13.

NOVA SCOTIA RESOURCES LIMITED - SPECIAL AUDIT

INTRODUCTION

13.1 Section 15 of the Auditor General Act empowers the Auditor General to conduct and report on special audits throughout the year. In October and November 1996, in response to requests by government, the Public Accounts Committee of the House of Assembly and individual members of the Legislature, we conducted a special audit of Nova Scotia Resources Limited (NSRL).

13.2 Members of the Legislature, media and public have made allegations about the Company's mishandling of certain negotiations and other business matters during the past few years. The allegations related to:

- circumstances surrounding the Company's termination of three senior officers;
- a lack of follow through on certain business transactions commenced before the terminations occurred; and
- the mishandling of the disposal of certain NSRL assets.

13.3 Each allegation purported that the Company either made expenditures it could have avoided, or missed opportunities to lower costs and increase revenues.

13.4 We have examined those issues involving financial transactions. The circumstances relating to the employee terminations were excluded from the scope of our audit because the issues relating to the terminations are primarily legal in nature.

13.5 We had previously conducted an audit of NSRL in 1991, which was followed up in 1992. During the 1991 assignment we examined issues relating to accountability, financial management, planning and compliance with policies. The results of those assignments were discussed in the 1991 and 1992 Reports of the Auditor General.

RESULTS IN BRIEF

13.6 This section of the chapter summarizes the major observations and conclusions of the audit. It does not provide sufficient information for a complete understanding of the issues examined by the audit, or the support for our conclusion. It should be read in conjunction with the other sections of the chapter to obtain an appropriate understanding of the issues.

- An agreement between Nova Scotia Resources Limited (NSRL) and LASMO Nova Scotia Limited to have NSRL assume complete ownership of all partnership assets upon completion of the Cohasset project may have been of marginal value to NSRL. However, execution of the agreement would have exposed the Company to greater risk and NSRL was having difficulty negotiating how much legal liability LASMO would continue to have under the new arrangement.

- NSRL's decision to conduct a joint development of the Balmoral oil field with LASMO as an alternative to a redistribution of partnership assets was beneficial to NSRL.

- NSRL's plan to negotiate a transaction with PanCanadian Petroleum Limited to monetize some of NSRL's tax pools was terminated due to government's decision to divest itself of the Company. We concluded that if the government had executed the agreement with PanCanadian, it could have benefited by approximately $5 million between the fall of 1994 and the end of 1996. However, when government made the decision to dispose of NSRL in early 1995, it would not have been able to predict how long it would take to sell the Company and/or its assets. Also, management believed the transaction may have negatively impacted the divesture process, and that monetization of these tax pools could be achieved at a later date.

- The rules under the *Canadian Income Tax Act* regulating the type of transaction that was being negotiated between NSRL and PanCanadian were terminated in early 1996. However, NSRL taxation advisors suggest there are other possible means of monetizing tax pools, and we have observed negotiations by NSRL with other companies to achieve this result as part of the divesture of NSRL. Until a specific transaction is agreed to between NSRL and other parties and presented to Revenue Canada for approval, it will not be certain whether additional benefits will be available to NSRL from its tax pools.

- A competitive process was used to dispose of the western Canada oil and gas properties. Yet, some of the properties were sold for less than valuations would suggest as their worth. Based on this conflicting information, we cannot express an opinion on whether or not NSRL received what the properties were worth. However, the sale was conducted with the objective of maximizing the sales price while minimizing risk, and holding on to the properties with the hope that better offers could be found was believed to have an unacceptable element of risk.

- The government had a reasonable amount of information and advice upon which to base its decision to dispose of NSRL.

AUDIT SCOPE

13.7 Our audit addressed NSRL's handling of three specific business matters, based on allegations that:

- The Company did not execute an agreement with LASMO Nova Scotia Limited that would have provided the Company greater benefit upon completion of the Cohasset project.

- The Company did not execute an agreement with PanCanadian Petroleum Limited that would have enabled NSRL to receive a benefit on account of tax deductible exploration and development expenditures. It was further claimed that recent changes to the *Canadian Income Tax Act* make a similar business arrangement of limited value to the Company if it were to be completed now.

- The Company disposed of western Canada oil and gas properties that were very profitable, and did not receive the best price possible from the sale.

13.8 The scope of our audit did not include any areas other than those we considered to be directly related to these three issues. It does not address the sale of any assets or ownership interest other than the western properties (which includes an ownership in Direct Energy Marketing Limited) because, to date, no other sales have been finalized. It would be inappropriate for our Office to comment on any divesture activities that are currently in progress, as our comments could impact the outcome of any negotiations underway.

13.9 Each of the issues are described in greater detail in later sections of this chapter. However, we first provide a brief history of the Provincial government's involvement in oil and gas exploration and development which should assist readers in understanding these issues, as well as our audit conclusions.

13.10 We examined reports, correspondence, agreements, minutes and other documents relating to the above noted issues. We interviewed officers of government and NSRL, as well as others in the oil and gas industry. Background research, review of taxation law and various analyses were conducted to facilitate our planning of the audit and our understanding of the issues examined.

13.11 At all times during this audit, Company and government officials have been very cooperative and helpful. This chapter has been reviewed and discussed with Company and government officials. Responses to the audit have been prepared by NSRL management and the government, which are included in our Report, immediately following this chapter.

PRINCIPAL FINDINGS

Background

13.12 This section of the chapter summarizes background information relevant to an understanding of the issues addressed by our audit. It does not represent a complete history of Nova Scotia's oil and gas activities.

13.13 *Offshore oil and gas* - The exploration for petroleum in the waters off Nova Scotia began in 1959 with the issuing of an exploration license to Mobil Oil Canada Ltd. Mobil and its partners drilled Nova Scotia's first offshore well in 1967. This initiated an exploration cycle that lasted until 1978. Although commercial quantities of oil and natural gas were not discovered, some significant discoveries were made. As a result, a second exploration cycle began in 1979 and over ten years resulted in the discovery of 12 significant natural gas finds, and a few such oil finds. As of November 1996, more than 135 wells have been drilled offshore and approximately 6.4 trillion cubic feet of natural gas and 217 million barrels of oil and natural gas condensates have been discovered. The Scotian Shelf is still relatively unexplored, and it has been estimated that findings to date represent only 35% of total natural gas potential and 20% of total oil potential.

