New liability management framework for oil and gas in Alberta

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Overview

In its continued effort to reduce the number of orphan and inactive wells in the province, the Government of Alberta introduced a new Liability Management Framework in July 2020. In December 2021, the Alberta Energy Regulator (AER) released Directive 088: Licensee Life-Cycle Management, and the accompanying Manual 023, to implement the new framework. Licensees are responsible for ensuring their infrastructure and sites are safely closed and cleaned up. The AER describes the costs associated with this closure work as end-of-life obligations or "liability." The new framework uses a wider variety of parameters to perform a holistic assessment on licensees at all phases of energy development and ensures timely closure. The holistic assessment shows a licensee's risk and performance profile throughout the energy development life cycle. The new framework does not apply to oil sands mines and coal mines.

The AER has commenced a phased transition away from the previous Liability Management Rating (LMR) Program. There is now established closure spend targets for licensees by July of each year, which outline a licensee's minimum obligation to abandon, remediate and reclaim certain oil and gas sites. Several directives relevant to liability management have been amended and more amendments are proposed. As we move towards the second half of 2022, licensees will need to ensure these new requirements are being implemented to avoid enforcement actions. Further to routine compliance, acquisitions or divestitures requiring transfer of licenses, new projects requiring repurposing of wells or sites for alternative use (for example, helium, lithium, geothermal, *etc*.), and insolvency or ceased operations requiring forced sales or care and custody by working interest participants, all trigger holistic assessment under the new framework.

Background

On January 31, 2019, the Supreme Court of Canada released its decision in *Orphan Well Association v. Grant Thornton Ltd.*, popularly known as *Redwater*. At issue was the ability of trustees or receivers to disclaim property or unprofitable oil and gas assets to avoid a company's end-of-life/environmental obligations, including the payment of

security deposits to the regulator to address the obligations. The case was decided under the LMR Program, which the AER discovered, with the Redwater case, was not an accurate measure of whether a company will be able to address its regulatory and liability obligations.

In its decision, the Supreme Court of Canada determined that a regulator exercising a power to enforce a public duty is not a creditor of the individual or corporation subject to that duty. In seeking to enforce the bankrupt company's end-of-life obligations, the regulator is acting in the public interest and for the public good. While a trustee or receiver is not personally liable for claims, they cannot ignore the environmental obligations of the bankrupt estate they are responsible for overseeing.

Liability Management Framework

In July 2020, consistent with the Supreme Court of Canada's decision in *Redwater*, the Government of Alberta launched a new Liability Management Framework.

The framework applies at all phases and throughout the life cycle of energy development, rather than at the end of the project, and includes five key components:

- **Licensee Capability Assessment System (LCA)**, which uses business intelligence to assess the ability of oil and gas operators to meet their regulatory obligations;
- **Licensee Special Action** (now called Licensee Management Program), a proactive support for operators to help manage their assets and maintain operations;
- **Inventory Reduction Program** (plus Area-Based Closure and Closure Nomination), which includes closure spending targets to help reduce inactive wells inventories;
- **Legacy and Post-closure Sites Program**, while yet to be fully articulated, a panel will be established to address legacy and post-closure sites, or sites that were abandoned, remediated or reclaimed before current standards were put in place, as well as sites that have received reclamation certificates and the operator's liability period has lapsed; and
- **Expansion of the Mandate of the Orphan Well Association**, which includes protecting the value of producing assets.

Directive 088 and Manual 023 - Licensee Life-Cycle Management

Directive 088: Licensee Life-Cycle Management (Directive 088) and its companion Manual 023: Licensee Life-Cycle Management (Manual 023) provide new tools to help licensees increase accountability for end-of-life obligations for projects. They also support the implementation of the first three components of the Government of Alberta's framework: Licensee Capability Assessment System (LCA), Licensee Management Program and Inventory Reduction Program.

1. Licensee Capability Assessment System (LCA)

The first component of the new framework, the backbone of the holistic assessment, determines a company's ability to manage its liability obligations. It supports a holistic assessment of licensees that will reoccur at various times as the licensee moves through the energy development life cycle.

It considers six factors to build an overall licensee profile. These factors include financial health, magnitude of liability, remaining lifespan of resources, operational capability, administrative compliance and closure activities. Broadly, the six LCA factors are categorized into and assess two groups of assessment parameters: risk and performance.

The two LCA factors in the risk group are financial health and magnitude of liability. These two risk factors and their parameters are weighed as low, medium and high. The financial health factor assesses the level of financial distress of a licensee. The level of financial distress is then used to calculate a licensee's mandatory spend target.

The magnitude of liability factor estimates a licensee's total magnitude of liability (active and inactive) including abandonment, remediation and reclamation using Directives 001 and 011. In addition, it has monetary thresholds as the risk benchmark. Low magnitude is less than $25 million; medium is between $25 million and $150 million; and high is greater than $150 million.

The four LCA factors in the performance group assess a licensee's performance compared to similar companies in terms of business type, size and production portfolio. Their parameters are weighted and ranked by a tier ranking system - Tier 1, 2 and 3. The four performance group factors are the remaining lifespan of resources, operational capability, administrative compliance and closure activities. The remaining lifespan of resources factor assesses a licensee's mineral resources and infrastructure, the extent to which existing operations fund current and future liabilities, and the timeframe when liability will exceed income potential. Tier 1 is far, Tier 2 is medium and Tier 3 is near.

