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Implementing the New Liability and Financial Assurance Rules for Oil and Gas Operations on Federal Lands in the Arctic and for the East Coast Offshore

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Regulations Commented On: *[Draft] Canada Oil and Gas Operations Financial Requirements Regulations and accompanying Regulatory Impact Assessment Statement* (RIAS), Canada Gazette, vol. 149, No. 28, July 11, 2015, *[Draft] Canada-Newfoundland and Labrador Petroleum Financial Requirements Regulations,* Canada Gazette, vol. 149, No. 28, July 11, 2015 and *[Draft] Canada-Nova Scotia Petroleum Financial Requirements Regulations*, Canada Gazette, vol. 149, No. 28, July 11, 2015

The current liability and assurance rules for oil and gas operations on federal lands and for the east coast offshore are, by any account, outdated and inadequate. The federal government undertook to review these rules following the Montara and Macondo spills and the National Energy Board (NEB) undertook its own review, *The Past is Always Present: Review of Offshore Drilling in the Canadian Arctic, Preparing for the Future* (2011). As a result of these initiatives the government introduced Bill C-22 which became the *Energy Safety and Security Act*, SC 2015 c.4 (*ESSA*). *ESSA* obtained Royal Assent on February 26, 2015 but will not (s.119) enter into force until 12 months after Assent or on an earlier date prescribed by Order in Council. The delay permits the development of the necessary regulations, including the three related regulations (supported by a common RIAS), that are the subject of this post. Bill C-22 once in force will, *inter alia* amend the liability and financial assurance provisions of the *Canada Oil and Gas Operations Act*, RSC 1985, c. O-7 (*COGOA*), the *Canada-Newfoundland and Labrador Atlantic Accord Implementation Act*, SC 1987, c.3 and the *Canada-Nova Scotia Offshore Petroleum Resources Accord Implementation Act*, SC 1988, c.28. This post will focus on the *COGOA* rules although what is said here for the most part applies equally to the areas covered by the *Accord Acts*. The first part summarizes the current *COGOA* provisions. The second part summarizes the changes that *ESSA* makes to *COGOA*. The third part discusses the regulations and the accompanying RIAS. The fourth part offers some comments on the regulations while the final part asks what is missing from this regime.

What follows is complicated. It is complicated still further because *ESSA* contains what are known as “co-ordinating amendments”. These are additional amending provisions which are contingent on amendments to other statutes. In this particular case s.118 of *ESSA* provides that *COGOA* will be further amended when both *ESSA* and Bill C-15, the *Northwest Territories Devolution Act* enters into force. Since that Act has already entered into force as SC 2014, c.2 the relevant trigger is that described above for *ESSA* to enter into force. Suffice it to say that these additional amendments will, *inter alia*, change our understanding of the application of the new liability cap provisions of *COGOA*. I am grateful to Nicole Godbout, legal counsel with the NEB, for drawing these coordinating amendments to my attention.

1. The Current *COGOA* Regime

COGOA makes use of both absolute and fault based liability to try and create a regime to ensure that "the polluter will pay" for any costs associated with a spill from drilling or production. The Act channels absolute liability to the person who holds the drilling authorization (effectively the operator) (s.26(1)) for damage to third parties and clean-up expenses, up to a "prescribed amount". The liability is absolute rather than strict because there are no grounds for exculpation listed in the statute. In addition, *COGOA* imposes fault-based liability on any person whose fault or negligence caused the spill or who by law are responsible for others whose fault or negligence may have caused the spill. Fault based liability is unlimited but requires proof of negligence. Under the current regime, the *Oil and Gas Spills and Debris Liability Regulations*, SOR/87-331 limits the absolute liability of the holder of the well authorization to between $10 and $40 million (the "prescribed amount") depending on the location of the well (e.g. onshore or offshore). These amounts were first fixed in 1987 and have not changed in the intervening years. Experience with other spills, especially offshore spills such as Montara and Macondo, demonstrate that these amounts are completely inadequate. As for financial assurance (i.e. proof and security arrangements demonstrating ability to pay) the Act requires the holder of the well authorization (s.27) to provide the NEB "with proof of financial responsibility in the form of a letter of credit, a guarantee or indemnity bond" or other form satisfactory to the NEB and in an amount satisfactory to the NEB. The holder of the authorization must ensure that the "proof of financial responsibility" remains in force for the duration of the work or other activity. In the event of an incident, the Board may (s.27(2)) require that monies be paid out of funds made available through the financial instrument to satisfy "any case or class of cases" in respect of any claim that might be made under the statute, regardless of whether or not proceedings have actually been instituted. Neither the Act nor the regulations provides any guidance as to the amount or form of financial assurance that the NEB should require, neither as to a specific amount nor as to the criteria or methodology that the Board should apply in determining an appropriate amount. A Q & A statement on the Board's website prepared as part of the Board's Arctic Review describes the Board's actual practice:

> There is nothing in the *Canadian Oil and Gas Operations Act* that limits the amount of financial responsibility. In the past, the Board has required security in an amount equal to the limits of absolute liability. It has also required proof of financial responsibility in the form of audited financial statements or guarantees as evidence that the company is able to meet any financial liability that might be incurred as a result of drilling the well. It is up to the NEB to determine the amount of proof of financial responsibility.

It is perhaps worth emphasizing for the discussion that follows that the NEB's discussion to some extent conflates two distinct concepts, financial security and financial resources. "Financial security" (or financial assurance or evidence of responsibility) generally refers to particular financial instruments such as letters of credit or promissory which serve to guarantee that an operator (and the regulator) will have funds on hand to cover losses and clean-up expenses. "Financial resources" on the other hand may simply refer to the idea that an operator's assets exceed its liabilities by a sufficient amount that it can be expected to have resources on hand to pay for the costs (clean-up and compensation for damage) entailed by a spill.

2. The Changes to *COGOA*

ESSA keeps the basic structure of absolute and fault-based liability outlined above but makes five main changes to the liability and financial assurance provisions of *COGOA*. First, the amendment adds a new head of recoverable damages in the form of liability for "all loss of non-use value relating to a public resource that is affected by a spill…". For some discussion of the non-use value issues under *ESSA* as well as a broader discussion of Bill C-22 see the post by my colleague Martin Olszynski here. Second, the amendments significantly change the upper liability caps from $40 million to $1 billion, with the actual amount varying depending upon the same sorts of locational factors as before. In some cases, however, (e.g. onshore wells not located close to a waterbody in Nunavut) the cap (s.26(2.2)(c)) for absolute liability remains low - $10 million.

Third, the amendments effectively adopt the distinction (described above) that the Board has made in its practice with respect to financial assurance (responsibility) and available financial resources (although the Board's terminology as suggested above is not completely consistent with that adopted in the Act). As for the provision of actual security (or financial assurance (responsibility)), the Act continues to require (s.27(1)) that this principally shall be in the form of a letter of credit, guarantee or indemnity bond. It is here that the coordinating amendment provisions become important. As the text will ultimately appear when these amendments are triggered s.27 will require that in any application for approval of a well, or for production, in any offshore area within the geographical scope of *COGOA* (hereafter *COGOA* offshore well) this shall be $100 million or such greater amount as might be determined by the Board (and in a particular case as described below, a reduced amount). In other areas, and for other types of authorization, the Act (s.27(1)(b)) reverts to the current approach and stipulates that this shall be "in an amount satisfactory to the Board." There is nothing however which requires the Board to follow the practice referred to above of requiring an applicant for an authorization to provide financial assurance (responsibility) in an amount that equals the amount of its absolute liability. A further innovation in *ESSA* is that the amendment will permit an applicant (s.27(1.01)) to comply with the prescribed $100 million financial assurance requirement (i.e. *COGOA* offshore wells, but not other cases) by providing proof that it "participates in a pooled fund … established by the oil and gas industry … maintained at a minimum of $250 million" and meeting other prescribed requirements.

As for the availability of financial resources (not financial assurance (responsibility)), a new s.26.1 will require that a person proposing to drill a well or to produce oil or gas must provide proof "in the prescribed form" that it has the financial resources to pay up to the amount of its absolute liability limit (see above) or, if the NEB considers it necessary, a greater amount. The Act does not provide any specific guidance to the Board as to the matters that it should take into account in determining whether it is necessary to prescribe a greater amount, although it does provide that the NEB (s.26.1(3) "is not required" to consider the potential loss of non-use values.

