

Daily Oil Bulletin

COPYRIGHT OF THE DAILY OIL BULLETIN 2015

LMR: Has The Baby Been Thrown Out With The Bath Water?

SEPT. 30, 2015 – [VIEW ISSUE \(/HEADLINES/2015-09-30\)](#)



Alan W. Tambosso, P.Eng. P.Geol.
President, Sayer Energy Advisors

In April, Sayer penned an article for the *Daily Oil Bulletin* titled “*The Impact of Changes to the AER’s LMR System on M&A Activity*” (DOB, April 29, 2015 (<http://www.dailyoilbulletin.com/article/2015/4/29/impact-changes-aers-lmr-system-m-activity/>)). To follow up that article, today we will look at the collateral financial damage that may have occurred to the public treasury as a result of the changes.

In July 2012, the **Energy Resources Conservation Board** (“ERCB”), now known as the **Alberta Energy Regulator** (“AER”), implemented changes to the Liability Management Rating System (“LMR”) which, in summary, required operators to increase the deposit amounts that were on account with the AER in order to satisfy the obligation of abandoning non-productive wells and reclaiming those wellsites.

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 licensees which the AER deemed to be at risk of being in financial distress, the regulator obviously saw the need to increase its security position.

Companies which cannot satisfy the LMR’s ever increasing demands for deposits may ultimately be served with a closure order, an order to shut-in **all** of the wells operated by the licensee, whether individual wells are at that time economic to produce or not. Additionally, the AER will generally not approve the transfer of any licences from a licensee that has an LMR of less than 1.0 (i.e. a licensee whose deemed liability value exceeds its deemed asset value) or if such transfer results in the licensee’s LMR dropping below 1.0.

The end result of these policies is that once a licensee gets into a negative situation with the AER it is extremely difficult for it to get out of that situation. Operating income from the licensee's operated wells is reduced to nil due to the closure order; a property sale is out of the question unless the company can find a purchaser to take all of its operated liabilities along with the formerly producing wells; finding equity financing for an entity to get out of an LMR problem is a non-starter as is securing additional bank financing for payment of abandonment deposits.

The inevitable consequence has been an increasing number of companies which have involuntarily "donated" wells to the **Orphan Well Association** ("OWA"), an independent not for profit organization that operates under the delegated authority of the AER. The stated purpose of the OWA is "*to manage the abandonment and reclamation of upstream oil and gas orphan wells, pipelines, facilities and their associated sites.*"

A review of information available through various sources on the OWA's website reveals some interesting but not surprising statistics.

Since the ERCB implemented changes to the LMR system in July 2012, the OWA has acquired an ever-increasing number of orphan sites (wells, pipeline segments or facilities), as broken out in the table that follows. In the latest fiscal year, which ended on March 31, 2015, the OWA more than quadrupled its year-end orphan well count from the previous year, taking in 591 wells and holding 705 orphan wells in inventory at year-end. At August 26, 2015 (the date of the most recent report published by the OWA), the total count of orphan wells to be abandoned was 695.

The data for periods prior to the fourth quarter of 2012 is not broken down between wells, pipelines and facilities, because, according to a representative of the OWA, "*Wedidn't previously report on new properties added into the program or on pipelines and facility inventory because the counts were so small and not as significant as the wells*".

FISCAL YEAR	INVENTORY AT FISCAL YEAR-END (March 31)			
	ORPHAN WELLS	ORPHAN SITES	ORPHAN PIPELINES	ORPHAN FACILITIES
2014/2015	705	451	730	53
2013/2014	162	416	121	13
2012/2013	74	387	76*	10*
2011/2012	14	389	detail not provided	detail not provided
2010/2011	detail not provided	388	detail not provided	detail not provided
2009/2010	detail not provided	435	detail not provided	detail not provided
			* estimated	

Roughly 75% of the 591 wells which the OWA took possession of in the 2014/2015 fiscal year came from six companies, **Cougar Oil and Gas Canada Inc., Fairwest Energy Corporation, PetroGlobe Inc., Stealth Ventures Inc., Tallgrass Energy Corp.** and **Winter Petroleum Ltd.** Many of these wells were uneconomic at the time the wells were shut-in consensually or at the time that closure orders were issued; however, many of the wells were still potentially commercial producers at that time.

While the AER, the OWA and the LMR system are not to be blamed for the demise of any of the six entities, it is important to note that the end result of shutting-in many producing wells held by these and other companies has caused the province to potentially forego a significant revenue stream.

