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The Impact Of Changes To The AER's LMR System On M&A Activity

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As oil and natural gas mergers and acquisitions ("M&A") advisors, we are regularly asked *"What impact has the Alberta Energy Regulator's ("AER") changes to the Liability Management Rating System ("LMR") had on M&A activity?"* The short answer is that although all of industry saw the train coming down the tracks, little could be done to mitigate the impact, and the effect of changes to the LMR system have been significant.

In 2012 the AER implemented changes to the LMR system which, in summary, required operators to increase the size of the deposits that were on account with the AER to satisfy the obligation of abandoning non-productive wells and reclaiming those wellsites. The requirement for a deposit is based on a means test applied by the AER, which in effect computes the AER's assessment of the financial stability of an operator based upon the ratio of currently economic wells which it operates to the non-producing or uneconomic producers in its portfolio.

The intent of the changes to the system was to mitigate the potential cost to the public treasury of dealing with the increasing cost of the abandonment of orphaned wells and the restoration of those wellsites. Due to the increased number of companies which the AER deemed to be at risk of being in financial distress, the regulator obviously saw the need to increase its security position.

The main reason that the changes to the LMR system have had such a negative impact on industry, particularly the junior sector, is that the changes have come at a time when the sector is starved of capital. Equity markets, which have been the primary source of funding for junior oil companies, have been effectively closed to juniors for a prolonged period of time. In the past couple of years, only a select few juniors have been able to raise funds in the public markets.

Absent the ability to raise new funds, many junior companies ran up their debt levels, often right up to the limit of credit allowed by their lenders. When the price of oil crashed late last year, cash flows fell dramatically, severely impairing the ability to service the increased debt levels. With reduced asset values due to lower commodity prices, lending values have also suffered a corresponding drop. Few loans have been called, though, as it has been noted that since the drop in the price of natural gas in 2008 and the subsequent drop in the price of oil in 2014, most lenders have appeared to be loath to act harshly on their clients, apparently following the old lending credo that *"a rolling loan gathers no loss"*.

The end result of the increased levels of debt, coupled with decreasing commodity prices and increased demands for deposits from the AER is that a number of junior companies have been left in the unenviable position of having unsustainable levels of debt, marginally economic production and an invoice from the AER.

Companies which are effectively out of money are in no way able to comply with the AER's demands for increased deposits. This could result in closure orders, further hindering the financial situation of the subject company, and also possibly placing the security of the lender's credit at risk. With producing wells shut-in and potentially being placed in second position behind the AER, lenders could be left in a position of being unable to execute on the security held for the loan.

Many companies which are in situations similar to those described above have entered into processes to *"explore strategic alternatives available to enhance shareholder value"*. Unfortunately for the stakeholders in these entities, the viable alternatives are few and far between for a company with too much debt, too little cash flow, a collection of wells in need of abandonment and a deposit

owing to the AER. The *"logical buyer"* for such an entity is another junior; however there are few juniors that are in the position of being able to take on additional financial and operational liabilities in these unsettled times.

Since the implementation of changes to the LMR system, the **Alberta Oil and Gas Orphan Abandonment and Reclamation Association** (the "OWA") has taken possession of hundreds of orphan wells from a growing list of companies that includes, as the most generous contributors to the OWA, **Cougar Oil** and **Gas Canada Inc.**, **Fairwest Energy Corporation**, **PetroGlobe Inc.**, **Stealth Ventures Inc.**, **Tallgrass Energy Corp.** and **Winter Petroleum Ltd.** The current count of orphan wells to be abandoned which the OWA has in its possession stood at 705 as of April 7, 2015, roughly 75% of which have come from the previously-listed six companies.

Increased awareness of the current and future cost of dealing with non-productive wells has been migrating into the M&A marketplace for years. Several years ago, most purchasers of assets appeared to pay little attention to the cost of dealing with future liabilities. Regardless of the number of non-producing wells, assets generally changed hands for prices based solely on the value of the producing wells.

A few years ago we started to notice increased purchaser awareness of future liabilities. Many prospective purchasers were interested in purchasing only assets with few liabilities. A few savvy purchasers made offers to purchase that excluded liability wells from the property. As the LMR changes came into effect, the purchaser awareness has evolved to the point where acquiring shut-in or abandoned wells is a rare occurrence.

Some vendors with LMR issues have asked potential purchasers to acquire non-producing wells, sometimes outside of the area of interest, in order to conclude a transaction. This request is almost always unsuccessful, as agreeing to it would not improve the prospective purchaser's LMR. In some instances, prospective purchasers have apparently been told that there is no deal to be done if the "extra" wells are not acquired along with the wells of interest. In those instances, a transaction is rarely concluded.

Some vendors have reacted to the changes pro-actively. The latest evolution in the M&A marketplace has seen some vendors actually isolating liability wells from the properties which they want to sell, recognizing that the only way to sell the property is to ultimately deal with the

obligations themselves. Not all vendors can do this, as retaining liability wells while selling producing wells in many instances will put a vendor's LMR ratio off side, leading to a requirement to forward a deposit to the AER.

Some astute junior companies with healthy LMR ratios have been able to take advantage of the changing regulations to enter into transactions which otherwise might not be available to them. As an example, consider a small, private entity with a number of operated wells in various areas, with no real focus area. The former market for such a company to sell to might have been extremely limited, even if the company's wells are long-life, low rate wells, due to the lack of focus and lack of upside.

With a positive LMR, that entity would find that a similar entity, with decent assets but a slightly negative LMR could actually acquire the entity with positive LMR and then improve its ratio to the point where it might actually be able to get a reimbursement from the AER of a portion or all of its deposit. In essence, the company with positive LMR can use its positive ratio as an equivalent to cash in an M&A transaction. The company with no upside is able to merge into an entity with more upside for its shareholders, and the surviving entity is able to improve its current financial situation by reducing its obligation to the AER.

The changes to the LMR system have also increased interest from some junior companies in acquiring non-operated properties. While operatorship has historically been a jewel in the crown, many companies are revisiting the necessity of retaining operatorship. As the ratios used by the AER apply only to operated wells, having a non-operated position can be more attractive than it has been in the past.

Being a non-operator can work well if the operator of the property is financially stable; however, things can change for the worse if this is not the case. The impacts of holding a minority working interest in a property which is operated by a company which is offside with the AER are many, too many to discuss in detail in this article.

In summary, the M&A marketplace has been evolving to accommodate the changing requirements relating to the handling of non-productive wells. Unfortunately for some companies, the costs associated with these changes have been too much to handle during these challenging times. For others, the ability to recognize the impacts and effects of these changes, and to act accordingly, can present interesting opportunities on the M&A front.

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