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Alberta's energy regulator imposes further restrictions on embattled energy industry in response to Redwater

JUNE 23, 2016 6 MIN READ

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One month after the May 19, 2016 Alberta Court of Queen's Bench's decision in *Redwater Energy Corporation* (*Re*), 2016 ABQB 278 ("*Redwater*"), the Alberta Energy Regulator ("AER") has released Bulletin 2016-16 (the "Bulletin"). The AER (and Orphan Well Association) have appealed the *Redwater* decision to the Alberta Court of Appeal, where it is pending. Effective June 20, 2016, substantive changes were made to the transfer requirements for licensees, and licensee eligibility. The changes were designed to "minimize risks to Albertans" arising from the impacts of *Redwater*, while the AER and the Government of Alberta work to develop "appropriate regulatory measures" to more permanently address *Redwater*. In the meantime, the implications are far reaching for an industry still digesting *Redwater.*

Background

The aspects of *Redwater* that are most relevant to the Bulletin include the determination that a Trustee is permitted to renounce and avoid liability for the costs of abandonment, remediation and reclamation. As dual compliance under the *Oil and Gas Conservation Act*, the *Pipeline Act* and the federal insolvency regime (specifically, section 14.06(4) of the *Bankruptcy and Insolvency Act* ("BIA") is not possible, abandonment orders issued under the provincial legislation are inoperative in respect of the enforcement orders regarding renounced assets. For further discussion of the *Redwater* decision, see our prior update "Implications of the Redwater decision – Where does the buck stop?".

AER has summarized the impacts of *Redwater* as permitting receivers and trustees to "avoid end of life obligations" by disclaiming AER licensed assets "as a means of avoiding abandonment and reclamation obligations that normally attach to AER licenses." (AER Public Statement 2016-01). Most stakeholders agree that *Redwater* creates a significant risk of a substantial increase in the number of disclaimed AER licensed assets that then become the responsibility of the industry-funded Orphan Well Fund.

The effects of Bulletin 2016-16

The interim measures taken by the AER in the Bulletin are as follows:

1. **Closer scrutiny of licensee eligibility:** All applications for license eligibility under *Directive 067: Applying for Approval to Hold EUB Licenses*, will be considered and processed as non-routine, and the AER may "exercise its discretion to refuse an application or impose terms or conditions on license eligibility approval".

2. **Re-review of eligibility on license transfers:** The AER may re-review the license eligibility of existing but previously unused license eligibility approvals prior to approval of license transfer and other applications.
3. **Increased liability ratings required for transferees:** The AER will now require all transferees to have a Liability Management Ratio ("LMR") of 2.0 or higher immediately following the purchase of AER-licensed assets, as a condition of transferring existing AER licenses, approvals and permits.

The LMR is a deemed asset to liability ration calculated pursuant to the AER's directives. In explaining the increase in the minimum LMR from 1.0 to 2.0, the AER indicated that, licensees that met the previously required minimum LMR of 1.0 have purchased licensed assets, in some circumstances, "only to find themselves in financial difficulty within weeks or months following the acquisition". The AER suggests that licensees can meet the new LMR minimum of 2.0 by "posting security, addressing the existing abandonment obligations, or transferring additional assets".

The implications of Bulletin 2016-16

The implications of Bulletin 2016-16 are significant, and include:

1. **License Approval Delays.** Given the AER's communication that it will process license eligibility applications as "non-routine", the likely effect will be delays in application approvals, potential additional conditions on such approvals, and protracted deal closing periods if the sale is to a "Newco" unlicensed in Alberta. "Newcos" who have passed the eligibility test but not yet acquired AER licensed assets will need to update information to demonstrate their current position. It is unclear what impact any change in insurance, directors, officers and possibly shareholders since the date of license approval will have, but these new terms create the possibility that additional conditions may be imposed on that licensee if the net effect of such changes is perceived to be sufficiently adverse.
2. **Uncertainty for Existing Transactions.** The immediate effect of the rule without grandfathering provisions that exempt or phase in the new transfer requirements could be extremely problematic for transferees who have either signed deals and not yet closed them or signed and closed deals but cannot now effect the license transfer without posting additional security. Depending on how representations, warranties and covenants in the governing sale agreements are drafted regarding the licensee transfer obligations, claims could arise for breach if requirements for posting the potentially substantial additional security are not satisfied.
3. **Limiting the Potential Market of Purchasers.** There are a significant number of licensees currently operating below the 2.0 LMR threshold. (The *Liability Management Programs Results Report* of the AER, dated June 4, 2016 (available for download here) which indicates there were 569 licensees with an LMR below 2.0 and only 219 with an LMR of 2.0 and higher; 207 licensees fell within the 1.0-2.0 LMR range). It is expected that the doubling of the LMR minimum requirement to 2.0 will further encourage the unbundling of poorly performing or unprofitable assets from those that have greater value, potentially exacerbating the effect of *Redwater*. Those licensed assets that are marginally

profitable and/or have the effect of weakening the LMR on any given collection of assets are more likely to be left behind by Trustees in an effort to improve the LMR to the 2.0 threshold, and therefore the potentially marketable value, of the assets of a debtor it endeavors to sell. If this happens, it is difficult to appreciate how the risk to Albertans will be minimized.

4. **Constraining Opportunities for Smaller Producers**. Smaller producers who may be more likely to have an LMR in the 1.0-2.0 range are effectively prevented from transacting with each other to transfer AER licensed properties or undertake the acquisition of additional AER licensed assets unless such acquisitions elevate their LMR to 2.0 or higher. As noted above, that means at least 207 licensees are directly impacted. A low existing LMR combined with the LMR of assets sought to be sold by Trustees means that such producers are less likely to be in a position to avail themselves of acquisition growth opportunities. Lenders may also be less likely to make credit available to facilitate such transactions where the LMR ratios of the credit seeker falls below 2.0.

It is clear that this Bulletin is intended by the AER to be an interim measure to enable the AER to "develop broader and more permanent regulatory measures in accordance with government policy in response to the *Redwater* decision". In the meantime the embattled Alberta energy sector braces itself yet again against the significant impact of this decision, the outcome of ongoing lender reviews, the appeal of *Redwater* and the government's response thereto.