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ALBERTA SHALLOW RIGHTS REVERSION

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The ERCB LLR Trap

(Am I My Brother's LLR Keeper?)

THE ERCB LICENSEE LIABILITY RATING (LLR) PROGRAM IS ONE OF THOSE THINGS THAT NO ONE SEEMS TO BE IN CHARGE OF. It's not really a general land matter; it's only sort of a regulatory matter and is often missed on A&D transactions. Small companies forget to worry about it, and large companies figure it will never apply to them.

In this article we will focus on one small part of the LLR program, namely the potential trap that exists when parties transfer licensed wells and facilities on a sale without first considering the LLR implications.

What the Heck is a "LLR"

The LLR Program is administered under a set of ERCB Directives, starting with Directive 006, which nicely summarizes the program as follows:

> *The LLR Program assesses a licensee's ability to address its abandonment and reclamation liabilities each month and on receipt of a licence transfer application ("LTA") in which it is the transferor or transferee.*

The LLR is corporation specific and is based upon the wells, facilities and (rarely) pipelines licensed in that company's name. The resultant LLR number value is comprised of the ratio of deemed assets/deemed liabilities. The calculation parameters are set out in Directive 006. Some important aspects of which are as follows:

- **The 1.0 Rule.** Every licensee is required to maintain a monthly LLR of 1.0 or greater and must have a pre and post transfer LLR above 1.0. If you fall below 1.0 a security deposit must be paid to the board. The calculation and impact of the 1.0 rule is discussed in detail below.

- **Licensee Specific.** The licensee (operator) assumes 100% of the assessed LLR for any particular well or facility. It is irrelevant to the board if you beneficially own only 5% of the crappy underperforming oil facility. As operator you are responsible for 100% of the deemed liability value for that facility license.

- **Deemed Assets.** The asset value (the numerator) is "…calculated by multiplying a licensee's reported production of oil and gas from the proceeding 12 calendar months in cubic meters oil equivalent by the 5-year rolling average industry netback by 3 years…" (Directive 006, Appendix 5, part 1.2) Big long sentence, but the important concept is that the asset value for LLR purposes will not come crashing down as the price of oil and gas falls. It takes a while for the asset value to rise or fall.

- **Deemed Liabilities.** The liability value (the denominator) is the ERCB established abandonment and reclamation cost for all wells and facilities held by a particular licensee. There are parameters in Directive 006, Appendix 6 setting out how these values are calculated.

It is important to note that the monthly asset and liability value for every well and facility can be obtained under the ERCB digital date submission (DDS) system. These values are private and only the licensee can check its specific well or facility value. Pipelines generally do not have an asset or liability value, unless they are a problem site.

Resultant LMR (Liability Management Rating) values for all licensees are publically available on the ERCB website. The spreadsheet is located under "Rules, Regulations and Requirements", then "Liability Management Programs", then "Reporting" then "Licensee Liability Rating Report - updated monthly". The LMR

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Since the board will have just rejected the transfer, they will almost certainly send a letter to the vendor/licensee asking it to establish that it retains the surface and mineral rights for the wells in the rejected LTA.

is basically your LLR plus or minus any security deposits paid. We will just refer to LLR in this article. Remember that the public LLR value does not provide you with any information on the underlying dollar value of deemed assets and deemed liabilities, only a numerical value.

The A&D LLR Trap

A significant A&D issue arises where the asset specific LLR profile of the licensed assets being bought and sold "tips" the LLR of either the vendor or purchaser below 1.0 post transfer. Under Directive 006:

> *If either the transferor or transferee has a Post-Transfer LLR below 1.0, a security deposit for the difference between its deemed liabilities and deemed assets must be received by the EUB before the licence transfer application is approved. (Directive 006, Appendix 2, part 8).*
>
> *If all required security deposits are not received by the due date(s),* ***the licence transfer application will be closed and the transferor will be required to establish that it retains surface and mineral rights for any well license included within the cancelled license transfer application.*** *(Directive 006, Appendix 1, part 9) (emphasis mine).*

See also Directive 006, Appendix 2, part 5 which states:

> ***Sections 16 and 17 of the Oil and Gas Conservation Act require a licensee to hold a working interest participation (WIP) in each well or facility for which it is the licensee.*** *(emphasis mine)*

I could go on, but suffice it to say that it is a very bad thing to close a transaction and have your LTA rejected by the ERCB post closing. Both parties will typically be immediately non-compliant with the ERCB once the transfer is rejected. Since the board will have just rejected the transfer, they will almost certainly send a letter to the vendor/licensee asking it to establish that it retains the surface and mineral rights for the wells in the rejected LTA. The licensee will also be required to show that it holds a WIP in the facilities.

