After Redwater: Legal and Practical Implications
Outline

• The Regulatory Landscape
• Redwater: The Basics
• Insolvency Proceedings: Before, During and After Redwater
• Redwater: Potential Implications
The Regulatory Landscape
Licensee Liability Rating Program (LLR)

• The purpose of the AER's LLR Program and licence transfer process is to:
  • prevent the costs to suspend, abandon, remediate and reclaim a well, facility or pipeline in the LLR Program from being borne by the public of Alberta should a licensee become defunct; and
  • minimize the risk to the Orphan Fund posed by the unfunded liability of licensees in the program.

• In order to transfer licensed assets, the transferor must have an LMR of 1.0 and the transferee must have an LMR of 2.0
Who Has an LLR?

Each licensee with the AER will have a calculated LMR which includes its LLR.

In Alberta, a Licensee Liability Rating (LLR) is the ratio of such licensee's deemed assets in the LLR Program, to its deemed liabilities in the LLR Program.

\[
LLR = \frac{m^3OE \times \text{Industry Netback} \times 3 \text{ years (Deemed Assets)}}{\text{Sum of the Deemed Liabilities}}
\]

**Deemed Assets:**

\(m^3OE\) is defined as the 12-month production of oil plus gas volumes reduced by a shrinkage factor (sales gas) and a gas/oil (\(m^3OE\)) conversion factor. Crude oil, bitumen, and field condensate are treated as oil. Natural gas liquid revenue is included in the gas revenue. Sulphur is excluded.

- The shrinkage factor is a rolling 3-year provincial industry average.
- The \(m^3OE\) conversion factor is a rolling 3-year provincial industry average.
- Industry netback is a rolling 3-year provincial industry average netback.

**Deemed Liabilities:**

The deemed liability of a licensee is the sum of the costs to suspend, abandon, remediate, and reclaim all wells and facilities for which it is the licensee, adjusted for status (active, inactive, abandoned, and problem site designation).
Calculation of LMR

The AER runs its LMR assessment on the first Saturday of each calendar month using reported data and if a licensee has an LMR under 1.0, such licensee must post a specified security deposit (cash or letter of credit) to the AER in an amount equal to the difference between its deemed liabilities and its deemed assets.

If a licensee fails to place a security deposit, it is subject to compliance enforcement actions which may include warnings, closure or abandonment orders, a "refer" status or a number of other enforcement mechanisms.
LLR and Transfers

• Upon a receipt of a transfer application for licenses (completed electronically in Alberta), the AER conducts a post-transfer LMR assessment of both the transferor and the transferee. If transferee has a post-transfer LMR below 2.0, the AER will require a security deposit to bring the transferee's deemed assets above 2.0* before the transfer application is approved. The transferor's LMR needs to be 1.0 for the transfer application to be approved.

• Security deposit must be received by the AER before the licence transfer application is approved (30 days to provide).

• If not received by the due date, the licence transfer application will be closed.
Inactive Well Compliance Program

- On April 1, 2015 the AER implemented the Inactive Well Compliance Program (IWCP). The goal of the IWCP is to address the growing backlog of inactive wells which are non-compliant with Directive 013: Suspension Requirements for Wells, introduced in December 2004 (Directive 013).

- The IWCP applies to all inactive wells which are non-compliant with Directive 013 as at April 1, 2015 (IWCP Inventory). The purpose of the IWCP is to bring each licensee's IWCP Inventory into compliance pursuant to Directive 013 within 5 years.

- The IWCP is basically a grace period giving licensees a chance to catch up with their compliance with the AER's suspension and abandonment requirements.
Orphan Well Association

The Orphan Well Association (OWA) is a not-for-profit organization operating under the delegated authority of the AER to manage the abandonment and reclamation of upstream oil and gas orphan wells, pipelines, facilities and their associated sites.

**What is an orphan?** It is a well, pipeline or facility which does not have a legally responsible or financially capable party to satisfy the abandonment and reclamation obligations (ARO).

**Who does the work?** The OWA engages contractors to perform the necessary work to properly abandon and/or reclaim the orphan.

