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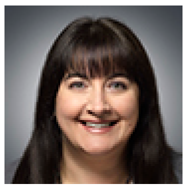
The Alberta Energy Regulator Makes Waves with its Response to the Redwater Decision




By Kathleen Shannon and Bradley McFadden

Highlights

- The Alberta Energy Regulator (AER) issued Bulletin 2016-16 which has put in place interim measures in response to the Court of Queen's Bench decision in *Redwater Energy Corporation (Re)* (*Redwater*)[1]
- The interim measures set out in AER Bulletin 2016-16 are:
  - The AER will consider and process all applications for licence eligibility as non-routine and may exercise its discretion to refuse an application or impose terms and conditions;
  - For previously unused licence eligibility approvals, prior to the approval of any application, the AER may require evidence that there have been no material changes since approving the licence eligibility such as to the directors, officers, and/or shareholders or insurance; and
  - Transfer of existing licences, approvals and permits will now require all transferees to demonstrate they have a liability management ratio (LMR) of 2.0 or higher immediately following the transfer.
- These interim measures will significantly restrict industry participants from buying or selling oil and gas assets and will likely have a chilling effect on new capital investment in Alberta's energy industry
- The pool of prospective purchasers of oil and gas assets from troubled entities has been reduced dramatically and this will likely lead to more orphan wells

Bulletin 2016-16 and the Interim Measures

On June 20, 2016, the AER issued Bulletin 2016-16 setting out interim measures to address the effects of the Court of Queen's Bench decision in *Redwater*. In that decision, the Court held that sections of the *Oil and Gas Conservation Act*[2] and *Pipeline Act*[3] were inoperative to the extent they conflicted with section 14.06 of the federal *Bankruptcy and Insolvency*

Act,[4] which allows a receiver or trustee to renounce the uneconomic assets of a bankrupt energy company. As a result, a receiver or trustee can renounce AER-licensed assets (i.e., wells and facilities) along with their associated abandonment and reclamation obligations and those renounced licensed assets cannot be included in the calculation of the company's LMR.

The interim measures set out in AER Bulletin 2016-16 are:

- All applications for licence eligibility submitted under *Directive 067* will be considered and processed as non-routine, such that the AER may exercise its discretion to refuse the application or impose terms or conditions
- Prior to approval of any application from holders of previously unused licence eligibility approvals, the AER may require evidence that there have been no material changes since approving the licence eligibility. The AER has specifically stated that this may include a consideration of whether the directors, officers and/or shareholders are substantially the same and whether adequate insurance has been maintained
- Transferees will now be required to demonstrate to the AER they will have a LMR of 2.0 or higher immediately following the transfer, prior to approval of any transfer of existing licences, approvals and permits. Previously, under *Directive 006*, both the transferee and transferor were required to maintain a LMR of 1.0 or higher to receive approval of the transfer from the AER. Note that Bulletin 2016-16 does not change the requirement in *Directive 006* that the transferor must maintain a post transfer LMR of 1.0 or higher

These measures came into effect immediately upon the issuance of Bulletin 2016-16 and will remain in effect until the AER's appeal of the *Redwater* decision is complete or until new regulatory measures are implemented. In that regard, the AER also announced that it is working on appropriate regulatory measures to address the impact of the decision and it will work with industry, other stakeholders and the Government of Alberta to develop a regulatory solution.

The Impact

The interim measures put in place by the AER will have a significant impact on individual energy companies, as companies will find it increasingly difficult to buy or sell oil and gas assets, and the industry as a whole. It is likely that the increased costs associated with these changes, as well as the regulatory uncertainty that will exist, may cause capital investment to be directed to projects and opportunities outside Alberta.

The new requirement for transferees of AER-licensed assets to have a post-transaction LMR of 2.0 means that in order for a company to buy AER-licensed assets, the value of its producing AER-licensed assets must now be twice that of the cost of the company's abandonment and reclamation obligations. This doubles the previous LMR ratio of 1.0 and significantly reduces the pool of potential purchasers for AER-licensed assets, as by the AER's own count only 28% of companies currently registered as licensees for AER-licensed assets have an LMR of 2.0 or higher.[5] While companies can increase their LMR to 2.0 by paying increased security deposits with the AER, this simply adds to the overall cost of transactions and the burden of carrying on business. The combined effect of a lower pool of prospective purchasers and the potential for increased transaction costs means that the ability of companies to buy and sell AER-licensed assets will be severely restricted.

These new restrictions on the sale of AER-licensed assets will have a significant impact on many (if not most) junior oil and gas companies as the AER has effectively eliminated a tool these companies can use to manage their LMR. These new rules will severely restrict the ability of companies to sell oil and gas assets in order to either manage their LMR through the disposition of lower LMR assets, or to otherwise strengthen their balance sheets, thus letting them, among other things, manage their exposure to abandonment and reclamation costs. If companies are not able to engage in what were previously standard business transactions in order to address these issues, where else can they turn? If these new restrictions on transactions result in an increased number of companies going into receivership, these new rules may actually have the effect of increasing the number of orphan wells that the Orphan Well Association (OWA) becomes responsible for, which is surely not what the AER wants.

Pending the outcome of the AER's appeal of the *Redwater* decision, the law established by the Court of Queen's Bench in its decision still stands and trustees and receivers are able to renounce and disclaim AER-licensed assets. As a result of the significant LMR changes in the new rules, trustees and receivers may find themselves unable to sell certain AER-licensed assets which they may have been able to sell under the old rules and they will likely renounce any such assets that they believe they may not be able to sell. This could result in many wells that are marginally economic (at current commodity prices), which would have traditionally been sold to and operated by a new (solvent) purchaser, being renounced by the trustee or receiver and left for the OWA to deal with and pay for.

In addition to increasing the cost to purchase oil and gas assets, the fact that new license applications will be processed on a non-routine basis and will be subject to the AER's discretion with respect to approval or additional conditions means that, pending a more formal regulatory solution being implemented, there is significant uncertainty as to the regulatory framework faced by new participants in Alberta's energy industry. Increased costs and regulatory uncertainty may very well serve to scare away new capital investment, as investors seek to deploy their capital in projects outside Alberta. It will take time for new participants to become qualified which will mean they have to go through that process without first having a prospective purchase in hand.

There is little debate among industry or Albertans that industry should be responsible for all abandonment and reclamation costs. However, industry participants will only be able to fulfill those responsibilities if there is a healthy energy industry in Alberta. In light of the collapse of commodity prices over the last few years, the increasing number of insolvencies among energy companies and the continuing financial struggles of many others, one has to question whether new measures which could further harm industry, both through restricting transactions and creating a risk that capital investment will leave for other jurisdictions, actually serve to protect the public interest.

Vendors and purchasers will no doubt be looking for creative ways to do deals in a manner that stays on side of the new rules. The number of corporate transactions as opposed to asset transactions may well increase.

The AER has indicated that it will soon consult with industry in respect of a more formal regulatory framework. We hope that these consultations happen soon and result in balanced regulations which protect the public interest while allowing the industry to recover.

Companies wishing to discuss the impacts of AER Bulletin 2016-16, the interim measures and how companies can address these measures in future transactions are welcome to contact any member of Field Law's Energy Group. Field Law will continue to monitor the AER and OWA's appeal of the Redwater decision, as well as the formal engagement with stakeholders on more permanent regulatory measures.

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[1] 2016 ABQB 278.

[2] RSA 2000, c O-6.

[3] RSA 2000, c P-15.

[4] RSC 1985, c B-3.

[5] http://calgaryherald.com/business/energy/alberta-toughens-regulations-after-court-ruling-on-orphan-wells

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