13.14 Oil and gas operations offshore of Nova Scotia are jointly managed by the governments of Nova Scotia and Canada, in accordance with the Canada-Nova Scotia Offshore Petroleum Resources Accord Implementation Act and the Canada-Nova Scotia Offshore Petroleum Resources Accord Implementation (Nova Scotia) Act; both proclaimed in January 1990. The Accords give Nova Scotia the right to negotiate royalty payments for its sole benefit. The legislation created the Canada-Nova Scotia Offshore Petroleum Board, which oversees the day-to-day management of offshore petroleum operations on behalf of both governments.

13.15 To encourage offshore exploration and development, the Federal and Provincial governments later repealed provisions of the legislation which required that production licenses have at least 50% Canadian ownership. This increased the potential for foreign investment as a means of funding offshore ventures.

13.16 Canada's first offshore development project, at the Cohasset and Panuke oil fields, commenced production on June 3, 1992. The fields are located in 36 metres of water, 250 kilometres southeast of Halifax and 41 kilometres southwest of Sable Island. The project was the result of a joint venture between NSRL and LASMO Nova Scotia Limited, an affiliate of LASMO PLC of England. LASMO assumed the role of project operator. At the start of the project, it was estimated that the fields would yield approximately 50 million barrels of oil, at rates up to 40,000 barrels per day. Whereas such reserves are small by world standards, it was predicted that the fields' high productivity, shallow water depth and moderate climate would make development viable.

13.17 *Nova Scotia Resources Limited* - Nova Scotia Resources Limited is a wholly owned corporation of the government of Nova Scotia. It was incorporated under the Nova Scotia Companies Act in 1979, and conferred Crown corporation status in 1981. Its mandate is to invest in and manage the Province's participation in petroleum, energy and mineral development. The Company has been involved with onshore energy projects, but the majority of its activity has related to offshore exploration and development.

13.18 As of December 31, 1995, NSRL and its subsidiaries held the following assets.

- An interest in 19 significant hydrocarbon discovery areas offshore Nova Scotia.
- A 50% interest in the Cohasset and Panuke oil fields.
- Ownership of 7.2% of all discovered natural gas reserves offshore Nova Scotia, including 10% of the Venture Gas Project fields.
- Interests in producing oil and gas properties in western Canada. (The Company sold all of its remaining western Canada properties in 1996.)

13.19 NSRL managed its investment in onshore and offshore projects through a series of subsidiary companies. (NSRL's corporate organization is depicted in Exhibit 13.1 on page 187.) Most offshore activity has been conducted by Nova Scotia Resources (Ventures) Limited [NSR(V)L]. NSR(V)L is 99.9% owned by Nova Scotia Resources Exploration Limited, which is a wholly owned subsidiary of NSRL. The corporate structure was designed to enable NSR(V)L to declare itself a taxable corporation in accordance with the *Canadian Income Tax Act*. This declaration made NSR(V)L eligible for Federal government assistance through the Petroleum Incentive Program which ran until March 1986.

13.20 Aside from a $525,000 grant made in NSRL's first year of operation (1981), the Provincial government has not injected any operating funds into the Company. However, the Federal government provided $109 million of incentives to the Company during the period 1987 to 1992. The remainder of NSRL's financial requirements have been met through borrowing. The Company's debt peaked in March 1994 at $501 million. As of December 31, 1995 NSRL had total debt of $439 million; all of which is guaranteed by the Province. (NSRL's unaudited consolidated financial statements dated September 30, 1996 indicate total debt had further dropped to $430 million.) Between 1981 and 1995, NSRL paid $232 million to service its debt.

13.21 As of December 31, 1995 NSRL assets had a book value of $27 million. Throughout its existence NSRL has made considerable investment in offshore ventures. However, in accordance with generally accepted accounting principles, these investments have been written-down to reflect the prospects for recovery of invested capital through future revenues. Write-offs to December 31, 1995 have totalled $357 million.

13.22 NSRL had an accumulated deficit of $412 million at December 31, 1995. This represents the total of all annual net incomes and net losses by the Company since its incorporation.

13.23 *The Cohasset Project* - In September 1990, the Canada-Nova Scotia Offshore Petroleum Board approved a development plan for the Cohasset and Panuke oil fields. By that time NSR(V)L and LASMO Nova Scotia Limited each owned 50% of the oil fields. A joint operating agreement between NSR(V)L and LASMO was executed on July 12, 1990, with LASMO declared the operator of the development project. After approximately two years to arrange for the equipment, work force and necessary authorizations and agreements, the project commenced production on June 3, 1992. This event represented the first commercial offshore oil production in Canada.

13.24 At the time of the start of production, the two offshore fields had estimated recoverable reserves of approximately 50 million barrels. It was expected that daily flow at full production would approximate 40,000 barrels and the project would produce for six years. The oil was very light and sulphur free, which was expected to attract a premium price in the world markets.

13.25 In September 1990, when the project received the approval of both the Provincial government and the Canada-Nova Scotia Offshore Petroleum Board, the total cost of the project was estimated to be $705 million. Of this, $225 million was forecasted for capital expenditures on items such as well head platforms, flow lines, a CALM buoy and production facilities (to be built upon the leased jack-up drilling platform Rowan Gorilla III). Operating costs of $480 million were projected for salaries; supplies; and the lease of the Rowan Gorilla III, helicopters and two tanker ships. Revenues of $970 million were forecasted, yielding a projected net positive cash flow of $265 million. One-half of this would accrue to NSR(V)L.

13.26 The Cohasset project has been controversial, primarily due to significant and regular changes in the project's revenue and cost projections. The most current estimate of the project's total capital and operating expenditures is $1.04 billion. This represents a 48% increase from the estimates made at the time of the project's approval. As this estimate rose gradually over the years, and the estimated profit turned into a net loss (at one point estimated to be as high as $100 million, with NSRL responsible for one-half), the relations between NSRL and LASMO became strained. In a meeting of the Public Accounts Committee on October 6, 1993, the new President and CEO of NSRL criticized LASMO for the cost overruns. He also indicated that estimated reserves had been down-sized from 50 million to 34 million barrels.