**Who pays?** All costs and expenses are paid out of the Orphan Fund Levy. However, the Defaulting WIPs are not released from liability with respect to those costs and the AER has an action in debt for the recovery of such costs.
Orphan Well Association

Under Part 11 of the *Oil and Gas Conservation Act*, the AER is entitled to collect the Orphan Fund Levy on behalf of the OWA from licensees. Each licensee pays an amount calculated as follows:

\[
\text{Levy} = \frac{A}{B} \times \text{Total Levy}
\]

where

- A is the licensee's or approval holder's deemed liabilities for all facilities, wells, and unreclaimed sites included within the LLR and OWL programs, and
- B is the sum of the industry's deemed liabilities for all facilities, wells, and unreclaimed sites included within the LLR and OWL programs.
Liability of Solvent Entities

- *Oil and Gas Conservation Act/Pipeline Act*
  - Past or present working interest participants may be liable ("a person who owns a beneficial or legal undivided interest in a well or facility")
  - AER Section 106 Orders against directors, officers, agents or others directly or indirectly in control of the WIP at the time of contravention of the Act

- *Environmental Protection and Enhancement Act*
  - Much broader scope of parties potentially liable
  - Person who owns or controls all or part of a beneficial or legal interest in an activity
  - Successor and assignees of such persons or persons acting as principal or agent

- Note that these liability provisions are not "new"
Redwater: The Basics
The Facts:

- Redwater Energy Corp. (Redwater) held 19 producing and economic wells, 72 uneconomic wells and facilities.
- Redwater was ordered into receivership and later bankruptcy by its principal secured creditor, Alberta Treasury Branches (ATB) who appointed Grant Thornton as receiver and trustee (the Receiver).
- The Alberta Energy Regulator (AER) required a security deposit before approving any sale of Redwater's assets.
- The Receiver reacted by renouncing or "disclaiming" any interest it held in the uneconomic wells pursuant to the Bankruptcy and Insolvency Act (BIA).
- The AER reacted by issuing Closure and Abandonment Orders (Abandonment Orders) against Redwater.
- The Receiver took the position that it would not comply with the Abandonment Orders as it had renounced the uneconomic wells and as such had no obligations in respect thereof.
- The AER argued the Receiver was a "licensee" so must comply with all aspects of the regulatory regime, including the Abandonment Orders and posting any security in connection with any well license transfer.
A Financial Picture of Redwater's Assets

<table>
<thead>
<tr>
<th>Wells</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>19 producing/economic wells</td>
<td>$4.1 million</td>
</tr>
<tr>
<td>72 non-producing/uneconomic wells</td>
<td>&lt;$4.7 million&gt;</td>
</tr>
<tr>
<td>Consolidated</td>
<td>&lt;$0.6 million&gt;</td>
</tr>
</tbody>
</table>

The Receiver and ATB tested the following questions in Court:

- Can the 19 producing/economic wells be sold and the uneconomic wells be left behind?
- If so, who gets the money?
Court of Queen's Bench of Alberta (May 2016 Decision)

- The Court held:
  - The doctrine of federal paramountcy dictated that the Receiver had the ability to renounce the uneconomic wells and the AER was not entitled to require a deposit when assets were sold
  - Forcing compliance with abandonment orders would upset the priorities of the BIA resulting in a super-priority for the environmental claims

- The AER appealed the decision and increased the LMR requirements for a transferee of licensed assets from 1.0 to 2.0

Court of Appeal of Alberta (April 2017 Decision)

- The majority of the Court upheld the lower court judgment, with a strong dissent from Justice Sheila Martin
Supreme Court of Canada (January 2019 Decision)

- 5:2 Split Decision
- "Bankruptcy is not a license to ignore rules"
- The AER's use of its statutory powers to regulate the oil and gas industry and defray the public cost of unfunded abandonment and reclamation obligations (ARO) does not conflict with the federal bankruptcy regime
- The AER is not a creditor as it was enforcing regulatory obligations, not seeking repayment of a debt
- Even if the AER were to meet the test for a creditor, Redwater's ARO was too remote and uncertain to attach a monetary value to it
- As the AER wasn’t a creditor with a claim provable in bankruptcy, its "claims" for compliance with the Abandonment Orders and posting of security deposits for transfers operate outside of the priority scheme of the BIA
Oil & Gas Insolvency Proceedings: Before, During and After Redwater
Example Timeline of a Receivership

- **Debtor in distress**
- **Creditor sends Notice of Intention to Enforce Security**
- **Receivership Order granted**
  - Stay of Proceedings in effect
- **Sales Process Order granted**
- **Receiver takes control**
- **Sales Process**
- **Approval and Vesting Order(s) granted**
- **Approved Deal(s) Closes**
- **AER grants license transfers (if operated assets sold)**
- **Distribution of Funds and Discharge Order granted**
- **Receiver discharged**
- **Defunct Debtor 'exists' but no principals**
Insolvency Proceedings Before Redwater

