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Analysis: Collateral Damage Caused By The Alberta Energy Regulator's Response To The RedWater Decision

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In advance of the well-publicized decision of the Alberta Court of Queen's Bench regarding the matter of the disposition of the assets of insolvent **RedWater Energy Corp.** ("RedWater"), the **Alberta Energy Regulator** ("AER") fired a shot across the bow of oil and natural gas producers, as well as the officers and directors of such entities, by issuing **Bulletin 2016-10** on April 8, 2016. The stated purpose of Bulletin 2016-10 was "*to remind licensees and their directors and officers of their statutory responsibilities when ceasing operations because of insolvency or for any other reason*."

As a direct response to the RedWater decision, the AER launched a missile which was clearly aimed at the engine room by issuing **Bulletin 2016-16** on June 20, 2016. The latest Bulletin listed certain regulatory changes, with the stated purpose "*to minimize risks to Albertans*."

In subsequent interviews with the media, the AER has acknowledged its recent changes to the regulations may "*inconvenience some stakeholders*." That short quote is Sayer's nominee for the understatement of the century.

The latest amendments to the regulations seem to be poorly thought out and appear to have been rushed out without any understanding as to what the true magnitude of this "*inconvenience*" will be to stakeholders. Remember, the stakeholders include not only oil and natural gas companies and their lenders and suppliers, but also the citizens of Alberta.

We understand that the AER intends these to be interim measures, pending the earlier of a decision on its appeal of the RedWater decision or the implementation of appropriate regulatory measures. To that end, we present herein the views of an advisory firm that has extensive experience in dealing with the marketing of oil and natural gas assets and companies on behalf of both solvent and insolvent entities. We trust that our advice will be considered by the AER in the implementation of further regulatory measures.

The view of Sayer Energy Advisors is that the regulations announced in Bulletin 2016-16 will cause the **Alberta Oil and Gas Orphan Abandonment and Reclamation Association** ("Orphan Well Association" or "OWA") to inherit, in the very near term, significantly more liabilities than would have been the case if the regulatory changes announced in Bulletin 2016-16 had not been made. Many stakeholders, namely the citizens of the Province of Alberta, should be concerned by this "*inconvenience*", which will ultimately cost the Province a lot of money.

Our view is shared by the law firm of **Burnet, Duckworth & Palmer** ("BD&P"), which issued an opinion on the impact of the regulatory changes shortly after the AER released Bulletin 2016-16. In its release, BD&P stated "… *we are of the view that Bulletin 2016-16 has the real potential to cause an acceleration of assets finding their way into the Orphan Well Association when good faith transactions cannot be completed due to the impact of the interim regulatory measures described above*."

With a recent history of working with over 40 oil and natural gas companies in receivership, CCAA, Bankruptcy and Insolvency Act ("BIA") or other restructuring processes, Sayer has a wealth of experience and knowledge relating to selling assets from distressed companies. Through years of working through such situations we understand that in order to maximize the returns for all stakeholders, a collaborative effort is required. Bulletin 2016-16 does not appear to show the AER as being willing to provide substantial collaboration, at least in the near term.

Over the past few years, we have noticed that prospective purchasers have been more reluctant to acquire shut-in or uneconomic wells as part of an asset purchase than purchasers were in the more distant past. This awareness has in large part resulted from the increased burden on holding uneconomic wells in the portfolio since the ERCB (now the AER) implemented changes to the **Liability Management Rating System** ("LMR") in July 2012. This indicates that the LMR program has generally been achieving its intended purpose.

The case of RedWater Energy Corp. and its implications

At the time it went into receivership, RedWater had very few assets which were worth acquiring. Parties that might have been interested in buying any assets out of the company would have been hamstrung by the regulations which stipulated that the only way the AER would approve the transfer of a well licence from a company in receivership would be if the purchaser acquired **all** of the company's operated assets.

We understand that the secured creditors of RedWater and the receiver believed that, absent a structural change in procedure, nothing could be sold out of the company, as there were no assets with enough value to cover the cost of acquiring the liabilities that had to be taken on as well. This led to the legal challenge of the AER's regulations and the subsequent RedWater decision.

As evidence came out in the RedWater trial and as shown in Bulletin 2016-16, the AER appears to have missed the point, in that "*cherry picking*" assets from an insolvent company means that the OWA does not ultimately get **all** of the wells owned by the insolvent company, only **some** of the wells. Conversely, if the sale of certain assets is not allowed, then it is likely that the OWA **will get all** of the wells that an insolvent company operates.

Bulletin 2016-16 pretty much guarantees that in most receivership situations, **all** of the wells operated by an insolvent company will be going to the OWA, which does not necessarily need to be the case. We believe that a better resolution would involve a pre-set formula to divide amongst the

AER and the creditors the proceeds from the sale of any of the assets of an insolvent company. The need for a pre-set formula is so that prospective purchasers of the assets have certainty going in that they can actually conclude the acquisition with AER approval, prior to committing time and capital to evaluating the subject assets.

