AER LLR Program – Introduction and Issues

***CAPL Business Luncheon* – March 15, 2016**

Paul Negenman
Phone: 403.218.7542
Email: pnegenman@lawsonlundell.com

LAWSON LUNDELL LLP

INTRODUCTION

Today we will discuss:

- AER *Directive 006 Licensee Liability Rating Program* (LLR) *and Licence Transfer Process*.
- The LLR Trap on A&D transactions.
- Recent insolvency proceedings of significance to the LLR Program.

OVERVIEW

The purpose of the LLR Program is to minimize the risk to:

- the Orphan Fund
- the general public (through government)

posed by unfunded well, facility, and pipeline abandonment and reclamation liability.

OVERVIEW

The balance is rather subtle.

LLR programs do not require operators to post a *"performance bond"* or full security for the liability posed by the underlying operations.

Rather, the security is related to overall health of the licensee company and the price received for oil and gas.

OVERVIEW

Your corporate Liability Management Ratio (LMR) fluctuates over time and can change dramatically based upon A&D activity, well production and produce price. If you don't think ahead, you can fall into the “LMR Trap” and be forced to pay a Security Deposit to AER or face closure orders or worse.

OVERVIEW

Deep breath, slow down. Let's start at the beginning.

DIRECTIVE 006

What the heck is Directive 006 and why does your LMR matter?

DIRECTIVE 006

Directive 006 is the AER regulatory framework that governs the ability of licensed operators (Business Associate Code holders) to operate wells, facilities and pipelines in Alberta.

The “Licensee Liability Rating Program”.

DIRECTIVE 006 – Licensed Operator

It is crucial to remember that the LLR applies to the AER licensed operator of the well, facility or pipeline.

The AER does not care about your underlying working interest in the well.

The licensee takes 100% of the LLR hit.

DIRECTIVE 006 – LLR

Every licenced well, facility and pipeline is included in the AER administered LLR online database.

Each well and facility has a dollar specific:

- Deemed asset value (the numerator)
- Deemed liability value (the denominator)

Pipelines do not generally have assigned values.

DIRECTIVE 006 – LMR

Individual well and facility LLR values are aggregated by "eligible producer licensee" and the total deemed assets over deemed liabilities is your corporate LMR (Liability Management Ratio).

Your corporate LMR is calculated monthly and the resultant ratio (not the dollar amounts) is posted on the AER website under "Liability and Management Programs".

Whatever. Isn't this JVs problem?

DIRECTIVE 006 – The 1.0 Rule

Nope, it’s everyone's problem.

If your monthly calculated LMR falls below a ratio of 1.0, you are required to post a Security Deposit with AER, in a form acceptable under *Directive 068 – ERCB (AER) Security Deposits*.

DIRECTIVE 006 – The 1.0 Rule

Failure to post a Security Deposit, or otherwise maintain a LMR above 1.0 is a non-compliance event under the brand new *Manual 013 Compliance and Enforcement Program (formerly, Directive 019: AER Compliance Assurance)*.

A noncompliance triage assessment would be conducted by the AER, which process can result in a global refer status and ultimately abandonments and closure orders.

Deemed Assets

The numerator portion of your LMR is your Deemed Assets value.

Directive 006 Appendix 5 sets out the deemed assets calculation. Very “mathie”, but generally Deemed Assets are comprised of production multiplied by price:

- reported production for the preceding 12 months x
- the 3-year average industry netback

Deemed Assets – The Oil Price Crash

The production x price calculation can have a significant impact on small oil focused companies who are considering shutting-in or reducing production as oil prices fall:

- Lower production starts to hit on a 12 month rolling average

- Lower price value kicks in as the 3 year rolling average price fall

Deemed Assets – The Oil Price Crash

Really just a repeat of what gas producers went through when gas prices crashed.

This leads to some very nasty AER letters to struggling operators right when they were most vulnerable.

The requirement to come up with fresh cash or credit to pay a Security Deposit was very difficult for some companies just as cash flow and access to capital (borrowing base) was falling.

Deemed Liabilities

The denominator portion of your LMR is your Deemed Liabilities value.

Directive 006 Appendix 6 sets out the deemed liabilities calculation.

The calculation is different for wells and facilities.