Fourth, while the new Act, as noted above, prescribes absolute liability amounts and in one case (*COGOA* offshore wells) the amount of financial assurance (responsibility) that must be provided ($100 million), the new Act also introduces a power to prescribe lesser amounts under certain circumstances. The power is laid out in a new section of the Act (s.27.1) which provides that the Board may make a recommendation to reduce the prescribed amount of absolute liability (s.26(2.2) *or* the amount of financial assurance (responsibility) required under s.27(1)(a) (which deals exclusively with the provision of financial assurance for COGOA offshore wells). It is important to recognize that the section conflates two different concepts: that of the cap on

absolute liability and that of the amount of financial assurance that should be made available. In any event the new s.27.1(2) & (3) goes on to provide that the lower adjusted amount, if approved by the Minister, serves to cap the amount of financial assurance that the applicant must provide (but note that, except in the case of operations within Nunavut, the actual amount of financial assurance (responsibility) to be provided is in the discretion of the Board and is not prescribed by the Act). The RIAS accompanying these draft regulations describes the power to prescribe a lesser amount as follows:

> …. the Act also establishes the authority for the Boards to recommend to the ministers (i.e. in non-Accord Act areas: the Minister of Natural Resources or the Minister of Indian Affairs and Northern Development; and in the Accord Act areas: the federal Minister of Natural Resources as well as the provincial minister with jurisdiction over offshore oil and gas) *that the absolute liability limit and corresponding financial resources amount*, *or the amount of financial responsibility, be lowered* for certain low-risk projects on a per-project basis (emphasis supplied).

Finally, the Act (s.14) creates some new regulation making powers including the power to make regulations with respect to a pooled fund and concerning the circumstances under which the NEB might make a recommendation to reduce the level of financial assurance in any particular case. There is, however no regulation making power, either in the current Act or in the provisions introduced by *ESSA*, to limit the discretion of the Board with respect to fixing the amount of financial assurance that is to be provided by the applicant (but note, as above, that the amount is prescribed in respect of *COGOA* offshore wells (the new s.27(1)(a) as further amended by the coordinating amendment provisions).

In sum, it is important to emphasize that the new Act makes four distinctions as to "amounts" as follows:

1. The amount of absolute liability (s.26(2.2))
2. The amount of financial assurance\responsibility that must be provided (s.27) (presumably in a typical case less than (1) - otherwise the distinction that *ESSA* makes between financial assurance (responsibility) and proof of financial resources is a nonsense.)
3. The amount of financial resources (s.26.1) that an applicant must demonstrate (the amount fixed under (1) – the level of absolute liability).
4. The amount of prescribed financial assurance ($250 million) that can be covered by way of participation in a pooled fund operated by industry.

The result is that an applicant may not be required to post financial assurance (responsibility) as to the full amount of its absolute liability although it will always have to demonstrate that it has available financial resources up to that amount. The amendments to *COGOA* involved a trade-off between dramatically increasing the cap on absolute liability and a refusal to draw a tight connection between the cap and the provision of financial assurance.

3. The Draft Regulations

The regulations deal with three issues which the Act left to be prescribed by regulations. These are, in the order discussed above: (1) details as to the pooled fund as a means of establishing financial assurance (responsibility); (2) the circumstances under which the Board should be able

to recommend lesser amounts for financial assurance and\or the applicable absolute liability limit; and, (3) the means by which an applicant might be able to establish the availability of financial resources (*not*, financial assurance (responsibility)).

The Pooled Fund

As noted above, the Act provides that an operator may be able to meet its financial assurance (responsibility) requirements (at least in some cases) by membership in a pooled fund operated by industry. The regulations flesh out some of the requirements that an industry fund must meet. Thus, s.3 prescribes that a pooled fund must be located and administered in Canada and that it can be used "solely to make payments" with respect to oil and gas operations occurring in areas covered by the Accord Acts and at least some of the areas falling under *COGOA* (more on this below). The same section requires that such payments must be made to the relevant Board on demand and that the administrator of the fund must provide the Board with certain information including audited financial statements which establish that the fund is maintained at a minimum of $250 million. In addition, s. 4 effectively repeats the requirement of s.27(5) of the Act which stipulates that where there is a payment out of the fund the holder of the authorization in respect of which the payment was made has a duty to reimburse the fund. The regulation prescribes that this amount is due within seven days of the date of payment.

