VOX / ENERGY
Report on Business: Globe Investor Column
Royalties might be best alternative to flow-through shares

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Flow through is dead; long live flow through. That sums up what's happening to this kind of financing as far as the oil patch is concerned.

As predicted here a few months ago, traditional flow through is almost dead. I didn't make any friends among people who sold the stuff, but my reasoning was sound: The market had become way too big. There just isn't enough exploration success in Canada to support the billions chasing it via flow through. It hasn't disappeared, nor will it, but it has been drastically cut down to size.

But good financiers live and die by their creativity and they've given us another very interesting and more intelligent way to get tax deferral and upside on energy prices.

The product I'm looking at is called the **WCSB** Oil & Gas Royalty LP. Although it is lumped into the flow-through category because it offers good tax benefits, it's actually quite different than what you've come to expect from that heading.

The first distinction is where your money will be put to work. Rather than chasing exploration, where the real success rate is less than 20 per cent, this fund (the third fund from **WCSB**) will pursue development drilling. The difference between development and exploration is that the former involves drilling a hole where you're fairly sure there's oil, such as between two other producing wells. You don't typically find elephants this way, but the success rate is much higher. **WCSB** predicted 70 per cent for its first two funds, but so far is batting 100 per cent.

The second distinction is that, as the name implies, the fund is buying GORRs – gross over-riding royalties. Royalties are sweet assets because you get paid first; your cash comes right off the revenue line, second only to the government's royalty collectors. You don't have the risks of cost overruns and so on. And you're getting a cash return on your money. You also have a certain upside if commodity prices go up. You're not investing in a highly geared oil equity that can make you tons of money through capital gain (or lose you money the same way), but it's relatively safe and stable.

And you get tax benefits, the difference being it takes longer to run your writeoffs through – about five years, as opposed to one year for exploration flow through.

Based on conversations I've had with sharp oil and gas minds here in Calgary, I think royalties will become a prevailing source of financing for small energy companies. It will probably be a long time before they can borrow enough to finance their budgets, at least on terms that make sense. And because most of them trade at a discount to what they're probably really worth, they can't issue stock in an economic matter.

So producers are warming to the idea, too. They get other benefits: A royalty doesn't show up as debt, because it isn't debt. It only costs them if their drills are successful.

As to success, **WCSB**'s previous offerings are showing very good results. The first fund, launched last year when oil prices and therefore royalty prices were high, promised the first monthly distribution by the end of June, but paid it six weeks early. At 60 cents a unit, it represents a cash yield of between 7 and 10 per cent.

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The second fund raised and deployed capital at a more fortuitous time. It also started distributing early, and looks to sport an annual yield of between 14 and 18 per cent. Plus there are the substantial tax benefits on top of that.

The potential downside is obvious: Although royalties spare you some management risks, they don't spare you the trouble of lousy drill results. So far, **WCSB** is doing better than it thought, but that's no guarantee. Drilling development wells is safer than drilling for new finds, however. And as a retail product it's not cheap, but scarcity has its value, and this is scarce.

This isn't to say that exploratory flow through is a bad idea, but you're better off investing in these products in proportion to the relative sizes of the markets, and that means more of the production variety and less of the exploration kind.

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