Deemed Liabilities - Wells

For wells, deemed liabilities are comprised of:

- Abandonment Liability – determined on a site-specific basis using the AER license cost processing program (depth, events, other); plus

- Reclamation Liability – cost specified by the Regional Reclamation Cost Map by area. (2.1)

Deemed Liabilities - Wells

Note:

- New wells do not attract Deemed Liabilities until the earlier of abandonment or 12 calendar months from its finished drilling date. (2.1.1)

- Multiwell Pads can (and should) be linked. Once linked, the first well has 100% of the reclamation liability, but additional wells attract only 10% of the reclamation liability. (2.1.2)

Deemed Liabilities - Facilities

For facilities, deemed liabilities are comprised of:

- Abandonment Liability – determined by multiplying the well equivalent from the AER Facility Well Equivalent table (i.e., the size of the facility) by the well equivalent cost; plus

- Reclamation Liability – determined by multiplying the well equivalent by the cost specified by the Regional Reclamation Cost Map by area (2.2).

Deemed Liabilities - Facilities

Note – an out of date facility license design capacity filed with AER can result in your Facility Well Equivalency being too large, which can results in very large liability values.

If your facility is running at a lower throughput, or you have downsized the facility, be sure to update this information with AER.

Deemed Liabilities - Facilities

Notes:

- Linked Facilities – Facility licenses can be linked to the first downstream production reporting facility so that the group received a single active or inactive status. (2.4.1)

- New facilities do not attract Deemed Liabilities until the earlier of: first reported throughput, abandonment or 12 calendar months from its license approval date. (2.4.2)

Deemed Liabilities – Gas Plants

Note on large Gas Plants (10, 20 or 40 well equivalents and over) License Transfer Applications (LTA). (2.3)

These transfers are **not routine** and require an up to date *Directive 001 Site Specific Liability Assessment* to transfer.

This will often lead to costs and delays in acquiring or updating the assessment before the AER will process the transfer. So, think ahead.

Deemed Liabilities – LFP

Even more custom are *Directive 024 Large Facility Program* transfers.

Very custom, think straddle plants.

Large Facilities are listed in their own spreadsheet on the AER website. Not very many. Really think ahead if you are buying or selling one of these.

Deemed Liabilities – Problem Sites

Note on Potential Problem Site and Designated Problem Site LTA.

These transfers are **not routine** and require an up to date *Directive 001 Site Specific Liability Assessment* to transfer. Also a big red flag for real issues and real costs.

Problem sites are flagged in the DDS system and have a large liability hit on your LTA. Ergo, a good reason to prepare your LTA pre-closing.

Deemed Liabilities – Pipelines

"A pipeline license is not considered in the calculation of deemed liabilities unless it is a designated problem site". (Appendix 6, clause 2.5)

Ergo, pipelines are included in your LTA, but will not have an assessed deemed asset or liability value.

I believe single well batteries also show up this way.

Corporate LMR

The sum total of the above:

- well and facility,
- asset and liability values,
- by licence,

is your corporate LMR.

Corporate LMR

The AER recalculates corporate LMR's on the first Saturday of each month.

You must remain above a ratio of 1.0 or you will get a letter from the AER requiring a security deposit.

Calculating Your LMR

Lots of engineers and accountant types like to pore through the Deemed Asset and Deemed Liabilities formulas.

Super cool to them, and there are certainly benefits in knowing how the system works.

There are also third party computer programs, such as XI Technologies Inc., that can run the numbers. Nice if you need third party information.

Calculating Your LMR

However, remember that you do not need to do the math. The dollar value of:

- your corporate LMR; and
- the asset specific LLR of every licensed well and facility

is included on the AER Digital Data Submission (DDS) website and can be accessed using your DDS ID and password.

Calculating Your LMR

Your dollar value LMR shows up on the DDS system under the “Reports/Liability Rating/View Liability Rating” heading.

The specific LLR of a well or facility shows up on the DDS system under the “Reports/Liability Rating/View Liability Rating/ Wells or Facilities” heading.

Calculating Your LMR

On asset deals, you can check your pre and post transfer LMR by simply:

- Printing your dollar value LMR
- Printing the appropriate well and facility LLR pages and compile them on an Excel spreadsheet

The LLR Management Plan

Licensees who are below 1.0 may access the *LLR Program Management Plan*, which is designed to:

> "… allow licensees to undertake appropriate measures over a set time period to meet their LLR Program requirements".

Ergo, a method to give small non-compliant licensees a lifeline.

The LLR Management Plan

Can allow more flexibility in transferring out bad well and facility licenses when you are in the plan.

However, the plan is cumbersome:

- Lots of paperwork
- Must eventually get back to 1.0, i.e. sell or pay
- Don’t get out until you hit 1.2
- Currently, all plans must end by Dec 31, 2017

Analysis

Boring part over. Now for the fun part.