The operations factor assesses maintenance of infrastructure and sites, and compliance with operational requirements. The closure factor assesses a licensee's rate of closure activities, spending, and pace of inactive liability growth. The administration factor looks at a licensee's compliance with administrative regulatory requirements, including management of debts, fees and levies. Tier 1 means all invoices are paid in full with no penalty, Tier 2 means all others that include penalties and Tier 3 means invoices that are not paid.

These LCA factors have replaced the use of the liability management rating (LMR) and security deposit collection for licence transfers.

2. Licensee Management Program

The second component of the new framework provides tools for the AER to proactively monitor licensees identified in the holistic assessment component to be at greater risk. The AER will undertake specific engagement or regulatory actions with the licensee, including education and compliance assurance measures such as changing licence eligibility under Directive 067, requiring security deposits, or issuing orders.

3. Inventory Reduction Program

The third component of the new framework sets closure spend targets (mandatory targets and voluntary targets) for each licensee in July of each year. These are minimum obligations set for all licensees to abandon, remediate and reclaim their inactive oil and gas sites. Closure spending means reasonable costs actually incurred in the abandonment, remediation and reclamation of a well, facility or pipeline. Eligible costs are costs incurred on inactive and abandoned sites, active sites where a well or facility has been shut in but did not meet the inactive criteria, and abandonment and remediation of pipeline and pipeline installations that results in an abandoned status. Costs incurred for well and facility suspension, pipeline discontinuation, remediation on active sites are ineligible.

Licensees may elect to provide security deposit in the full amount of their mandatory target, instead of meeting the mandatory target through closure work. The AER will determine a threshold for licensees to make election of payment of security in lieu of target closure work. Higher voluntary closure spend target will offer licensees regulatory incentives such as extension of deadline for the removal of surface equipment, and maximum three-year extension for expired Crown mineral lease wells. The AER will publish annual industry-wide closure spending targets for a five-year period.

Area-Based Closure (ABC) is now a part of the Inventory Reduction Program. There is proposed ABC and confirmed ABC. Licensees may submit work proposals under the proposed ABC up to a maximum of five years into the future. Work starting within the current or upcoming year is submitted under the confirmed ABC.

Closure Nomination Program is another component of the Inventory Reduction Program. Starting in late 2022, landowners and others who may qualify can nominate eligible inactive or abandoned oil and gas sites for closure. There appears to be some concern from some stakeholders that this may generate patchwork closure activities that may affect organized closure work under the ABC program. This concern will need to be addressed in the details of rules for the Closure Nomination Program

4. Licence Transfers

Directive 088 has updated the license transfer process. There are two types of licence transfer applications. The first is application submitted by both the licensee and transferee, and the other is application that is part of an insolvency proceeding or under the care of the Orphan Well Association facilitated by the AER in the regulator-directed transfer (RDT) process.

Eligible Licenses for transfer are licences that have status as Issued, Amended, Discontinued, Suspended, Abandoned, RecCertified or RecExempt. Licenses with status of Cancelled or Re-entered are not eligible for transfer. Previously, reclamation certified and reclamation exempt licences could not be part of a transfer application. This has changed under the new framework. The AER may apply discretion to require licensees to include in the transfer, reclamation certified and reclamation exempt licences that are part of an insolvency proceeding, corporate cleanout or white map sale transaction.

A licence transfer application will trigger a holistic assessment of both the transferor and transferee. In addition to the LCA factors, the AER will consider:

- “Unreasonable Risks” in Directive 067;
- New licensee with no history;
- Site-specific risks or designated problem sites;
- Statements of concern submitted;
- Multiple transfer applications or multiple parties involved;
- Repeated transfer of licences;
- Unpaid Crown debt, municipal taxes or surface lease payments; and
- Transfer with the intent to repurpose wells or sites for alternative use (for example, helium, lithium, geothermal, *etc*.).

To offset any potential increase in risk that may arise from a licence transfer, a transferor or transferee may be required, as a condition of approval, to provide a security deposit to the AER.

5. Security Deposits

The AER requires security deposits throughout the energy development life cycle. The maximum amount of security that may be required is the licensee's total liabilities, which includes the cost of providing care and custody, the cost to permanently end operations such as the abandonment and reclamation of the site. A request for a refund or transfer of security will trigger a holistic assessment of the licensee or the transferor and transferee, as the case may be.

Takeaways

The AER has commenced implementing the new liability framework. The key aspects are Directive 088 and Manual 023, which contain important details of the new framework. The new framework outlines certain requirements with specific timelines that require attention in order to avoid a negative licensee profile and enforcement action by the regulator. Mergers, acquisitions or divestitures requiring transfer of licenses, or new projects requiring repurposing of wells or sites for alternative use (for example, helium, lithium, geothermal, etc.) trigger holistic assessment under the new framework.

Insolvency or ceased operations requiring forced sales or requiring care and custody by working interest participants also trigger aspects of the new liability framework. In both *PricewaterhouseCoopers Inc v. Perpetual Energy Inc,* 2021 ABCA 16 and 2022 ABCA 111 and, *Manitok Energy Inc (Re),* 2022 ABCA 117, the Alberta Court of Appeal confirmed that abandonment and reclamation obligations are liabilities for the purposes of determining the financial status or solvency of a corporation. The liabilities are an inherent part of the asset value. While they do not constitute a conventional debt payable to an identifiable creditor, they are accounted for as depressing values on the left-hand side of the balance sheet. They are the obligation of the bankrupt company owed to the public and cannot be ignored by the trustee of bankrupt corporations.

As environmental, social and governance disclosure and reporting obligations evolve, liability management and the rules that govern it take further priority on the agenda of licensees. Affected energy companies are encouraged to consult with their BLG legal advisor to ensure full compliance with the AER’s new liability management framework.

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