13.27 Reserve estimates subsequently rose again and are now estimated to be 44 million barrels. Also, in August 1995 NSRL entered into an agreement with LASMO to produce from the adjacent Balmoral field under the terms of the original joint operating agreement. Accordingly, NSRL management now estimate that, excluding debt service costs, the Company will break even on the project. Each of the partners in the venture were to finance their contribution in any manner considered appropriate. NSRL borrowed its requirements on the open market. The most current estimates by NSRL management indicate that interest paid on money borrowed for the Cohasset Project by NSRL will total $65 million.

13.28 Upon completion of the Cohasset project, the Provincial government will have received $23 million of royalties from the venture partners. Other benefits of the project to the Province include increased employment, economic spin-offs to local industry and a greater tax base for the government.

13.29 *Divesture of Nova Scotia Resources Limited* - A business plan proposal was completed by NSRL in the summer of 1993 and presented to the Minister of Natural Resources. Company management were confident that they could develop offshore oil projects under a cost structure significantly lower than currently in existence for the NSRL/LASMO joint venture. Accordingly, a course of action was recommended that would have NSRL become an operator of small oil fields after the Cohasset project was completed.

13.30 On July 22, 1993, Cabinet approved the course of action proposed, subject to receiving a favourable second professional opinion. The government contracted with Indeva Energy Consultants to review the business plan and comment on the viability of the recommendations included therein. The consultant reported to government in September 1993, concluding that the future operations of NSRL were viable under all but worst-case scenarios. A new Board of Directors, with most members having significant experience in the oil and gas industry, was selected to govern the operation of NSRL.

13.31 Upon the installation of the new Board of Directors on March 28, 1994, the government asked the Company to prepare a comprehensive business plan with more detail and alternative courses of action over a longer time frame (five years). The plan was prepared during the next few months and was approved by NSRL's Board in September of 1994. It provided scenarios for various courses of action, ranging from continued operation as an oil and gas developer to a wind-up of the Company. Each scenario included revenue and cost estimates. The plan forecasted that, in terms of future cash flow, the best scenario still involved becoming an operator of small oil fields. Accordingly, the plan recommended such a future for NSRL.

13.32 Before government received the plan, it started a process to select a firm to value the Company in order to provide information upon which to base a decision on whether or not to sell the Company. The government hired Rothschild Canada Limited to conduct a valuation of NSRL (which was reported in March 1995). On February 27, 1995 most of the Board of Directors and three senior officials of NSRL were dismissed. Upon review of the preliminary results of the valuation, and NSRL's plan, and after discussion by Executive Council, the government chose to divest itself of the Company as quickly as possible. A new Board of Directors comprised entirely of senior members of the government's public service was installed. On June 7, 1995, Rothschild was hired by NSRL to help with the divesture of the Company.

Negotiations with LASMO

13.33 *Description of the issues* - Soon after the start of the Cohasset project, serious concerns were expressed about cost overruns. NSRL and the government attributed a significant responsibility for the over expenditures to LASMO, the operator of the project. In August 1993, in response to these concerns, NSRL and LASMO agreed in principle to a new distribution of the remaining partnership assets upon the conclusion of the Cohasset project. There were a number of conditions to the understanding, but the four major requirements were as follows.

- NSRL would assume operation of the Cohasset and Panuke oil fields after LASMO deemed that production of the fields by the partnership was no longer economically viable. All risk of continued operation would be borne by NSRL.
- NSRL would assume 100% ownership of the Balmoral oilfield. The field was owned equally by the two partners, but was not slated for development because of its low estimated reserves.
- All equipment owned by the partnership would be sold to NSRL for one dollar at the conclusion of the partnership.
- Project abandonment costs (e.g., equipment retrieval, well sealing), effective at the time of LASMO's withdrawal, would be estimated and agreed upon, and LASMO would provide for its share of that cost.

13.34 This arrangement was very attractive to NSRL management because of its vision of the Company's future at the time. Management was of the opinion that the Company could profitably operate oil fields that were too small to be developed by larger oil and gas companies. They believed that NSRL could operate the Cohasset and Panuke oil fields at a lower cost than under the joint operating agreement, primarily through renegotiation of equipment leases and/or acquisition of lower cost equipment and supplies. At the time, LASMO estimated that the Cohasset project would no longer be economically viable to the partners once daily production dropped below 10,000 to 15,000 barrels per day. NSRL management believed the Company could become an operator of the fields after LASMO deemed them no longer feasible, and make profits as long as rates of flow remained above 6,000 barrels per day. Management also believed that NSRL could profitably develop the Balmoral field.

13.35 Based on the above assumptions, management believed it was beneficial for NSRL to assume ownership of the oil fields and partnership assets upon LASMO's quitting of the project. NSRL planned to continue production until its minimum daily production (i.e., 6,000 barrels per day) was met. Thereafter, the Company would have equipment it could deploy to other small fields it owned or acquired.

13.36 Over the following year or so, both companies negotiated the details of this agreement. However, early in 1995 the government decided to get out of the oil and gas business. Thus, the agreement in principle with LASMO was no longer as beneficial to NSRL. NSRL would not be developing oil fields, and without this activity government believed the remaining partnership assets lost much of their value to the Company.

13.37 The primary assets owned by the venture partners are the production facilities on the Rowan Gorilla III, a CALM buoy, two well head platforms and various flow lines. The drilling rig and tanker ships were leased and will return to their owners at the end of the project. Current management of NSRL estimate that the partnership assets could be disposed of for about $10 million (one-half accruing to NSRL). The production equipment installed on the Rowan Gorilla III cost the partnership approximately $115 million, but it would cost $10 million to remove it from the leased rig and there would be a very small market for its resale.

13.38 Also, NSRL and LASMO could not agree on how this agreement in principle would affect LASMO's legal liability after the joint operating agreement expired. Faced with this difficulty, and an agreement that would provide NSRL with properties it would have no capacity to develop and equipment of marginal salvage value, it negotiated a different agreement with LASMO. This agreement involved the joint development of the Balmoral oil field.

13.39 The Balmoral oil field is located three to four kilometres from the current location of the Rowan Gorilla III jack-up rig on the Cohasset field. The field was considered by the venture partners to be too small to produce feasibly at the time that the reserve was discovered in 1991. However, at that time, it was assumed that production would involve the relocating of the drilling rig upon the completion of production at the Cohasset and Panuke fields.

