a statutory lien as is created in section 32, this creates problems for the borrower who has less than an undivided 100% interest in the leases involved.

22 XYZ Oil may be able to provide notice of its interest by granting security to a chartered bank under section 82 of The Bank Act, which section 82 security could be registered under section 180 of The Mines and Minerals Act.

23 Title opinions given to lenders are often based on the assumption that all title documents and instruments relating to the property mortgaged were given to the lender's solicitors for review, which leaves the lender bearing the risk of the existence of an instrument or interest which was neither registered nor disclosed.

which were not capable, under the Act, of registration. If a mortgage of a Crown Petroleum and Natural Gas lease operates, as does a land mortgage at common law, as a grant of the legal estate to the mortgagee, leaving in the mortgagor an equity of redemption, and Section 176(6) applies only to prior registrable transfers, a second mortgagee or transferee will not receive a first charge or unencumbered title, as the case may be, notwithstanding the fact that the Crown's records show a clear and unencumbered title in the borrower or vendor, as the maximum *nemo dat quod non habet* will apply.[24] The foregoing general principle, if sound, will apply as well to other interests in land such as carved-out or reserved royalties and production payments.

If a mortgage of a Crown Petroleum and Natural Gas lease is not a prior transfer as used in Section 176(6) and operates, as do land mortgages under The Land Titles Act,[25] as security only, an argument may be framed that it does not effect the conveyance of an interest in land, and as such, will not have priority over subsequent dispositions of interests in land such as royalties and production payments.[26] Under this position, the mortgagee has the same exposure relating to subsequent conveyances of interests in land to *bona fide* purchasers for value without notice as exists with respect to statutory liens for overdue royalty arising after the creation of a mortgage.

Section 179 of The Mines and Minerals Act confers on the Lieutenant Governor in Council power to make regulations "providing for the registration of documents" and the foregoing reference to some of the problems arising with respect to Crown Petroleum and Natural Gas leases demonstrates that serious consideration should be given to using this power and to amending the statute, if necessary, to provide a complete system of registration for mortgages, royalties, production payments and like interests. As early as 1862 in England[27] it was considered prudent to establish a registry system to prevent innocent parties from suffering when they had done everything possible to protect their interests. As late as 1968 in Alberta we may, with respect to Crown Petroleum and Natural Gas leases, be permitting the principle of *nemo dat quod non habet* to operate with all its shortcomings, so that in a contest between a prior grantee of an overriding royalty, who could not register his interest, and a subsequent *bona fide* mortgagee from the working interest owner, who also could not register his interest (both innocent parties) one of them will suffer through no neglect or fault of his own.[28] To institute a complete registry system for Crown Petroleum and Natural

24 No one gives what he does not possess—no one gives a better title than he has.
25 R.S.A. 1955, c. 170, s. 106.
26 See *Smith* v. *National Trust Co.* (1912) 45 S.C.R. 618, 641, where the common law mortgage with the conveyance of an estate is compared with the statutory form of mortgage which does not effect the conveyance of the legal estate in land. In the absence of legislation establishing that a mortgage of a Crown Petroleum and Natural Gas lease operates as security only, the common law position should prevail as against subsequent dispositions by the borrower so that the borrower cannot subsequently give good title to the purchaser of an overriding royalty or production payment.
27 32 *Halsbury's Laws* 229 (3d ed. Simonds 1955).
28 If the mortgage is by a company to secure bonds or debentures, section 99 of The Companies Act, *supra*, n. 14, provides for registration which may give notice to the world, but if the mortgage of the borrower's interest in the Crown lease is given on a direct basis, by deposit of title documents or otherwise, and is not given to secure bonds or debentures, registration under The Companies Act by the lender may not be available. Registration under The Companies Act, if available, would be helpful in the case of a contest between the prior registered mortgage and a subsequent carve-out of a production payment but if the carve-out predates the registration of the mortgage, registration of the mortgage under The Companies Act may be of little assistance.

Gas leases will create certain administrative difficulties, but it is submitted that the benefits far outweigh the burdens.

The procedures and problems referred to above relating to a private placement of secured bonds with institutional lenders also exist where the bonds or secured debentures are being distributed to the public and, in the latter case, the borrower must also comply with the provisions of the Securities Act in effect where the distribution is being made or where the securities are listed for trading.