My interest in the LLR Program is almost entirely focused on two things:

- How to properly manage LMR on A&D transactions; and

- What happens when good wells and operators go bad.

A&D - The LLR Trap

The “LLR Trap” refers to the scenario where the pre or post transfer LMR of either:

- the transferor (vendor); or
- the transferee (purchaser)

falls below 1.0 as a result of the LTA prepared as part of the closing of the A&D transaction.

LTA Submission to AER

Upon submission of the LTA, the AER conducts a LMR assessment of both parties before processing the LTA.

If either party falls below 1.0, the AER issues a LMR assessment letter and the party below 1.0 must submit a Security Deposit to the AER before the LTA will be approved.

Security Deposit

Security Deposits are outlined in AER *Directive 068: AER Security Deposits*.

Security Deposits can be either:

- Cash - paid by cheque, trust cheque, money order or bank draft; or
- a Renewable, Irrevocable Letter of Credit (LOC)

LTA Closure

The below 1.0 party has 30 days from the LMR assessment date to provide the required Security Deposit or the LTA will be closed:

> "…and the transferor will be required to establish that it retains the right to hold any license included within the cancelled licence transfer application".

(Directive 006 Appendix 2 paragraph 9)

LLR Trap

In a sloppy A&D transaction, the parties will:

- close the transaction (beneficial title passes)
- submit the LTA post closing
- have the AER require a transferee Security Deposit
- have the LTA closed for failure to pay the Security Deposit

This makes the vendor (transferor) AER non-compliant for having sold the Assets but not transferring the AER licenses.

LLR Trap

Don’t fall into the LLR Trap. As we have already discussed, it is simple and easy to determine:

- the Asset specific LLR of the wells and facilities being transferred. Create a spreadsheet

- Measure this value against the LMR of both parties

LLR Trap

Caution – LLR and LMR is calculated monthly and can change from month to month. Be sure to build in a buffer on your numbers.

PSA Considerations

You must also consider custom drafting in your purchase and sale agreement (PSA).

Options include:

- Escrow closing
- Null and void clause
- Condition precedent to pre-pay asset specific LLR

PSA – Escrow Closing

When you buy a house, you do not typically close until the transfer of land is registered by LTO. Closing funds and all the paper is held in escrow by a lawyer until registration of the transfer of land.

If there is a post-closing LMR risk, you should close this way. However, this is almost never done.

PSA – Null and Void

Instead, we almost always use a wishy washy “null and void” clause that allows the vendor to claim the transaction to be null and void if the LTA is not processed.

This clause usually includes a provision whereby the vendor has an option to pay the purchaser Security Deposit, if required.

Sloppy and risky, but this is what we usually do.

PSA – Security Deposit Condition

Where there is a significant asset specific LLR liability and a newco purchaser, you must include purchaser pre-closing Security Deposit payment to the AER as vendor condition precedent to closing.

A newco purchaser needs to be aware of the issue and ensure it has sufficient cash or credit to buy both the assets and pay the Security Deposit.

Reclamation Certified Wells and Facilities

Years ago the AER chose to stop allowing the transfer of reclamation certified wells and facilities. This is codified in Directive 006 Appendix 2 paragraph 6.

This has resulted in “logic creep” where companies now believe that abandoned wells and facilities cannot form part of a PSA.

Reclamation Certified Wells and Facilities

This “logic creep” mistakenly equates regulatory liability with common law or contractual liability.

It is wrong.

It is totally permissible to convey beneficial ownership of, and liability for, an abandoned and reclamation certified well or facility to a purchaser.

Reclamation Certified Wells and Facilities

This practise is very common (but not universal) in A&D transactions in the WSB.

Parallels the very common practise of passing all past, present and future environmental liabilities to the purchaser.

Also, the practise is consistent with the increased use of “white map” PSAs.

Reclamation Certified Wells and Facilities

If included in the PSA, either expressly (preferred) or via white map or other language:

- The environmental liabilities for such abandoned and reclamation certified wells and facilities flow to the purchaser under the PSA

- If the vendor is required to deal with the AER post closing as the licensee (think casing vent leak), the vendor must comply with the AER request but will seek indemnity under the PSA from the purchaser.

Corporate Compliance Record

Directive 006, Appendix 2 paragraph 4 allows the AER to consider the corporate compliance record of both the transferor and transferee prior to processing the LTA.

This can create transfer problems with troubled companies who have focused or global refer issues, or a past history or AER non-compliance.