13.40 Between May and August 1995, the venture partners designed an alternative means of producing the Balmoral field that would be profitable. They agreed to drill into the field from the rig's current location by way of a technology referred to as directional drilling. This technology enables a well to be drilled into a field located a distance away from the drill rig by directing the drill bits to produce a well that runs for a distance under the surface of the ground. The benefits of this approach are that the rig would not have to be relocated, with the associated costs, and the flow from the Cohasset and Panuke wells would not be interrupted. Thus, the only significant incremental cost of producing Balmoral would be the cost of drilling the directional well.

13.41 NSRL negotiated participation in this project costing a maximum of $1.1 million if a dry hole resulted, or $1.6 million if the well produced. The two partners would equally share in the revenues.

Upon completion of the drilling, NSRL's share of the drilling costs were estimated to be 40%, which was funded by assistance from the Federal government's Offshore Development Fund.

13.42 The drilling was successful. The estimated reserves for Balmoral were increased from 1.1 million to 3.5 million barrels. Also, adding the extra flow from Balmoral to the declining flow from existing wells made it feasible to extract greater amounts from the Cohasset and Panuke wells than originally estimated. Management of NSRL estimate that at an average oil price of approximately $28 (Canadian) per barrel, the Balmoral field and the extra flow from Cohasset and Panuke wells will provide revenue to NSRL of $56 million.

13.43 The agreement to produce the Balmoral field was executed on August 28, 1995. This event put an end to the negotiation over the sharing of partnership assets and costs at the completion of the Cohasset project.

13.44 *Conclusions* - Based on our review, the Balmoral project has been beneficial to NSRL. However, we asked management why the Company would proceed with a new development project when it was in the process of divesture. Management explained that there was a time-specific window of opportunity for optimizing the return from the Balmoral project. It had to start after the flow from the Cohasset wells subsided enough to allow for additional flow from Balmoral, and before the depletion of the Cohasset wells, after which the rig would move to the Panuke field. Further, the Balmoral property would not have been attractive to a purchaser of NSRL because this window of opportunity would likely have been missed.

13.45 In addition, we asked NSRL management if the Balmoral project could have been more profitable to the Company if it had acquired 100% of the oil field as part of the negotiation to redistribute partnership assets at the end of the Cohasset project. Management indicated that under that scenario and based on the information available at the time, it could not have made more profit. NSRL would have had to wait until the Cohasset project was over and the partnership with LASMO dissolved. Then, assuming an average price of oil at $28 (Canadian), estimated recoverable reserves of 1.1 million barrels, completion costs of $4 million, operating costs of $150,000 per day and a project length of 180 days, the project would have lost approximately $200,000. Using the same assumptions as noted above, but having the development of Balmoral in partnership with LASMO, would net NSRL $13.8 million. The reason for this difference is that the partnership does not experience any increase in operating costs under this arrangement.

13.46 After the project commenced, reserve estimates were increased based on experience in the production of the well. Even if the higher recoverable reserves were forecasted at the time negotiations with LASMO were occurring, it is unlikely a different decision would have been made. Assuming recoverable reserves of 3.5 million barrels and using the assumptions noted above, NSRL would have made a profit of $21 million if it conducted the project on its own, but is projected to make a profit of $47 million developing it along with its current partner.

13.47 However, we have not seen evidence that the agreement to develop Balmoral and the agreement to redistribute partnership assets were mutually exclusive (i.e., both agreements could have been executed). The Balmoral project was profitable to both partners, and was included in the Joint Operating Agreement as a project for future consideration. LASMO took some extra risk in drilling Balmoral and incurred a little more than fifty percent of drilling costs but, this concession does not appear to exceed the value of a redistribution of the partnership assets. If sold outright, the partnership equipment may have netted an additional $5 million to NSRL (LASMO's share of the salvage value of the equipment). However, we agree with management's assertion that completing the redistribution of assets agreement with LASMO would have created additional risk for NSRL, especially in the area of project abandonment and liability for future claims. The potential marginal gain from the agreement does not appear to outweigh the additional risks involved.

13.48 We also enquired whether the Company may have been more attractive in the divesture process if NSRL obtained full ownership of the equipment and oil fields, or whether the remains of the Cohasset and Balmoral fields may have had value to another company if sold separately. We observed expressions of interest in the purchase of the Cohasset and Balmoral fields and other partnership assets upon completion of the joint venture. However, the companies showing interest were excluded from bidding on them. According to our enquiries, there are legal requirements that offshore oilfields be operated only by companies that demonstrate experience, expertise and adequate financial backing. We were informed that the companies that bid on the offshore properties did not meet these requirements. This issue is discussed further in the section of the chapter entitled *Western Canada Oil and Gas Properties* on page 183.

Monetization of Tax Pools

13.49 *Description of the issues* - The *Canadian Income Tax Act* recognizes that the nature of oil and gas exploration is one of significant investment and costs that do not result in income until years later when projects begin to produce and the petroleum products are sold. The Act permits eligible property acquisition, exploration, development and overhead expenses to be placed into "tax pools", effectively capitalizing them in anticipation of future earnings. In accordance with detailed provisions of the Act, the pools can be amortized over a period of future years, thus applying the past expenses over a term that corresponds to the period that revenue is produced from an oil or gas property.

13.50 As of December 31, 1995 NSR(V)L had $457 million of deductions available to reduce future taxable income. Although it is difficult to attribute the total in the tax pools to individual activities of the Company, roughly one-half represents natural gas exploration between 1981 and 1988, and the other half represents investment in the Cohasset Project. However, assuming a break-even outcome of the Cohasset project, some of the tax pools may be required by NSR(V)L to reduce future taxable income from the project.

13.51 Management of NSR(V)L, over the years, regularly forecasted how much of the tax pools were needed by the Company to offset its future taxable income. Such forecasts have always indicated that significant portions of the tax pools would not be required by the Company (notably, those relating to NSR(V)L's exploration for natural gas). Accordingly, management has often explored alternative means of using the tax pools to increase the cash flow of NSR(V)L. This is sometimes referred to as *monetization* of tax pools.