This trap occurs due to the standard procedure in industry for closing A&D transactions, namely:

- sign the sale agreement;
- close the sale; and
- prepare and submit the LTA post closing.

Example 1. So let's pretend that you are a great big oil company selling to a start-up. Got an ok price but you are still very excited because you cannot believe you are going to be able to off load a bunch of marginal wells and facilities. Your purchaser start-up company has received an ERCB business associate code (operator code) so you figure you are good to go. The purchaser is 100%

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financed and the financing is based upon the value of the assets being acquired.

You close and submit the LTA post closing.

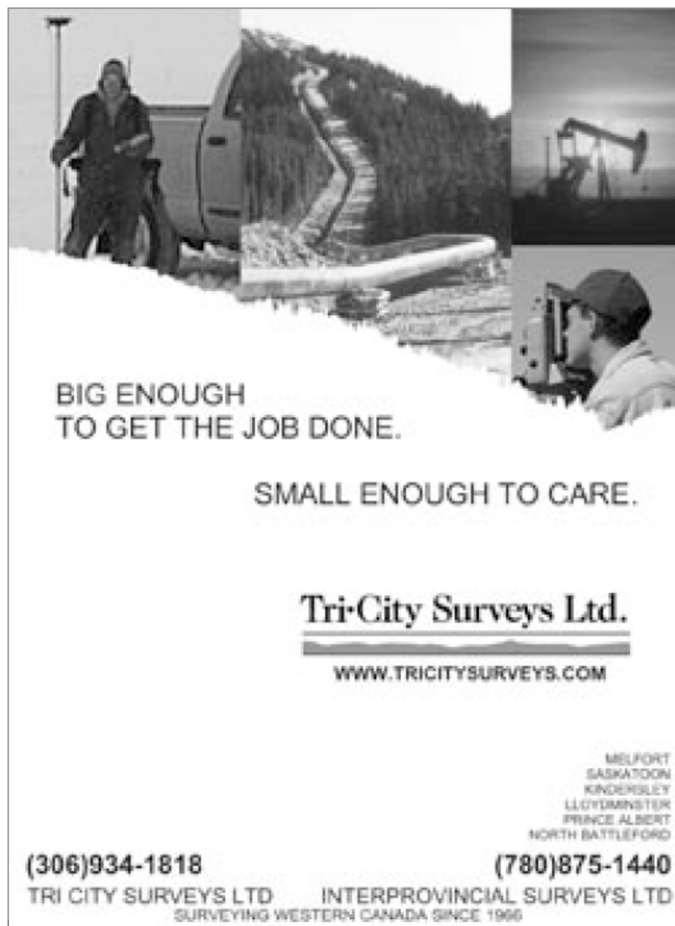
- The ERCB begins a routine LTA review and calculates the asset specific LLR profile of the licensed assets being sold is negative $2.5 million. Meaning that the deemed liability value is greater than the deemed asset value by $2.5 million;

- The board writes a nice letter to the proposed purchaser/transferee requiring them to submit a security deposit for $2.5 million within 30 days from the assessment date. This occurs because your start-up has no pre-transfer wells or facilities and so has a deemed asset/deemed liability value of $0/$0 for an LLR of 1.0;

- The purchaser calls and politely points out that they are 100% financed and have no more money to pay the security deposit;

- In the meantime you have sent out all the NOAs and completed all the Alberta Energy transfers and surface transfer documents; and

- After 30 days the ERCB closes the LTA.



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You are non-compliant. Much badness ensues not just with the ERCB, but internally as you must continue to manage the assets in accounting and in the field because you are still the licensee.

You have closed, you no longer beneficially own the assets and you have completed the closing specific conveyancing. Therefore you cannot confirm to the ERCB that you as licensee retain surface and mineral rights in the wells and hold a WIP in the facilities. You are non-compliant. Much badness ensues not just with the ERCB, but internally as you must continue to manage the assets in accounting and in the field because you are still the licensee.

Don't Forget About the Transferor's Post-Transfer LLR

Example 2. Please remember that both the transferor and transferee's LLR must be above 1.0 post transfer. Image you are buying from a distressed vendor for a bargain basement price. Sweet. You work for a great big company so why the heck should you care about your vendor/transferor's LLR. Well, here comes the trap. Suppose the vendor company has one good well, one bad well and no other licensed wells or facilities. Its LLR deemed asset value is $200,000, deemed liability value $100,000, for a company LLR of 2.0. If you buy only the good well and remove $150,000 of deemed asset value and $50,000 of the deemed liability value, the post transfer LLR of the vendor will be $50,000/$100,000 for a post transfer LLR of 0.5. No can do. The board will reject the transfer unless the transferor comes up with a $50,000 security deposit to bring its LLR to 1.0. So you have bought and paid for the assets but the board closes the LTA because the *vendor's* post transfer LLR will be below 1.0. You cannot get the licenses into your name and your distressed vendor is non-compliant and teetering on a closure order.

