Intelligence MEMOS

From: Brian Livingston

To: Federal and Provincial Governments

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Re: **Shut and Swap Can be A Lifeboat for Canada's Oil Producers**

The federal government has pledged specific support for Canada's beleaguered oil producers but has yet to deliver.

Ottawa and provincial governments – particularly Alberta – will need to collaborate on the design of support. This note proposes that government provide support to oil producers that shut in production by offering a loan that mimics a "swap" arrangement.

Greg Pardy of RBC Capital Markets has advanced a similar proposal, which he terms "Shut and Swap." Producers would get cash today for production that they would deliver in several months. This would allow them to cease producing and turn back on when prices recover.

The aim of federal assistance should be a "bridge" for producers, allowing them to survive a period of abnormally low prices. Producers and their employees need a life raft. In the present turmoil, government must avoid the uncertainties and lost value from an impending wave of bankruptcies and loss of employment.

Without an orderly shut in of current production, Canada's oil market faces an operational and financial tailspin.

Operationally, there is inadequate demand to take up current production. The Western Canada Select (WCS) price has faced steep declines – now trading below $10 per barrel and possibly facing negative prices. Oilsands resources are especially costly to shut in because of the risks to reservoir integrity and the technical challenges of hibernation.

Excess supply can usually go into storage, providing a buffer. But the tanks are almost full and, when there's no more room, the shut-in process will be immediate and disorderly. Producers will liquidate barrels at firesale prices below variable cost. Without ongoing production, cash flow will disappear.

Nonetheless, forward markets expect oil prices to rise. Current CME futures show an uptick in WCS of about US$8 per barrel by December. Many producers would be viable at those prices. The challenge is to survive that long.

Financially, most oil companies are already shut out of both the debt and equity markets. With credit and capital frozen for oil producers, government is the lender of last resort. And as the ultimate resource owner and tax collector, government has a long term stake in the sector's viability.

Providing a swap-like loan should encourage an orderly shut in of production and provide a life raft of cash flow. The support could be structured as follows:

- Producers shut in production today,
- Government advances an amount reflecting the futures price for each barrel shut in,
- Producers repay this amount in seven months

Mirroring a swap, this would be a commercial arrangement.

Producers would have the option (but not the obligation) to participate. Government could cap its exposure by limiting this swap to, for example, 50 percent of a producer's pre-March output.

Admittedly, such a loan would be unsecured and governments would face credit risk. Some producers may not survive even with this financial assistance. However, the sector needs support now. Urgency does not allow for fine-tuning. The potential cost is warranted given the consequence. If there are no producers, Canadian resources will remain stuck in the ground.

Nonetheless, in advancing this support, government should restrict how funds are used until they are repaid. Covenants might include:

- A company must restrict any payments to shareholders (i.e., no increase in dividends or share repurchases)
- A company must restrict compensation to executives in the form of bonuses and deferred compensation
- A company can meet interest obligations and maturing debt obligations, but not pay down non-maturing debts
- A company should make maximum efforts to maintain current employment and to top up the 75 percent wage subsidy to 100 percent.

Such a Shut and Swap should be easy to implement rapidly. The loan arrangement would be relatively standard. It avoids the logistical challenge and costs of above-ground storage. Oil stays put for seven months, and producers receive immediate cash flow but can hibernate until prices recover.

The government's worst-case exposure for this proposal (i.e., if every participating company goes bankrupt) would be in the order of $4.5 to $6 billion. This assumes 1.5 million barrels per day are shut in for 210 days at current prices over that duration. Government would have a capped downside, an exit strategy and a sunset date.

Is this proposal perfect? No. But it keeps our oil producers alive, and the perfect is the enemy of the good. It can be implemented quickly. It will help the oil and gas sector survive the brutal next six to nine months.

Canada's petroleum sector is in the ambulance. This proposal could get it to the hospital for recovery.

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