We could cite numerous examples of the carnage that will land on the laps of the AER and the OWA in the very near future as a result of Bulletin 2016-16; a few current ones follow.

Insolvency case 1

This company sold many of its larger assets prior to going into receivership, paying out much but not all of its indebtedness. At that time, the residual assets had an LMR value significantly greater than 1.0, positive operating income and were considered saleable. With time, the residual assets could not support ongoing operations and had value less than what was needed to pay out the remaining debts of the company, leading to the eventual receivership.

Through the receivership process, due to routine field operation issues, declining natural gas prices, etc., many of the company's wells became uneconomic and were shut-in. Eventually the company's LMR value slipped below 1.0. In spite of this worsening situation, an offer to acquire all of the remaining assets of the company was recently negotiated, with the understanding that the purchaser would need to put an additional $3 million (approximately) on deposit with the AER to get the LMR value back to 1.0.

In order to get the LMR value to 2.0, as per the requirements of Bulletin 2016-16, the purchaser would now need to forward approximately $23 million to the AER. As a result of this, absent a grandfathering of the transaction, as the transaction was contemplated prior to the release of Bulletin 2016-16, the deal could easily die.

If the transaction that is in hand dies, our belief is that the OWA will soon after be getting all of the wells from the insolvent company, and it has **over 200 operated wells in its portfolio.** None of the 200+ wells should end up in the OWA, as there was a deal in hand to sell them all prior to the release of Bulletin 2016-16.

Insolvency case 2

This company is involved in a process to make a proposal to its creditors under the BIA. An offer to acquire all of the company’s assets was accepted prior to the issue of Bulletin 2016-16 and the purchaser has recently been actively conducting its due diligence.

The purchaser is an entity that has been operating oil and natural gas wells in Alberta for many years; however, its LMR value is slightly below 2.0. In order to conclude the transaction, according to Bulletin 2016-16, it must now, absent a grandfathering of the transaction, forward a significant deposit to the AER. If it does, none of the insolvent company’s operated wells will go to the OWA.

If the prospective purchaser does not wish to forward additional funds to the AER, or if it does not find another way to conclude the transaction, the insolvent company could end up in receivership with its **50+ operated wells ultimately likely heading to the OWA**.

Insolvency case 3 (Hyperion Exploration Corp.)

The shares of **Hyperion Exploration Corp.** were acquired by a subsidiary of a non-resident corporation on January 9, 2015. Minimal capital was put into the company subsequent to the purchase, resulting in a deterioration of the value of the assets. The company went into receivership on November 19, 2015, less than a year after the change in ownership. All of the company’s assets were recently sold to an active local oil and natural gas producer.

We mention this case because the end result would have been different if the sale process was ongoing subsequent to the issue of Bulletin 2016-16. As the purchaser’s LMR value was less than 2.0 at the time of the sale, Hyperion’s 47 operated wells would most likely have ultimately ended up in the care of the OWA, even though they were capable of economic production and were of enough interest that a third party acquired them out of a receivership sale.

The general feeling of the public seems to be that as the problem of an increasing number of orphan wells was created by industry, it is a problem that industry should be paying to fix as opposed to tapping the public purse. The government of the Province has “*a multi-layered process to ensure environmental laws are followed. The fundamental principle is that, in Alberta, the polluter pays …*”

Bulletin 2016-16 appears to be a poorly conceived and ill-timed attempt by the AER to appease the public by basically arranging for significantly more funds to be put into the OWA by industry in general, not specifically “*the polluter*”. As shown in the three previous examples, and many more too numerous to mention, it could easily make the situation much worse.

The financial situation of the Province will be impaired due to the fact that the onerous requirements of Bulletin 2016-16 will ultimately cause more companies to be forced to cease operations. With fewer qualified buyers, many of the wells from these companies will ultimately wind up in the OWA. These wells would, in many cases, be otherwise capable of generating revenue for the Province, through royalties, fees, taxes, etc. Many of these wells, absent the requirements of Bulletin 2016-16, could have been sold to other entities without any cessation of production.

The AER's monthly "*Liability Management Programs Results Report*" dated June 6, 2016 shows that there are currently only 219 companies with LMR values above 2.0, with 569 companies having LMR values below 2.0. Of the 219 companies that would now qualify as buyers with the AER, we see only about one third of these, or roughly ten percent of the total of all licensees, as being potentially active purchasers. The balance of qualified buyers are large entities which have not historically been active acquirers, companies with extremely focused asset bases, companies in financial distress, smaller companies with no history of being active purchasers of operated assets or service companies such as operators of disposal facilities.

