5 August 2011

Federal Budget 2012
Pre-Budget Consultations

Small Explorers & Producers Association of Canada
Recommendations to the
Standing Committee on Finance
House of Commons

The Small Explorer's and Producers Association of Canada ("SEPAC") with a membership of approximately 350 companies is the voice of the junior oil and gas producers in Canada. The junior sector invests in the neighborhood of $8 billion dollars each year in Canada drilling thousands of oil and gas wells and constructing related pipeline and processing facilities. Junior oil and gas producers are active across the country from Newfoundland and Labrador to British Columbia and our members' capital investment in Canada creates tens of thousands of well- paying jobs, mostly in rural areas of Canada where such jobs would otherwise be few.

Executive Summary

1) First recommendation: permanently improve the "flow through" share regime

In the first six months of 2011 $212 million in flow through equity was raised in Canada out of approximately $7 billion in total equity financings (source: Sayer Energy Advisors, Calgary). Flow through share offerings are disproportionately relied on by the junior oil and gas sector to attract Canadian investors to higher risk opportunities, particularly exploration directed spending.

Support from Canada's tax framework via flow through shares has contributed to creating in Canada a world leading public equity market for junior oil and gas companies. Toronto and Calgary have become global centres for oil and gas finance and, according to the TSX, Canada is home to a remarkable population of over one third of the world's publicly listed oil and gas companies, the majority of whom are junior and mid-cap companies who look to flow through shares as a source of financing .

Lower overall corporate tax rates, while a laudable goal of the government, do not address the unique financing requirements of junior oil and gas companies to compete for investment capital because the majority of these companies are not in a taxable position.

The flow-through of eligible expenses to investors is a deferral of tax only and the capital invested creates jobs, mostly in rural Canada, and generates corporate and personal income. Junior producers, having passed on their deductible expenses to investors, will be in a taxable position sooner, all other factors being equal.

There are two aspects to our recommendations on how to improve the existing flow-through share regime:

a) Increase the annual limit of Canadian Development Expense ("CDE") convertible to Canadian Exploration Expense ("CEE") from $1 million to $3 million.

b) Increase the corporate taxable capital ceiling for eligibility to access the annual CDE to CEE conversion from $15 million to $50 million.

2) Second recommendation: natural gas completion and development costs be deducted at a 50% straight line rate for a time limited 24 months

Natural gas production in Canada, and exports to the US, are enormous contributors to Canada's economy. However, North American capital flows are favoring development of cheaper US domestic gas sources. This is aggravated by more favorable tax treatment in the US of expenses related to developing natural gas reserves.

A 24 month time limited accelerated deduction at 50% straight line for completion and development expenses for natural gas wells would improve cash flow for Canadian producers and encourage investment on this side of the border at a critical time necessary to slow the decline of Canadian production and maintain our share of North American markets. This period would also allow time for our industry to make progress in increasing natural gas demand in Canada and develop Asian market access infrastructure.

SEPAC endorses the proposal of the Canadian Association of Petroleum Producers in this regard and we invite you to review CAPP's submission to the 2012 Parliamentary Pre-Budget Consultation for further details.

Details of SEPAC Recommendations

1) Flow through shares

The importance of encouraging flow through share investment by Canadians in Canadian energy exploration and development is reflected in the June 2009 Report of the House of Commons Standing Committee on Industry, Science & Technology which recommended:

"That the Government of Canada examine the flow-through share regime with a view to stimulating greater access to capital for exploration activities in the junior oil and gas and mining sectors."

a) Permanently increase the $1 million CDE to CEE conversion limit to $3 million

Currently, the Income Tax Act (the "Act") allows for the conversion of only $1 million of CDE to CEE in any particular calendar year, subject to certain other limitations. The beneficiaries of this provision are junior oil and gas companies who raise much of their investment capital in the equity markets. The flexibility allowed by this conversion feature was introduced to enable junior oil and gas companies to spend a portion of the capital raised from investors on less risky 'development' drilling rather than high risk 'exploration' drilling thus facilitating greater financial stability for investors. Because of increasing complexity in the type of wells being drilled and inflation, the costs to drill and complete oil or gas wells has substantially increased since 1996, when the convertible feature of CDE to CEE was set at $1 million.

b) Permanently increase the taxable capital limitation for CDE to CEE conversion

This recommendation is linked to the above CDE to CEE conversion limit proposal. The current ceiling for companies able to access the conversion from CDE to CEE is a taxable capital test (as defined in the Income Tax Act) of $15 million in the preceding year. The amount of capital needed even by start-up companies today is much larger than in the past and this limitation is too low even for the 'small' producers of Canada. We submit the taxable capital base ceiling be increased immediately to $50 million.

SEPAC believes increasing the CDE annual conversion limit will result in modest tax expenditure for Canada yet stimulate significant investment and economic growth. These conversions of CDE to CEE represent a small percentage of all oil and gas flow-through share financings.

2) Natural gas completion and development costs be deducted at a 50% straight line rate for a time limited 24 months

Details on this proposal will be submitted by the Canadian Association of Petroleum Producers with additional supporting data. SEPAC endorses the proposal as submitted by CAPP.

Thank you for considering these proposals.

Gary C. Leach, Executive Director
SEPAC