- The AER had the ability to block any sale by not approving well license transfers
- The AER would not approve sales unless the purchaser acquired the uneconomic assets or posted a security deposit.
  - This significantly reduced the amount available for the creditors as either (i) the purchase price was reduced or (ii) a portion of the sales proceeds were diverted to the AER as a deposit.
- The parties worked with the AER to negotiate license transfers and security deposit amounts
- Where no deal could be struck, all of the assets would end up orphans
- Strategic receiverships occurred (i.e. over only non-operated assets or over select high value assets outside Alberta where local regulatory requirements met)
Insolvency Proceedings After the Redwater Lower Court Decisions

- Receivers and trustees sold the valuable assets only, and disclaimed the uneconomic assets
- The AER no longer had the ability to block sales by requiring deposits or refusing well license transfers, and in fact the Court ordered the AER to effect the well license transfers
- The money from the sales went to the secured lender in priority to the AER
- The receiver or trustee disclaimed the uneconomic assets, which became the responsibility of the Orphan Well Association
Insolvency Proceedings After the Redwater SCC Decision

• The AER is entitled to enforce the regulatory scheme against the receivers/trustees as a licensees, including refusing to approve the transfer of assets and/or attach conditions to such transfers

• The AER is entitled to issue and enforce any Abandonment Orders against trustees and receivers

• Any current insolvencies with sales proceeds will likely have to apply those proceeds towards compliance with Abandonment Orders before any distribution to creditors can occur

• If the sales proceeds are insufficient to satisfy the cost of compliance with Abandonment Orders against assets in receivership or bankruptcy then:
  – Secured creditors will not recover any proceeds
  – The receiver/trustee will not be held personally liable for any shortfall
  – Remaining wells will go to the Orphan Well Association
Redwater: Potential Implications
Implications for Lenders

• Reduction in lending, tightened existing credit and/or increased fees to offset risks of recovery in an insolvency situation

• Revised methods of calculating the ARO grind on lending value
  – Quantifying AROs is inherently uncertain

• Secured lenders may want to avoid bankruptcies and receiverships and prefer informal enforcement or collection proceedings (terminate credit, allow company to "keep the lights on", sweep excess cash until other creditors or the AER shuts company down)
Implications for Lenders – continued

• Increased scrutiny of the borrower’s ARO situation and reclamation activities
  – New positive covenants to reclaim, report, maintain LMR above a certain number, others?
  – New reporting obligations of ARO activities, plans and compliance reports
  – New financial covenants (i.e. a new ratio) similar to LMR?

• Require borrowers to obtain third party performance bonds in respect of their reclamation obligations (similar to the mining industry in Alberta) however the complexities of this response prompted rejection in the past

• Priority agreements with the AER? No DIP financing without a priority agreement with the AER?
Implications for Regulators

• Unsold wells fall to Orphan Well Association – there may be more if the "good" assets cannot be sold due to a lack of appetite to run an insolvency proceeding, LLR restrictions on transfers and transaction closing risk

• Directors or officers could be held liable and thus vulnerable to sanctions under s 106 of the Oil and Gas Conservation Act

• Ball is in the AER's court to:
  • Provide policy guidance to receivers and trustees on liability for fees and post-bankruptcy creditors
  • Modify the current LLR regime (review is underway)
  • Clarify and enforce abandonment and reclamation timelines
Implications for Government

• Parliamentary reconsideration of the intersection of the BIA with Alberta's regulatory regime

• Potential protection for the costs and fees incurred by service providers assisting in an insolvency process (professional advisors including receivers/trustees, legal advisors, operations service providers, investment banks)
Implications for Trustees/Receivers

• May refuse appointment over oil and gas companies unless they receive a full indemnity from the appointing creditor

• Will need to negotiate asset sales with the AER

• May be appointed by the AER to monetize producing assets and use the proceeds to pay for reclamation of the remaining assets
Implications for Industry Participants

• Prepare for potential regulatory changes
• Reach out to trustees/receivers, even where they have disclaimed assets
• Dealing with insolvent partners
  • Look to your agreements
  • Know your partner
• Increased due diligence for acquisitions and divestitures
Questions?

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