Troubled Transferors

Transferors with a:

- LMR below 1.0; or
- LMR of 1.0 including a Security Deposit

must be handled carefully.

Troubled Transferors

Often these companies are already in some form of receivership.

Until recently, the receiver would typically require a purchaser to take all licenses as part of the PSA transaction.

The receiver cannot sell Asset of value and leave ugly licenses in the company – or can it???

Troubled Transferors

An AER Security Deposit does not form part of the Assets being sold by vendor in an A&D transaction. The security deposit cannot be transferred with the LTA. A Security Deposit is a corporate obligation, not an asset specific obligation.

However, the Security Deposit will form part of the company assets on a share purchase M&A transaction.

Troubled Transferors

In especially troubled circumstances, the AER can charge a $10,000 per well administration fee to allow the transfer to occur.

Cannot remember where this comes from, but I know it exists. Has anyone paid this fee?

WIP Requirement

Distressed operators who are under the burden of an AER Security Deposit requirement may be tempted to look to third party operators to “take over the license”.

Totally ok if the third party is a joint operator with a working interest.

Not ok if the third party is an outside agent charging a fee.

WIP Requirement

Directive 006 Appendix 2 paragraph 5 and sections 16 and 17 of the *Oil and Gas Conservations Rules* (OGCR) makes it clear that a licensee must be a working interest participant (WIP) in the well or facility.

Now, a smart lawyer could work with this rule and create a WIP structure for a non-traditional relationship. But make sure you don't get too clever and become non-compliant.

When the Shit Hits the Fan

So like, you are minding your own business one day and the AER sends you a letter saying:

> “Hey, the licensee of XXX wells is insolvent/defunct and we want these 10 wells abandoned pronto. Our records show you as a WIP. Pitter patter”.

AER WIP Liability

Ouch, but you must comply with the AER action demand if you are in fact a WIP.

Failure to do so is a non-compliance event.

AER WIP Liability

OGCR are clear that in the event of an insolvent/defunct licensee, liability flows out to the WIPs.

AER letters and enforcement of this concept are not rare.

AER Prior Licensee Liability

The OGCR also allows the AER to look to prior licensees if the current operator is insolvent/defunct and there are no WIPs.

This liability is less clear and very rare. I am curious if anyone has seen this rule enforced on a prior licensee?

Orphan Program and Fund

Do not forget that the Orphan Program and Fund still exists and can be accessed to recover monies paid on behalf of a defunct licensee/operator where a WIP is required to act.

The WIP must conduct the AER required operation, but can recover the defunct parties share of the costs.

Take time to get your money. Abandonment pretty quick, but reclamation only after final reclamation certificate is obtained.

EPEA Environmental Liability

Remember that parallel liability and enforcement can occur under the *Environmental Protection and Enhancement Act*.

EPEA licensee or broadly defined operator responsible for any environmental damage.

Polluter pays.

EPEA Environmental Liability

Note - This parallel liability is no longer administered by Alberta Environment and Sustainable Resource Development (AESRD), rather, AER now wears both hats under the single desk regulator approach.

Common Law

Apart from regulatory liability, a person who caused environmental or other damage to another person is liable under various common law actions.

Court actions by aggrieved land owners and others.

The PSA Liability Chain

Once a regulatory action or common law claim is initiated, a mad scramble occurs to find all upchain PSAs and determine if environmental liability can be moved up or down the indemnity chain.

This is where the general past, present and future environmental indemnity in PSAs gets tested.

REDWATER

Receivership of Redwater Energy Corp.

- Grant Thornton is Receiver
- ATB is the Bank

Very important hearing in Bankruptcy Court on November 15, 2015. No decision yet.

REDWATER

Facts

- Redwater LMR below 1.0, ergo Security Deposit required

- “Non-Producing” licensed assets – 72 licensed wells and facilities

- “Producing” licensed asset – 19 wells and facilities

REDWATER

Facts

- Receiver determines that:
  - It is “inconceivable that anyone would purchase them [non-producing licensed assets] under current market conditions”
  - If the [Redwater] estate were obligated to incur all abandonment and reclamation costs, the costs would exceed the value of the estate and result in no recovery for creditors, including ATB

REDWATER

Facts

- AER is not amused. Issues closure and abandonment orders for all Redwater licenses on the basis no one is in care and custody of the wells and facilities. Also puts Redwater on Global Refer status.