These provisions together make it clear that the fund is *not* a liability pooling fund or a mutual assurance fund of some sort. Instead, it is a simply a means by which an operator can share with others the duty to provide security (financial assurance (responsibility)) up front. The liability remains that of the holder of the authorization. While the fund will bear the loss if the authorization holder fails to pay, the fund has a right to reimbursement from the holder of the authorization.

The Case for Reduced Financial Assurance

As noted above, s.27.1 allows the Minister to reduce the applicable amount of financial assurance on the recommendation of the Board. Section 5 of the Regulations aims to describe the circumstances under which the NEB may make such a recommendation and as such establishes a number of conditions precedent. First, the Board must be satisfied in respect of a particular applicant that the estimated total of the losses, damages, costs and expenses (but not non-use value losses) for which the applicant could be held to be absolutely liable ($1 billion or $100 million as the case may be) is in fact less than that. The Board's recommendation must (s.5(2))

> … identify the hazards that are relevant to the proposed work or activity to which the application pertains and must include an assessment of the risks associated with each event that could reasonably be expected to occur in connection with each of those hazards and that could result in debris, in a spill or in an authorized discharge, emission or escape of petroleum.

The Board must also provide additional supporting information including

> (*a*) the estimated total of the losses, damages, costs and expenses referred to in subsection (1);
> (*b*) the recommended amount that is less than the amount referred to in paragraph 26(2.2)(*a*) or (*d*) or 27(1)(*a*) of the Act, as the case may be;
> (*c*) a summary of the reasons for the recommendation;

(*d*) a summary of any information provided by the applicant to the Board that the Board considers to be pertinent.

The structure of the Act and regulations make it clear that the minister can only act on the basis of a Board recommendation.

Opportunities for Establishing Financial Responsibility\Resources

As noted above, s.26.1 of *COGOA* requires an applicant to establish that it has the financial resources (not financial assurance (responsibility)) to cover the amount of absolute liability. The regulations elaborate on this requirement. Section 2(1) requires the applicant for an authorization to provide the Board with "a statement of its net assets or of funding arrangements that it has made that demonstrates to the Board's satisfaction that it is able to pay the applicable amount." Section 2(2) provides that the statement must be accompanied by

> … one or more of the following documents that substantiate it:
>
> (*a*) the applicant's most recent audited annual financial statement and, if the applicant has been given a credit rating by a credit rating agency that is current at the time the application is made, a document that indicates that credit rating;
> (*b*) a promissory note;
> (*c*) an insurance policy or a certificate of insurance;
> (*d*) an escrow agreement;
> (*e*) a letter of credit;
> (*f*) a line of credit agreement under which the funds identified in the statement are available;
> (*g*) a guarantee agreement;
> (*h*) a security bond or pledge agreement or an indemnity bond or suretyship agreement.

4. Commentary

This section comments on three matters: (1) the industry pooled fund provisions, (2) the "lesser amounts" issue, and (3) proof of financial assurance.

The Ability of an Applicant to Use an Industry Pooled Fund to Establish Financial Assurance

The RIAS described the intent behind the pooled fund provisions as follows:

> Establishing the parameters for the use of a pooled fund as an alternative to other financial responsibility instruments will afford added flexibility to those interested or involved in exploring for, and developing, oil and gas resources in Canada's offshore areas, while safeguarding the Boards' ability to have access to liquid funds, as required. This flexibility could be beneficial to operators, as it could potentially save them some of the administrative costs associated with having to renew or maintain financial instruments with a financial institution (e.g. there are costs associated with having a bank issue a letter of credit and ensuring it remains valid and accessible for a predetermined period of time [one year or more]).

It seems fairly clear from this that the pooled fund is intended to be used for offshore operations on the east coast and in the Arctic where absolute liability levels are at $1 billion. In the case of the Arctic this idea is carried through into the regulations by providing that the pooled fund can be used for oil and gas operations for what was described above as *COGOA* offshore wells (here again one has to read the ESSA amendment through the lens of the additional co-ordinating amendment provisions to make sense of this; the regulations are premised on this contingency).