III Overriding Royalties and Production Payments

Another method of raising risk capital for the oil and gas industry which, to date, has not been extensively used in Canada, is the reservation or carve-out and sale of production payments or overriding royalties for cash.[29]

A production payment may be defined as an interest in future oil or gas production which is limited in duration, bears no portion of production or development costs[30] and is created out of a larger property interest. The production payment has many of the characteristics of an overriding royalty but, unlike the overriding royalty, is limited in duration so that the production payment terminates after the recoupment of a predetermined sum plus an interest factor out of assigned production or, in rare cases, after a specified time.[31] In most instances production payments are measured in terms of a primary sum of money plus an additional amount equivalent to interest on the primary sum from time to time outstanding at a specified rate—a defeasible estate or interest.[32]

A production payment may be carved out of any larger interest held by the party in which the said party has the right to receive production in the future and may include working interest, carried interest or, in some cases, overriding royalty interest. The effect of the carve-out by ABC Oil, the working interest owner, of an 80% production payment having a primary sum of $1,000,000.00, with no interest factor, and assignment of the said production payment to XYZ Oil is generally as follows:

(a) ABC Oil receives 20% of the runs and out of this bears all expenses of production and development.

(b) XYZ Oil receives 80% of the runs until all amounts received aggregate $1,000,000.00.

(c) The 80% share of the runs received by XYZ Oil constitute income to XYZ Oil but do not constitute income to ABC Oil.

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29 The production payment method of financing has been used extensively in the United States because of applicable tax and depletion laws. For a detailed account of the area see N. J. Stewart, *Production Payments*, to be published in Vol. 8, Number 1 of the Alta. L. Rev.

30 The production payment owner may be responsible for certain severence, production and similar taxes, depending on the terms of the indenture creating the production payment.

31 The limited interest may terminate after net production to the owner equals $1,000,000.00 (the primary sum) plus a fixed percentage, calculated at fixed periods, of the balance from time to time outstanding of the primary sum. Amounts received monthly by the owner of the production payment are generally applied firstly to pay the amount of the accrued interest factor and the balace is applied to reduce the primary sum.

32 The primary sum and interest factor are payable solely out of production and the holder of the production payment cannot sue on a separate promise to pay the primary sum and interest. If there exists a separate promise to pay other than out of production, the transaction is akin to a note secured by a mortgage on 80% of production and is not a production payment as that term is generally used.

(d) ABC Oil has a 33 1/3% depletion allowance under the Income Tax Act, as an operator, and XYZ Oil has a 25% depletion allowance under the Income Tax Act, as a non-operator.[33]

Another method of creating a production payment is for ABC Oil, as the owner of the lease, to sell the lease to XYZ Oil reserving an 80% production payment having a primary sum of $1,000,000.00. In such a case, ABC Oil is in the same position as XYZ Oil in the example given above with respect to a carved-out production payment. The reserved production payment is exactly opposite to the carved-out production payment; in the former case the production payment is retained and the residual is conveyed and in the latter case the production payment is conveyed and the residual is retained.

The reserved production payment is employed only when a sale of properties is involved and usually a third party acquires the reserved production payment. This three party transaction is generally known as the ABC transaction with the seller dividing his leasehold interest into two parts and selling the residual interest to B and the reserved production payment to C. B, as purchaser of the residual interest, reduces its out-of pocket acquisition costs by the value of the reserved production payment, and C pays A the primary sum of the reserved production payment so that A receives payment in full but from two buyers instead of one. In the case of the carved-out production payment there are, as a rule, only two parties, A and C, with A retaining the residual interest and C acquiring, for the primary sum, the carved-out production payment; in each instance C acquires the same interest from A, a production payment.