How to Avoid the LLR Trap (Pre-Closing Due Diligence)

There is a simple due diligence process to avoid the trap. As always, doing your homework ahead of time will prevent nasty surprises. Whenever you are buying or selling licensed Alberta assets and either you or the other party potentially have post transfer LLR issues you should:

- Pre-calculate the asset specific LLR profile for the wells and facilities being sold/transferred. This can be done very simply from the ERCB DDS system. The information is private and can only be accessed by the licensee. We simply print off the summary page for each well and facility and create a spreadsheet. Totally simple. Completely negligent not to do this. Look especially hard for non-producing wells and facilities. These often get missed if information is pulled from accounting since they often do not keep track of non-producing assets. Non-producing facilities in particular are often large liability items that can really affect your deemed liability value. Also remember you are dealing with the ERCB licenses issued under the Liability Management Program. These numbers are different than facility codes and battery codes.

- Subtract or add the asset specific LLR profile dollar value from the corporate LLR dollar value of the transferor and transferee, respectively. Each party must have a post transfer LLR above 1.0 in order for the LTA to be processed without a security deposit.

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Very tough to unscramble the egg with a stand alone sale agreement clause. This type of clause appears to be an attempt to deal with the LLR trap without a full closing in escrow. As is typical with half measures, they usually only half work.

In example 1 above, the start up company will need to find an extra $2.5 million in financing in order to complete the sale since the asset specific LLR profile is negative $2.5 million. In today's market that probably means your deal is dead. Don't be sad, it is way way better than the alternative of closing and trying to figure out how to unscramble the egg when the LTA is rejected.

In example 2, you cannot buy the assets without first confirming that the vendor can pay the $50,000 security deposit in order to have the LTA processed. Good luck with that. Remember that the transferee cannot pay the money to the board on behalf of the transferor. The money must come from them. There are ways around this problem, but they must be addressed pre-closing.

Keep in mind that the asset specific LLR profile is good for only a month. The ERCB reruns its LLR values on the first Saturday of each month. The values will change from month to month. So you must make sure you build in a buffer amount to account for any change over a reporting month, or ensure you close and process the LTA within the same reporting month.

How to Avoid the Trap (Sale Agreement Drafting)

The more problematic issue is how to deal with the LLR trap in your sale agreement. At least three possible approaches exist.

Close In Escrow

To strictly comply with the *Oil and Gas Conservation Act* and Directive 006, the parties to a sale agreement should close in escrow subject to ERCB approval of the LTA. Think of a typical house sale. The parties meet at closing, sign all documents and close in escrow. The purchaser pays the cash to close not to the vendor, but to the vendor's lawyer in trust and he holds the cash plus any other closing paper pending land titles registration of the transfer of land. Simple and straight forward. Nothing truly closes until the transfer is registered. I expect this is how the ERCB thinks oil and gas transactions work. This may in fact be how deals should close, but I have only very rarely been involved in escrow closings based upon LTA registration. I can think of no reason not to use this approach, it just does not seem to be used very often.

Null and Void Clause

An alternative approach is the addition of a "null and void" clause in the sale agreement. This type of clause states that if the LTA is closed or rejected for any reason, the parties agree that the transaction shall be null and void and of no effect. The problem with such a clause is that it would usually only come into effect after closing occurred, the purchase price was paid, beneficial interest had passed and closing documents had been circulated. Very tough to unscramble the egg with a stand alone sale agreement clause. This type of clause appears to be an attempt to deal with the LLR trap without a full closing in escrow. As is typical with half measures, they usually only half work.

Pre-Closing Calculation and Payment Clause

My personal approach has been to draft an ERCB security deposit calculation and pre-payment clause. This is really just taking the due diligence discussed above to its logical conclusion. How the clause works is that the parties pre-calculate the asset specific LLR profile and review same together with the transferor and transferee dollar value LLR. If a post transfer deficiency is identified, the deficient party is required to pre-pay such amount to the ERCB (either by cash or a letter of credit) such that the post closing LLR of that party would be above 1.0. As indicated above, the LLR is calculated monthly and so the LLR value is somewhat of a moving target. To deal with this, I have the prepayment amount set at a value slightly above the deficiency amount to allow for any monthly changes. For long closings, we will recalculate the asset specific LLR value each month to make sure we have the most accurate value for closing.

The Alberta LLR Program has been around for a very long time. No one should ever get caught in the LLR trap, however it seems to come up at least a few times every single year.

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