Lesser Amounts

The reduced financial requirement provisions are designed to accommodate offshore projects that don't reflect the usual risk profile of such projects. The RIAS gives as examples shallow water natural gas extraction and onshore to offshore drilling. Such activities may not necessarily be low risk since much will depend on the geology and many such inshore areas may present highly valued environments both ecologically and for traditional use by aboriginal populations. Consider, for example, inshore areas in the Beaufort Sea and the Mackenzie Delta. Thus, while in principle it might be appropriate to lower the amount of financial assurance to be provided, this should only be permitted following a rigorous assessment premised on a worst case scenario review. While the regulations represent a valuable effort to limit the circumstances under which an applicant might be able to make a case for reduced financial assurance they do not seem to go this far and in particular do not use the language of worst case scenario planning. The regulations might usefully clarify this. For example, the provisions of the Inuvialuit Final Agreement (IFA) are much clearer in prescribing the importance of worst case scenario planning (IFA, s.13(11)). Finally, I was surprised to see that the Act apparently contemplates (and certainly as interpreted in the RIAS) lesser amounts not only for the provision of financial assurance (responsibility) but also reductions in the amount of an operator's absolute liability. It is also remarkable to me that this can be accomplished by means of a ministerial order (albeit on the recommendation of the NEB).

Proof of Financial Resources

The Regulation (s. 2(2)) offers an applicant a number of ways in which it can substantiate its claim that it has adequate financial resources to meet its level of absolute liability. While items (b) to (h) (quoted above) all require some form of security or assurance, item (a) is little more than a balance sheet exercise in which the applicant establishes that its assets exceed its liabilities by at least the amount of any level of potential absolute liability. It is obvious that most if not all applicants will aim to rely on this paragraph in order to demonstrate proof of available financial resources and will seek to avoid providing any form of additional assurance. Some will never qualify (see "Giving Away the Arctic Farm" post), but other cases may prove more difficult. Consequently it would be useful if the Regulation provided some guidance as to when the Board should require additional assurance under one of the remaining paragraphs. Clearly it should require additional assurance if the applicant cannot meet the basic coverage ratio as described above, but it is doubtful if that should be regarded as adequate, especially given the volatility of commodity prices. An oil and gas company that can demonstrate an appropriate coverage ratio when oil stands at $100 per barrel will be in a very different position if oil is at $55. Given this volatility the Board needs to demand a coverage ratio in excess of 1.0 and\or the opportunity to

require additional proof where coverage falls below a prescribed amount. While the Act imposes a duty on the holder to maintain its "proof of financial resources" "in force" for the duration of the activity, it is not clear what this means in the context of an audited financial statement of assets and liabilities.

What is Missing from this Scheme?

I think that there is one important element that is missing from this scheme and that relates to the rules pertaining to the provision of financial assurance (responsibility). As noted above, the Act makes a distinction between the provision of financial assurance (responsibility) and proof of financial resources. The distinction is an important one for several reasons. First, the Act is prescriptive as to the form of financial assurance (s.27(1) – letter of credit, guarantee or indemnity bond), and, once provided, that assurance results in a dedicated fund that can be used to pay any claims that fall within the ambit of the statutory causes of action (s.27(2)). The Act is far less prescriptive in relation to proof of financial resources. Second, amounts provided by way of financial assurance (responsibility) are available to the Board to pay claims and make payments to those who incur costs or suffer losses in dealing with a spill (s.27(2)) without recourse to the ordinary courts. This would not be the case with respect to proof of financial resources, at least where such proof takes the form of balance sheet coverage of assets over liabilities. Thus at least from the perspective of potential victims of an oil spill it is clear that financial assurance (responsibility) has significant advantages over proof of financial resources. It is therefore unfortunate that both the Act and these new regulations are far more concerned with proof of financial resources than they are with the provision of financial assurance (responsibility).

The default rule under the Act (the new s.27(1)(b)) is that the amount of any financial assurance (responsibility) is to be determined by the Board (s.27(1)(b)). The one exception to this is for what are described above as *COGOA* offshore wells for which the assurance is fixed at a minimum of $100 million. Beyond this, neither the Act nor the regulations create a presumption as to the level of assurance that the Board must require, or offer the Board any guidance as to the factors that it should take into account in setting that level of assurance. In this area of financial assurance therefore the Act and the Regulations mirror the status quo (except for Nunavut). At the end of the day this is more a problem with the legislation than with the regulations; this is too big of a problem to be fixed by means of regulations and will require an amendment to the Act.

The draft regulations are open for comment for thirty days from gazetting, July 11, 2015.

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