13.52 One means of monetization that has been employed by NSR(V)L for a number of years involved the purchase of Canadian oil and gas properties that were already producing. By investing in properties that were proven to be profitable (see the following section on page 183 which discusses these investments), NSR(V)L could earn a good rate of return which was completely sheltered from income tax. This was effected by applying expenses accumulated in the tax pools against the taxable incomes of the properties.

13.53 However, the transaction that is the subject of this section of the chapter is somewhat more involved.

13.54 NSR(V)L negotiated to enter into a tax pool monetization transaction with PanCanadian Petroleum Limited, a Canadian-controlled oil and gas company with headquarters in Calgary. By using the Joint Exploration Corporation provisions of the *Canadian Income Tax Act*, NSR(V)L and PanCanadian could form a joint undertaking in which certain of NSR(V)L's accumulated tax deductions (i.e., tax pools) could be transferred to PanCanadian to reduce its taxable income. The transfer is referred to as a *renouncing* of expenses.

13.55 To facilitate this transaction, NSR(V)L planned to declare itself a Joint Exploration Corporation and issue shares to PanCanadian to effect joint ownership. Under the Joint Exploration Corporation rules, only expenses incurred while an entity is a shareholder can be renounced to the shareholder; and then only to the extent of the shareholder's investment in the Joint Exploration Corporation's equity and debt. The planned transaction involved the renouncing of a portion of NSR(V)L's annual interest on its debt (which is eligible for capitalization into tax pools). The principal details of the transaction were to be as follows.

- NSR(V)L would issue 4,000 Class B Non-voting Common Shares to PanCanadian and one of its affiliates for $100,000, and then declare itself a Joint Exploration Corporation.

- NSR(V)L would issue debentures to PanCanadian equal to the amount of current eligible exploration and development expenses (i.e., interest) incurred by NSR(V)L subsequent to when PanCanadian became a shareholder. The debentures would be purchased by PanCanadian at a value in excess of their face value. In effect, this would have NSR(V)L returning less money to PanCanadian than it had borrowed, thus establishing the price PanCanadian was to pay for the renouncing of the eligible expenses. The portion of the money received by NSR(V)L that would have to be repaid would be placed in a sinking fund earning approximately the same as the debenture rate.

- Each year, NSR(V)L would renounce all exploration and development expenses (i.e., interest) incurred during the year to its new shareholder.

- After five years the agreement would terminate, the debentures held by PanCanadian would be bought back by NSR(V)L, and NSR(V)L would buy back its shares.

13.56 It was understood that the success of the transaction would be subject to the approval of Revenue Canada.

13.57 NSR(V)L estimated it would have at least $12 million of renounceable expenses each year; totalling $60 million over the five-year term of the agreement. At an average premium of approximately 20% on its debentures, NSR(V)L would earn $2.4 million each year, or $12 million over the five years. There was also a provision for increasing the annual renouncing of expenses if NSR(V)L took on a new development project and incurred additional renounceable expenses.

13.58 It is not clear how much benefit PanCanadian would earn from the agreement. However, according to NSR(V)L's tax advisors, the transaction was structured so that PanCanadian was the only entity that risked loss if the transaction was not deemed appropriate by Revenue Canada. Also, NSR(V)L could terminate the agreement with little cost if a decision was made to sell the Company or its assets.

13.59 Planning for this transaction began in the spring of 1994. A member of NSRL's Board of Directors was selected to help management identify and negotiate monetization opportunities. PanCanadian expressed interest and a framework for a monetization transaction was drafted. At this point, the Minister of Natural Resources was informed of the Company's intentions regarding PanCanadian. However, in a letter dated July 13, 1994, the Minister required that all discussion of the tax deal be halted. The Minister indicated that he and Executive Council would require the business plan of NSRL to be completed before they would grant approval for such a transaction. It was indicated that government wanted to be sure the substance of the transaction was consistent with plans for future operations of the Company.

13.60 Because of a pending deadline for the renouncing of 1994 expenses, management and Board members requested (and the Minister approved) an arrangement that would sell the 4,000 Class B Non-voting Common Shares to PanCanadian before approval to enter into the remaining terms of the transaction was granted. A put/call agreement would be executed whereby either party to the share purchase/sale agreement could require the other party to sell/buy back the shares at any time for any reason. The share purchase/sale and the put/call agreements were executed in November 1994.

13.61 As described earlier in this chapter, the government decided in early 1995 that it did not want to remain in the oil and gas business. It decided to sell NSRL and/or all of its assets. The negotiations with PanCanadian were terminated as they were perceived to be of value only upon the continuance of NSR(V)L. On June 6, 1995 NSRL exercised its right to "call", and subsequently repurchased NSR(V)L's shares from PanCanadian for $100,000, the amount originally paid by PanCanadian.

13.62 In January 1996, PanCanadian purchased LASMO Nova Scotia Limited. PanCanadian became NSRL's new partner in the Cohasset Project, but the change in ownership did not affect the terms of the agreement that governs the project.

13.63 *Conclusions* - In our opinion, participating in the PanCanadian transaction for the period up to the sale of NSRL would have profited NSRL (as well as PanCanadian). If the PanCanadian transaction had been executed in late 1994, NSR(V)L could have participated, to date, in the renouncing of a little more than two years' expenses, which would have earned it approximately $5 million.

13.64 Yet, we did not see any evidence that it was possible to accurately predict how long it would take to sell NSRL, and that the monetization transaction could have lasted so long. The valuation of NSRL by Rothschild was reported on March 3, 1995. The Confidential Information Memorandum used to generate interest in purchasing the Company is dated August 1995. As of January 1997, the sale of NSRL or its assets, except for the western properties, has not been finalized.

13.65 In our opinion, the PanCanadian transaction was structured so that participation would not hinder efforts to sell NSRL and/or its assets. An argument could be made that executing the transaction may have made NSRL more attractive to a prospective buyer. It is likely that PanCanadian would have continued the agreement with the new owners of NSRL, if they so wished. However, in its 1996 budget address, the Federal government indicated that the Joint Exploration Corporation rules of the *Canadian Income Tax Act* were terminated effective March 6, 1996, subject to certain transitional rules. The rule changes could also act to prohibit a renewal of the agreement, thus limiting its benefit to a purchaser of NSRL. Also, the purchaser of NSRL would have had to assume NSRL's debt in order for the monetization transaction to be applicable, and management indicates that this would be an unlikely scenario.