If companies with LMR values of less than 2.0 cannot acquire AER-licensed assets without taking measures as specified in Bulletin 2016-16, the field of prospective purchasers will become so depleted that there will not be many companies left which will be able to conclude significant acquisitions. In addition, as acquisitions have always been a key part of the sustainability and growth of active companies, many companies with LMR values above 2.0 will eventually see their ratios drop below the magic threshold, further limiting their potential to grow through acquisition as well.

In addition to the issues created with insolvent companies, Bulletin 2016-16 appears to make it difficult for companies that otherwise were not in any financial distress to do business, potentially hindering their future growth. The revised regulations will adversely affect the entire oil and natural gas mergers and acquisitions ("M&A") market as it is extremely difficult to see how M&A transactions can now proceed in a timely, cost efficient manner.

The AER's June 6, 2016 report shows the following companies as a few examples of the 569 companies with current LMR values of less than 2.0, therefore making them ineligible to accept well licence transfers under the new regulations, status quo. Does anyone really believe that **Bonterra Energy Corp.** (LMR 1.74), **Cenovus Energy Inc.** (LMR 1.65), **NAL Resources Limited** (LMR 1.74) or **TAQA North Ltd.** (LMR 1.99) pose a threat to the public purse if they acquire additional oil and natural gas wells? Apparently the AER does.

The AER recently indicated in discussions quoted in the media that it is willing to work with prospective acquirers of assets, on a case-by-case basis, when there is a proposed transaction that will result in the acquirer having an LMR value less than 2.0. The issue with this is that there are few, if any, companies which will commit time and capital to a potential transaction without assurance, in advance, that they can actually get the required AER support to conclude the transaction.

Similarly, few vendors will accept an offer to purchase without knowledge that the prospective purchaser has pre-clearance from the AER to conclude the transaction. Will the AER be able to pre-clear, on a timely basis, all prospective purchasers involved in all M&A transactions? In an industry that in the past five years has seen total M&A values ranging from $14 to $55 billion annually, it is not hard to imagine the strain that this will put on the resources of the AER.

We question the motivation of the AER and fairness to industry in taking the drastic step of jumping the LMR value requirement from 1.0 to 2.0 overnight, then subsequently mentioning in media interviews that transactions can be reviewed on a case-by-case basis upon request. We believe that a more gradual increase of the LMR value requirement over time, with advance warning, would have caused less chaos and confusion.

The citizens of the Province of Alberta own 81 per cent of the Province's oil, natural gas and other mineral resources. The **Alberta Department of Energy** ("Alberta Energy") "*manages the sustained development of these resources in a responsible manner that maximizes long-term benefits to the province*". The AER was formed as a corporation inside Alberta Energy "*with a mandate to provide for the efficient, safe, orderly, and environmentally responsible development of Alberta's energy resources"* (quotes taken from Alberta Energy's and the AER's websites).

To summarize the structure, we Albertans own the resources. On our behalf, the Province, through the AER and other various organizations, sub-contracts the extraction of these resources to companies which pay the Province, through the AER etc., significant fees and royalties for the right to do so, some of which are detailed as follows:

1. Fees to acquire the right to extract the resources, through land sale bonus bids;
2. Ongoing fees to hold the right to extract the resources through annual mineral lease rental payments;
3. Fees to gain access to minerals when on Crown land through bonus payments for surface leases held with the Crown;

4. Fees to access the minerals through drilling a well;
5. Fees to utilize local roads to move equipment in to access the minerals;
6. Ongoing fees to hold the right to access Crown surface land through annual surface lease rental payments;
7. Royalties paid on resources extracted from the leases;
8. Municipal taxes paid on surface equipment used to extract the resources;
9. Annual administrative and transfer fees;
10. Income taxes, corporate and personal, from all associated services and personnel used to extract the resources.

TheOWA is 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*" (source: OWA website). As previously indicated, industry funds all of the costs incurred by the OWA, mostly through an annual Orphan Fund Levy ("Levy").

As a direct result of the AER prematurely sending wells to the OWA, as will happen as a consequence of Bulletin 2016-16, the Province will no longer receive the revenue generated from points 2 to 10 above. In addition, the companies that fund the OWA will be burdened by an increased Levy to cover the cost of dealing with the overwhelming number of wells that will end up in the OWA. Having less available capital to work with, companies will drill fewer wells, spend less at Crown land sales, etc., ultimately further reducing the revenues generated on behalf of the Province.

We understand the thinking behind how the OWA works, and we get it that there is an issue with a large number of orphan wells that need to be dealt with in the Province; however, we believe that Bulletin 2016-16 is going to make things worse. The interim measures will ultimately only accelerate the rate at which wells are moved into the OWA, ultimately costing all stakeholders significantly more.

We are in favour of a go-forward plan that involves input from government, regulators, industry and all other stakeholders, such that a better resolution is achieved. We ask the AER to sit down with all of the affected groups to work through this very, very soon, before the increasing amount of damage is irreparable.

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