As an example, information from the public record shows that Tallgrass' operated property in the Bigoray area of Alberta was producing approximately 180 boe/d (80 bbl/d of oil and natural gas liquids and 600 mcf/d of natural gas) shortly before its wells were consensually shut-in. Tallgrass' operated property portfolio had the capability of producing another 140 boe/d which had been previously shut-in due to operational issues compounded by the company's lack of capital.

Recognizing that not all of Tallgrass' production came from wells on Crown land, as there were some wells with Freehold mineral and/or surface interests, we estimate that the wells in Tallgrass which were producing the 180 boe/d were contributing close to \$2.0 million to the provincial purse annually. Once the wells were shut-in and subsequently passed on to the OWA, this revenue stream to the province dried up.

Estimated Annual Government Revenue Generated from Tallgrass' Production at Bigoray

Crown Royalty \$ 1,500,000

Property Taxes \$ 150,000

Crown Rentals (mineral lease, surface lease) \$ 50,000

Regulatory Fees \$ 30,000

Income Taxes from Field Operators etc. \$ 50,000

TOTAL \$ 1,780,000

We understand that Tallgrass had a deficiency of approximately \$5.0 million in its LMR account, having put close to \$1.0 million down with roughly another \$5.0 million owing. Had a third party been allowed to accept the transfer of the licences from some or all of the producing wells while they were still actively producing, the AER could have received some capital to reduce this deficit, the province would have continued to receive its significant revenue stream as detailed above, and the OWA would not have inherited all of the 67 wells which it received from Tallgrass.

As far as revenue to the province, all is not lost, however. Once wells are in the OWA, it appears to be a fairly straightforward procedure for a third party to acquire the wells and to ultimately reinstate production. To summarize the process, to acquire a well from the OWA a company must acquire the mineral rights to the subject land, acquire the surface rights in order to be able to produce the well, apply to the AER for a well licence transfer and pay a transfer fee of \$10,000 per well to the OWA via the AER. Here is an outline of the complete procedure, as taken from the OWA's website:

The AER processes applications for transfer of well licences, even those for orphan wells. Therefore, any party wishing to acquire an orphan well has to apply to AER in accordance with section 24(6) of the Oil and Gas Conservation Act to request that the Board direct the transfer of the well licence. It is the Enforcement Section of the Corporate Compliance Group that processes Board Directed Transfer applications. The application comes with a fee of \$10,000 per licence in accordance with section 17.010(d.1) of the Oil and Gas Conservation Regulations. The money is paid into the AER but ultimately flows to the Orphan Well Association to help fund the abandonment and reclamation of orphaned sites. Please contact LiabilityManagement@aer.ca (<mailto:LiabilityManagement@aer.ca>) or the Liability Management helpline at (403) 297-3113 for more information.

A party wishing to hold a licence for an orphan well has to qualify to be the licensee of the well by having the right to the purpose to the wellbore (i. e., normally an active mineral lease, but can be the right to produce water or the right to inject or dispose into the well), and having the right to access the surface of the well site (i. e., a valid surface lease).

If the well is attached to an expired Crown Mineral lease, then the party wishing to acquire the well licence also has to apply to the Department of Energy for the right to the wellbore. This is normally an administrative process which the Department of Energy typically approves once it is satisfied that the AER will transfer the well licence to the same party.

The question being asked daily by industry is, why must the wells first be shut-in and then transferred to the OWA before a third party can accept the transfer of the well licences? Why can't certain wells be transferred, even prior to a company going under and prior to the wells being shut-in, while there is a positive revenue stream to the province and others? Would the province not be better off to keep the wells producing, therefore possibly allowing the companies that operate them to remain solvent?

In discussing LMR issues with one industry veteran recently, he answered these questions with a question of his own. "Orphans are created by killing the parents. Why can't we keep the parents alive and thus avoid creating more orphans?"

Perhaps the best summary analysis of the entire affair comes not from a seasoned oil industry veteran in Calgary, but from a non-oil and gas accountant from another Alberta city. In response to her question to Sayer about what the LMR system is all about, she received very detailed explanation of how and why the system was implemented and how it was and was not working. She then summarized it in a few words, which are fitting as the last words of this article. "Oh, I get it. The government was concerned that they might have to abandon a bunch of wells in the future if some companies went broke, so they put a system in place that resulted in the province getting all of those wells a whole lot sooner."

ARTICLE SECTION: [MARKET INTELLIGENCE \(/SECTION/MARKET-INTELLIGENCE/\)](#)

ARTICLE CATEGORY: [ANALYSIS \(/CATEGORY/ANALYSIS/\)](#)