13.66 Management also expressed concern that having PanCanadian as a minority shareholder may have hindered the process of divesting of NSRL.

13.67 We saw correspondence from NSRL's taxation advisors indicating other means of monetizing tax pools may be possible. We also have seen evidence of expressions of interest and preliminary negotiations concerning the "purchase" of portions of NSR(V)L's historic tax pools. NSRL's historic tax pools are much larger than the annual additions to the pool which were the focus of the PanCanadian transaction. Of course, for NSRL to benefit from any such transaction, it would need to receive the approval of Revenue Canada. Such approval will not be forthcoming until the exact details of a transaction are agreed upon and provided to Revenue Canada for its review. Also, we are unable to conclude whether such a transaction would adequately monetize the interest costs that were the subject of the PanCanadian transaction.

Western Canada Oil and Gas Properties

13.68 *Description of the issues* - In 1985-86, NSRL began to invest in working interests in oil and gas properties in western Canada. The Company purchased and sold, individually and in lots, numerous properties in Saskatchewan, Alberta and British Columbia. Most of the properties were producing oil and gas at the time of purchase. The primary objectives of NSRL were to acquire investments that would generate cash flow that could be sheltered from income tax by amortization of NSR(V)L's tax pools, and to provide a source of positive cash flow to contribute towards the overhead costs of the Company.

13.69 As a result of the purchase of one particular group of western properties, NSRL also acquired 9.9% interest in the shares of a company called Direct Energy Marketing Limited (DEML). DEML is a privately owned gas marketing company based in Calgary. It enters into long and short term contracts for the purchase and sale of gas.

13.70 A company named Venwest Resources Limited was incorporated to hold the western properties and the shares in DEML. All of Venwest's shares are held by NSR(V)L (refer to Exhibit 13.1 on page 187). Venwest contracted with a Calgary oilfield management company to manage its properties. Over the years, the management company bought and sold oil and gas properties for Venwest and managed its portfolio of properties with the goal of generating the highest return possible. Venwest held as many as 89 properties in 1988.

13.71 Rothschild Canada Limited was hired on June 7, 1995 to help with the divesture of NSRL. The consultant sought purchasers interested in the Company as a whole, or in individual or specific groups of assets. The nature of the expressions of interest led to DEML and the western properties being marketed and sold separately from NSRL's other assets.

13.72 DEML was sold on June 30, 1995 for $2.5 million. The oil and gas properties were sold on January 1, 1996 for $4.7 million.

13.73 *Conclusions* - DEML was sold for an amount in excess of the $1.5 million value estimated by Rothschild during its earlier assignment to value the assets of NSRL. The western properties were sold for less than the amount at which the consultant previously valued them, and were sold to a company that was not completely independent of NSRL. We examined these two situations, and discuss them below.

13.74 NSRL's western oil and gas properties were valued by Rothschild at between $7.2 and $7.9 million, as of January 1, 1995. The valuations were based on reserve estimates dated April 1, 1994, a 15% discount rate applied to post-tax cash flows from the properties, as well as other valuation parameters such as comparative acquisition prices. This discount rate was selected as it represented what Rothschild believed would be a required rate of return for a future owner of the properties. The high value of the range was derived by applying the discount rate to 100% of the properties' proved and probable reserves, whereas the low value was derived by applying the rate to 100% of proved reserves and 50% of probable reserves.

13.75 A later evaluation of the properties conducted by Paddock Lindstrom & Associates for Venwest indicated a present value of future forecasted revenue of $8.5 million, assuming a 15% discount rate. The estimate was dated December 31, 1994 and indicated an increase in oil and natural gas liquid reserves, and a decrease in gas reserves, resulting in a net increase in the properties' total value.

13.76 One year of production occurred between December 31, 1994 and the time the properties were sold. Management of NSRL estimate that the year of production would have reduced the present value of the properties by $1.5 million. Subtracting this amount from the $8.5 million estimated by Paddock Lindstom & Associates yields an adjusted present value of $7.0 million. The properties were sold for $4.7 million.

13.77 It is generally accepted that if a competitive and fair process is used to sell an asset, the result will be receipt of the fair value. Accordingly, we reviewed the process used to sell the properties.

13.78 The properties were offered for sale in two rounds of bidding. The first round established interest and non-binding offers, and the second round narrowed the list of bidders and required more detailed bids. Rothschild indicated to us that ten companies were invited to participate in the second round, and six responded. Geo-Energy Corporation, the company that previously managed the properties for Venwest, submitted the bid with the greatest cash benefit to NSRL. Management indicated to us that there was an advantage in selling to Geo-Energy in addition to receiving the highest proceeds. Because of Geo-Energy's previous involvement with the properties, there was a significant reduction in the legal requirements and transaction costs to effect the sale.

13.79 Management of NSRL informed us that Geo-Energy had no involvement in preparing the information provided to potential bidders, and that it had no additional access to Rothschild Canada Limited, the administrator of the bid process. We were reminded that Rothschild was being remunerated on a commission basis, so it was in its best interest to get the highest price possible. We recognized that the reserve estimates were a major decision factor for prospective buyers, so we reviewed controls over accuracy of the estimates. We found that the Rothschild valuation relied on the estimates of reserves, production, costs and other cash flows assessed by Gilbert Lautsen Jung Associates Ltd. as of January 1, 1995, as well as an independent evaluation by Paddock Lindstrom & Associates dated April 1, 1994.

13.80 However, we came across one situation in the sales process which we believed required further review. K2 Energy Corporation (K2) is a Calgary based junior oil and gas exploration and production company. Its current President and Chief Executive Officer is James Livingstone, who was the past President and Chief Executive Officer of NSRL. K2 expressed an interest in bidding on the assets of NSRL. K2 signed the appropriate confidentiality agreements, but were invited to bid only for the western properties. However, K2 had an interest in purchasing all of the oil properties of NSRL, including those offshore of Nova Scotia. Accordingly, the Chairman of K2 wrote a letter to ask why it was being excluded from bidding on all of the assets. The government rejected K2's bid for the offshore properties based on a concern about the adequacy of K2's experience, expertise and financial backing, and about its lack of decision as to whether or not it would have a partner. (K2 contested this action in a legal action before the Supreme Court of Nova Scotia, but was not successful.)