In the ABC transaction B, as the purchaser of the residual interest, acquires the right, licence or privilege to enter, drill for or take petroleum and natural gas in kind and, if this is all it acquires under the agreement,[34] its entire acquisition costs would qualify for a deduction under Section 83A of The Income Tax Act. If the production payment gives to C the right to take in kind its 80% share of petroleum or natural gas produced, C may have a Section 83A deduction for its acquisition costs of the production payment.[35] A, as vendor, will be required to take into income all amounts received from each of B and C whether or not C has an 83A deduction.[36]

If C acquires from A an 80% in kind production payment having a primary sum of $1,000,000.00, and an interest factor of 8% calculated

33 Income Tax Act, R.S.C. 1952, c. 148, s. 11(1) (b) and Income Tax Regulations, Part XII.

34 Income Tax Act, *id*, s. 83A(5a). Under the section B could have acquired the additional rights to enter, use and occupy so much of the land as may be necessary for the purpose of exploiting such right, licence or privilege without jeopardizing its right to an 83A deduction but, if other rights to, over or in respect of the lands are acquired it should be effected under a separate agreement. For purposes of simplicity the assumption is made that no other rights with respect to the lands are involved and that A sells only rights, licences and privileges which qualify under 83A(5a) of The Income Tax Act. For a discussion of the ABC and ACB transaction where surface equipment and facilities are involved, reference is made to Jones, Q.C., and Burton, "The ABC Transaction in Canada," *P-H Oil and Gas Taxes*, §2029.

35 The question of deductibility in such a case to C depends on whether C acquired a right, licence or privilege "to explore for, drill for or take petroleum or natural gas in Canada" as these terms are used in Section 83A(5a) of The Income Tax Act. C, as owner of the production payment, clearly does not have the right to "explore for or drill for" but may have the right "to take" petroleum or natural gas if these words mean "to take in kind" and the terms "explore for, drill for or take" are held to be disjunctive rather than conjunctive.

36 Income Tax Act, *supra*, n. 33, s. 83A(5b), (5c) and (5e). There are certain exceptions to this general rule dealing with acquisitions by A, by bequest or inheritance or under an agreement, contract or arrangement other than those described in 83A(5a); See 83A(5d).

monthly, C can borrow from a bank or other institution[37] the $1,000,000.00 at an interest rate of less than 8% and charge as security therefor the production payment received from A.[38] As long as C's note with the bank is not in default, C will have a monthly profit equal to the difference between 8% of the primary sum and the bank interest on the primary sum. C must take into income all amounts received on the production payment[39] against which, if he acquired a right, licence or privilege under 83A(5a) for $1,000,000.00 when he bought the production payment, he could deduct the full $1,000,000.00 leaving, subject to depletion and other deductible expenses, an overall profit of the difference in interest factors.[40] In the ABC transaction B, purchaser of the residual interest, takes 20% of the runs into income but he bears all of the development and operating costs his margin of profit subject to tax would, in all likelihood, be small during the period the production payment is outstanding but his return on invested capital may be large.

The ABC transaction would be most detrimental to C if C does not acquire, on the transaction, a deduction under 83A(5a) equal to the $1,000,000.00 paid by C to A for the production payment.[41] In view of the uncertainty under 83A(5a) with respect to C's acquisition costs of an in kind production payment, the transaction may be restructured so as to be an ACB transaction with C acquiring from A the latter's entire interest in the lease for $1,200,000.00 and then selling the residual interest remaining after C reserves a $1,000,000.00 production payment to B for $200,000.00. In this case, A's and B's tax positions have not changed, but C's may have, as C has now acquired, for $1,200,000.00, rights under Section 83A(5a) and, after the sale by C to B of the residual interest for $200,000.00, C's unused 83A(5a) expenses would be $1,000,000.00. C, in the ACB transaction could mortgage its production payment in the same way as it could have done in the ABC transaction.

Payments made from time to time by B as owner of the residual interest under the production payment may be akin to royalty and, if made to a non-resident, may necessitate the withholding of 15% of the amount of the payment.[42] If the residual interest owner and the pro-

37 Such an interest could be mortgaged under Section 75 or 82 of The Bank Act and may qualify as real estate under The Canadian and British Insurance Companies Act, *supra*, n. 11.

38 If the production payment is mortgaged and relates to production from lands subject to Alberta Crown leases, the problem of the lender with respect to registration is compounded as B, the residual interest owner, is the recorded lessee, but the production payment agreement will, in all likelihood, contain provisions by which the lessee's copy is deposited in escrow or alternatively the lease is registered in the name of a shell company which holds the lease in trust for C and B as their interests may appear.