- "*The orphan fund is designed to deal with orphans, not children that the parent wishes to disown.*" *(paragraph 5 of CAPP Affidavit)*

REDWATER

Issue

- Receivership and Bankruptcy law is a federal power under the Constitution. Ergo, bankruptcy law has paramountcy over Provincial laws.

- Is the AER under Directive 006 “merely” a creditor of Redwater, such that the Court could compel this partial sale of the good stuff?

- Or does the AER, under Directive 006, trump bankruptcy law and govern the process.

REDWATER

Under a 1991 ABCA case called *Badger Oil*, we see the AER position.

ERCB order to abandon and suspend wells in the interest of public safety. Was the receiver bound to act or is the Board a mere creditor.

Note – this is before Directive 006.

REDWATER

[63] In my view, there is no such direct conflict in this case. The Alberta legislation regulating oil and gas wells in this province is a **statute of general application within a valid provincial powe**r. It is general law regulating the operation of oil and gas wells, and safe practices relating to them, for the protection of the public. **It is not aimed at subversion of the scheme of distribution under the *Bankruptcy Act* though it may incidentally affect that distribution in some cases**. It does so, not by a direct conflict in operation, but because compliance by the Receiver with the general law means that less money will be available for distribution.

[64] …the Receiver, the manager of the wells with operating control of them, was bound to obey the provincial law which governed them [emphasis mine]

REDWATER

However, the 2012 SCC decision in *AbitibiBowater Inc.* confused matters.

Province of NFLD issues an environmental protection order compelling Abitibi to file remediation action plans for industrial sites.

REDWATER

The Court found that:

> “Not all orders issued by regulatory bodies are monetary in nature and thus provable claims in an insolvency proceeding, but some may be”

REDWATER

"Subjecting such orders to the claims process does not extinguish the debtor's environmental obligations any more than subjecting any creditor's claim to that process extinguishes the debtor's obligation to pay a debt. It merely ensures that the Province's claim will be paid in accordance with insolvency legislation. **Full compliance with orders that are found to be monetary in nature would shift the costs of remediation to third party creditors and replace the polluter-pay principle with a "third-party-pay" principle"** [emphasis mine]

REDWATER

If the Receiver/Bank wins:

- Bad assets can be left behind on a receivership or bankruptcy sale
- Bank gets more money
- WIPs or OWF get more bad wells
- Might help with financings and bank debt

REDWATER

If the AER wins:

- Bad assets cannot be left behind on a receivership or bankruptcy sale
- Bank gets less
- WIPs or OWF get less bad wells
- Might hurt financing and bank debt

SPYGLASS

Very clever “compromise” deal between the AER and the Receiver of Spyglass.

“Solution” set up at the very beginning of the receivership sale process.

- Spyglass insolvent
- E&Y as Receiver
- National Bank as the bank

SPYGLASS

Consent order on Approval of Sale Process granted on January 25, 2016. Packages for sale right now!

- Sales and Solicitation Process (SISP) attached as Schedule A to the Order.

- Custom Receivership Sale Agreement between the Receiver and AER attached as Schedule B.

SPYGLASS

The SISP has custom provisions negotiated with the AER.

- AER granted right to not approve a non Arm's Length qualified bidder (par 18)

- AER agrees to approve LTAs notwithstanding Spyglass' LMR is below 1.0 where Transferee will have a post transfer LLR above 1.0 (including Security Deposit) (par 27)

SPYGLASS

Receivership Sale Agreement terms include:

- Positive LMR Sales – get processed (par 3.1)
- Adverse LMR Sales – Receiver pays only 50% of the maximum security deposit Spyglass would have to post under the LLR Program (par 3.2)
- First $5M of net sales proceeds held in trust to pay any outstanding (unsold) abandonment and reclamation obligations (par 3.5)

CONCLUSION

The LLR Program kind of sucks.

But, a fully prepaid bond requirement on well and facility licensing might be worse.

Could happen, the Socialists are in power now.

THANKS FOR LISTENING

Paul Negenman

Vancouver

Suite 1600 Cathedral Place
925 West Georgia Street
Vancouver, British Columbia
Canada V6C 3L2
(T) 604.685.3456
(F) 604.669.1620

Calgary

Suite 3700, 205-5th Avenue S.W.
Bow Valley Square 2
Calgary, Alberta
Canada T2P 2V7
(T) 403.269.6900
(F) 403.269.9494

Yellowknife

P.O. Box 818
200, 4915 - 48 Street
Yellowknife, Northwest Territories
Canada X1A 2N6
(T) 867.669.5500
(F) 867.920.2206
Toll Free: 888.465.7608