13.81 However, after receiving the letter from the Chairman of K2, his company was cut out of the bidding for the western properties as well. A letter from Rothschild to the Chairman of K2 dated September 14, 1995 indicated that *"it has been determined not to entertain offers from K2 Energy Corporation for the purchase of <u>any or all</u> of the assets of NSRL"* (emphasis added). Two weeks later K2 was again invited to bid on the western properties.

13.82 In our opinion, in the interest of minimizing future risk and exposure to the government and public of Nova Scotia, it was reasonable for the government to set conditions for eligibility in the bidding for the offshore properties. Excluding K2 from bidding on the western properties was not in the best interest of making the sale as competitive as possible, but this situation was later corrected.

13.83 With the exception of the minor delay relating to K2 Energy Corporation's eligibility to bid on the western properties, as discussed above, we concluded that the process to sell the western properties was fair. Yet, the properties were sold for less than the evaluation of the present value of forecasted cash flows would suggest as their worth. Based on this information, we cannot express an opinion on whether or not NSRL received what the properties were worth.

13.84 However, we were informed that Rothschild and the Board of NSRL conducted the sale with the objective of maximizing the sales price while minimizing risk. Holding on to the properties with hopes that a better offer could be found was believed to have an element of risk, and was not considered to be a reasonable option.

Divesture of Nova Scotia Resources Limited

13.85 Each of the issues we examined in our audit were heavily impacted by the government's decision to dispose of NSRL. Due to this fact, we reviewed the government's reasons for leaving the oil and gas business in the manner that it did. The September 1994 business plan of NSRL provided alternative means of exiting the business, as well as alternatives for remaining in it. The exit strategies ranged from a gradual wind-down by completing the Cohasset project to one of immediate wind-up and sale. The business plan indicated that immediate wind-up had the least favourable future cash flow for the Company ($82 million), and continued operation had the highest ($336 million).

13.86 The government chose to divest itself of NSRL as quickly as possible. Government officials indicated that the following considerations were a factor in the decision.

- There was concern about the reasonableness of the assumptions described in the business plan, and concern about the recommendation that government pay or assume $300 million of NSRL's debt in return for a greater equity position in the Company.

- There was concern that if NSRL became an operator in the offshore, it would be exposed to significant risks in the areas of health, safety and environmental liability.

- The operations of NSRL had never been profitable. Significant losses had been incurred, and the Company had debt of over $470 million

- At the time the decision was made, the Cohasset project was projecting a net loss. Concern was expressed about the ability of the venture partners to control project costs. Government officials were not confident that NSRL could be more effective operating similar or smaller projects on its own or with different partners.

- Government re-evaluated its reasons for being in the oil and gas business. It concluded that government's goals with respect to economic development could be furthered by means other than direct participation in energy projects. Thus, there was little reason to incur the costs, debt and risk involved in the oil and gas business.

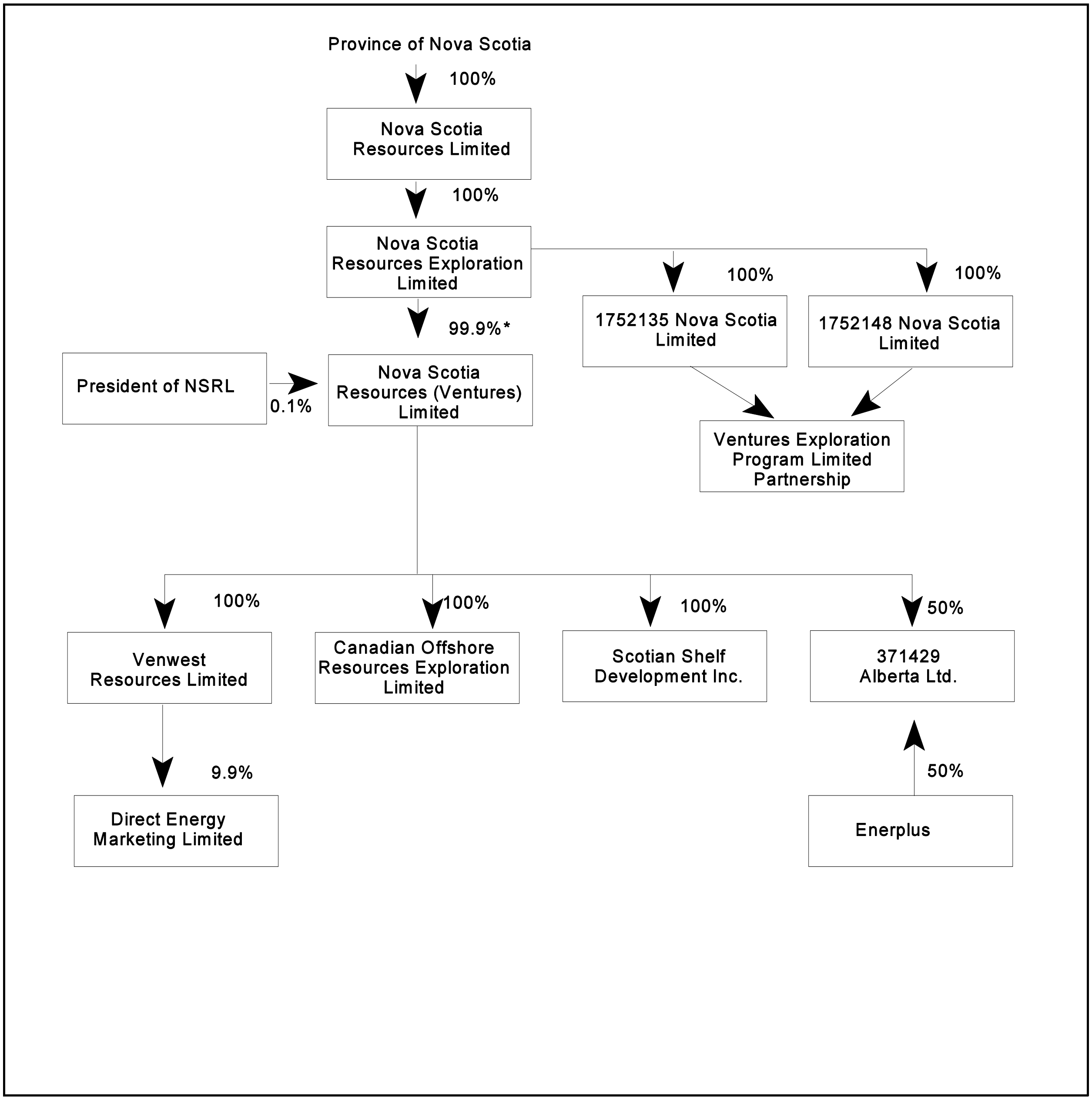
13.87 We reviewed government's concern about the reasonableness of the September 1994 business plan of NSRL. Government officials believed the assumptions in the plan were overly optimistic. Based on Rothschild's valuation and their own deliberations, they were very concerned about the risk of future events and business operations not coinciding with the plan. Also, the Rothschild valuation indicated that a divesture of NSRL could possibly produce a higher cash flow than indicated by the business plan.