39 Income Tax Act, *supra*, n. 23, s. 6(i)(j).

40 If C is a principal business oil or mining company as defined in Section 83A(3b) the $1,000,000.00 can be used as a deduction against its income regardless of source whereas other companies, individuals or syndicates can only use it as a deduction against income from operating an oil or gas well in Canada, royalties from an oil or gas well in Canada or deemed income under 83A(5b) or (5c). If non-principal business companies and individuals could use the deduction against all income regardless of source, it would increase the amount of risk capital available from Canadian investors. Individuals subject to U.S. tax laws have this right under U.S. law and the present treatment in Canada operates to penalize investments by individuals subject only to Canadian tax laws.

41 Without the deduction C would pay tax under Section 6(1)(j) on the $1,000,000.00, plus the interest factor when received, and if taxable at a 50% tax rate could not afford to pay more than $500,000.00 for the $1,000,000.00 production payment.

42 Income Tax Act, *supra*, n. 33, s. 106(1)(d). If the lessor's royalty under an oil and gas lease is "like rent" (*Berkheiser* v. *Berkheiser*, [1957] S.C.R. 387) and rent is payment for the use of something, it might be argued that a reserved or carved-out royalty or production payment is, unlike the lessor's royalty, not "for the use of anything" and, accordingly, is not a royalty as that term is used in Section 106(1)(d).

duction payment owner are both nonresident, this problem does not exist.[43]

The ACB transaction has the same effect *vis-a-vis* the Tax Department as a direct sale from A to B of A's entire interest in the lease for $1,200,000.00 as A, in each case, takes $1,200,000.00 into income under 83A and the purchasers acquire, in each case, Section 83A(5a) deductions of $1,200,000.00. In addition to the mortgaging by C of the production payment at a bank or institution, oil companies may be interested in acting as C in the ACB transaction as they acquire immediately a $1,000,000.00 tax deduction which could be used to reduce income taxes otherwise payable in the year of acquisition.[44]

The ACB transaction is, because of the uncertainty mentioned above under 83A(5a) with respect to the ABC transaction, to be preferred from a tax point of view to the ABC transaction and the carve-out of a production payment or an in kind overriding royalty.[45] In addition, it may have certain tax advantages over a purchase and mortgage to secure the purchase price for companies subject to taxation by jurisdictions other than Canada[46] and may enable a small operator to acquire a position in an area with a limited amount of investment which position, after payout of the production payment, has or may have considerable value.

If the uncertainty under 83A(5a) relating to carved-out production payment and overriding royalties is resolved in favour of an 83A(5a) deduction, the extent of financing by carve-out and sale of a limited interest, such as in-kind production payment and overriding royalties, may become more extensive in Canada, particularly for the smaller operator.

The foregoing touches briefly on some of the characteristics and problems presented by the more common of the existing methods of financing the oil and gas industry in Canada. Other forms or methods are employed to meet particular situations, and as the industry changes to meet changing tax and competitive situations, techniques of financing will follow close behind.

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43 Income Tax Act, Section 106(1)(d) refers to the payment of rent or royalty by a resident to a non-resident. In view of the 15% withholding tax possibility, the indenture creating the production payment should clearly set forth that withholding taxes, if any, from time to time payable, are the responsibility of the owner of the production payment and amounts withheld by the residual owner are deemed to have been received by the owner of the production payment and applied on the amount outstanding. Such a clause would be essential if the production payment or the residual interest is freely transferable to residents and non-residents.

44 It is unlikely that this group would contain many potential C's, as the company would, in all likelihood, prefer to retain the entire interest acquired from A in the ACB transaction.

45 The carved-out kind overriding royalty is, insofar as the purchaser C is concerned, subject to the same problems relating to deductions under 83A(5a) as is C in the ABC transaction referred to, *supra*, n. 35.

46 For the position under U.S. Tax laws of the ABC transaction and production payments, see generally: Breeding, *The Trend in Carried Interest Cases* (1963), 17 S.W.L.J. 242; Appleman, "The ABC Deal," 11 *Annual Institute on Oil and Gas Law and Taxation* 519.