13.88 Based on our review, we do not believe that government officials acted without regard for the government's financial interests. Each day, government must make decisions based on uncertain assumptions, estimates of future benefits and costs, and upon the level of risk it is willing to bear. As auditors, it would be very difficult to second guess decisions based on such factors; and the disposal of NSRL is one such decision. However, we believe the most important factor in such circumstances is that government avail itself of the best possible information, expert advice and analysis (including risk analysis); and that it give adequate attention to each of these in its decision making processes. In this situation, we did observe that information and advice were sought in making the decision about NSRL's future.

13.89 We wish to stress that our Office has not assessed the reasonableness of the business plans, financial projections or consultants' valuations. Additionally, some of our other audit conclusions are based on estimates made by NSRL management over the years, such as the various revenue/expense projections for the Cohasset and Balmoral projects, and estimates made about salvage values for partnership assets. Likewise, the reasonableness of these projections have not been assessed by our audit.

Exhibit 13.1

CORPORATE ORGANIZATION CHART



GOVERNMENT’S RESPONSE

The government welcomes the Auditor Generals’s report on recent business transactions of Nova Scotia Resources Limited. The province has full confidence that those transactions were conducted in a manner that was prudent, responsible and in the best interests of Nova Scotians.

The business dealings of Nova Scotia Resources Limited must be viewed in context. During its 15 year history to 1995, NSRL had amassed losses totalling $501 million. The business plan developed by NSRL management in 1994, called for an additional public investment of $300 million. That same plan also proposed that NSRL become a developer and operator of offshore oil and gas fields. The government was unwilling to increase the taxpayers’ exposure in this company, nor was it willing to take Nova Scotians into the high-risk business of developing and operating oil and gas fields. The policy decision, therefore, was made in 1995 to divest the province of NSRL and/or its assets.

With respect to the specific transactions examined by the Auditor General, the government is confident that, since 1995 management and the board of NSRL have provided sound stewardship of the Crown Corporation.

For example, the proposed agreement between LASMO and NSRL, whereby the Crown Corporation would assume sole ownership of the two companies’ partnership assets, would have exposed Nova Scotians to unacceptable risk. The decision to forego that deal, as results now show, was not only prudent but astute. The course of action taken will result in a return of some $47 million. Had NSRL assumed the partnership assets and become the operator at Cohasset and Balmoral, the company’s maximum return would have been $21 million.

The government is satisfied the report of the Auditor General is conclusive in its findings that each of the transactions under examination has been conducted in a responsible manner. Management of NSRL will respond with respect to specific transactions.

NOVA SCOTIA RESOURCES LIMITED'S RESPONSE

I am grateful for the opportunity to respond to the results of the Special Audit.

Background

As at March 31, 1994, Nova Scotia Resources Limited (NSRL) had accumulated a deficit position of $501 million by investing in the oil and gas business. In 1994, NSRL management proposed that NSRL become an operator and developer of oil and gas fields in the offshore; thereby, requiring an additional investment of $300 million.

I was appointed President of NSRL on February 27, 1995. In March, 1995, Government decided "to get out of the oil and gas business and divest of NSRL and/or its assets". My instructions were simple - "run NSRL like a business, but minimize risk and maximize return".

LASMO Negotiations

In my opinion, it was neither practical nor prudent for NSRL to finalize with Lasmo an agreement which would require NSRL to assume responsibility and risk for operation of the oil fields (Cohasset/Panuke):

- *NSRL lacked management depth and experience necessary to operate and develop oil fields.*
- *Risks (e.g. environmental) associated with development and operation of offshore oil fields are significant.*
- *NSRL was to become the operator only when Lasmo deemed that oil production <u>was no longer economically viable</u>. The Board of NSRL believed it would not be in NSRL's best interest to takeover a project deemed uneconomic by an experienced operator.*

Tax Pool Monetization

In my opinion, it was appropriate for NSRL to cancel plans with Pan Canadian to monetize tax pools of NSRL because:

- *In order to implement the planned tax monetization transaction with Pan Canadian, it was necessary for Pan Canadian to become a minority shareholder of NSRL. However, Pan Canadian was regarded as a potential purchaser of NSRL. The Board of Directors of NSRL viewed the addition of this minority shareholder as an unnecessary complication to the planned divestiture process.*
- *By foregoing the Pan Canadian opportunity, monetization of NSRL's tax losses was not lost - only deferred.*

Monetization of future NSRL tax losses by a purchaser of NSRL was dependent on NSRL's debt ($501 million) being assumed by the purchaser. Management of NSRL considered this possibility as unlikely and remote.

Sale of Western Canada Assets

NSRL sold its western oil and gas properties at their fair market value after Rothschild Canada Limited completed an extensive tendering/bidding process. The highest offer was accepted.

For purposes of clarification, the schedule below provides details of NSRL's debt and deficit position. Readers will note the following:

- *NSRL's overall debt has been reduced from $501 million as at March 31, 1994 to $436 million as at December 31, 1996.*
- *For the past three periods, NSRL generated net income which reduced the deficit by $37 million.*

Nova Scotia Resources Limited
Schedule of Debt & Deficit

Period Ended December 31st	*Debt $ (millions)*	*Deficit $ (millions)*
96	*436*	*405*
95	*439*	*412*
94	*470*	*431*
March 31st 94	*501*	*442*

During the past two years, NSRL management attempted to make the best possible business decisions based on the best available information.