

Upholding the Lexin Equipment Order – The AER Wins the Battle, But Most Likely Will Lose the War

By: Heather Lilles

Case Commented On: Interim Order and Order Re Equipment (ABQB), Alberta Energy Regulator (applicant) and Lexin Resources Ltd. (respondent), Court File Number 1701-02272 and *Alberta Energy Regulator v Lexin Resources Ltd.*, [2017 ABQB 219 \(CanLII\)](#)

Lexin Resources may only be a junior oil and gas company, but recent extensive coverage by local news agencies (see [here](#) for example) has caused the name of the small oil and gas producer to become as familiar as its larger counterparts, or – perhaps – as infamous as Redwater Energy Corporation. Redwater, another junior in the Canadian industry, became notorious last October when Chief Justice Neil Wittmann of the Court of Queen’s Bench allowed the Receiver of Redwater to disclaim unproductive oil and gas assets even where those assets were subject to abandonment orders from the Alberta Energy Regulator (AER). See the post of Professor Bankes on the *Redwater* decision [here](#).

Like Redwater Energy, Lexin has been petitioned into bankruptcy under the *Bankruptcy and Insolvency Act*, [RSC 1985, c B-3](#). In Lexin’s case, a Receiver was appointed on the application of the Alberta Energy Regulator – an unprecedented step for the Regulator. This post addresses two of the recent court actions involving Lexin Resources and the AER: the Interim Order Re Equipment which was issued by the Court of Queen’s Bench on February 14, 2017 (the “Interim Order”) and the recent decision in *Alberta Energy Regulator v Lexin Resources Ltd.*, [2017 ABQB 219 \(CanLII\)](#) (the “*Lexin Decision*”). This post does not directly discuss Lexin’s bankruptcy or what effect the Court of Appeal’s decision in *Redwater* (not yet released) could have on Lexin’s bankruptcy and its AER licensed assets.

The Background

Lexin is a relatively junior oil and gas producer, but it is also the licensee of 1380 wells, 81 facilities and 201 pipelines. Six of Lexin’s wells are critical sour gas wells, two of which are within the limits of the City of Calgary.

In 2016-17, the AER issued a number of regulatory orders to Lexin including environmental protection orders under s 113 of the *Environmental Protection and Enhancement Act*, [RSA 2000 c E-12 \(EPEA\)](#) and s 104 of the *Oil and Gas Conservation Act*, [RSA 2000, c O-6 \(OGCA\)](#); abandonment orders under s 27 of the *OGCA*, and most recently, AER Order No C 2017-01, as updated by AER Order No C 2017-01A (found [here](#)) (issued to Lexin pursuant to s 27 and s 106(3) of the *OGCA* and s 12 of the *Pipeline Act*, [RSA 2000, c P-15](#)). This last order closes Lexin’s AER licensed wells, facilities and pipelines (the “Closure Order”). According to the Closure Order, Lexin is in non-compliance with previously issued AER Orders, has failed to pay \$70 million in security for its end of life obligations, owes more than \$1 million in Orphan Fund Levies and owes Administration Fees.

Since the Closure Order, the Orphan Well Association has been directed to provide care and custody of Lexin oil and gas wells, facilities and pipelines (“Lexin Sites”).

The AER Equipment Direction and Interim Order

On October 27, 2016, the AER issued an Equipment Direction prohibiting Lexin and “all other persons” from removing equipment from the Lexin Sites without the AER’s prior approval (the “Equipment Direction”). According to the AER, the subsequent removal of equipment from the Lexin Sites without approval of the AER constitutes an “Unauthorized Activity”. The AER applied to the Alberta Court of Queen’s Bench for the Interim Order, arguing that the Unauthorized Activity was contrary to several provisions of the *Oil and Gas Conservation Rules*, [Alta Reg 151/1971](#) (*OGCR*). On February 17, 2017, Justice Tilleman granted the Interim Order and required “all persons” to refrain from engaging in the Unauthorized Activity without the prior written approval of the AER.

The *Lexin* Decision

According to Justice Tilleman, “the sole issue” before the Court in the *Lexin* Decision was whether “on the merits, the Equipment Direction will continue with respect to all of Lexin’s sites or only to Lexin’s sour gas wells” (at para 1).

At paras 3-22, Justice Tilleman provides a succinct summary of the parties’ numerous actions before the Court of Queen’s Bench and the Court of Appeal and the reader is directed to these paragraphs for details on Lexin’s unsuccessful *Companies’ Creditors Arrangement Act*, [RSC 1985, c C-36](#) application in Alberta and the AER’s successful receivership application. Lexin has sought leave to appeal both applications.

In the *Lexin* Decision, Justice Tilleman first addresses whether the AER may apply to the Court of Queen’s Bench for an order prohibiting the Unauthorized Activity. Section 19(2) of the *Responsible Energy and Development Act*, [SA 2012 R-17.3](#) (*REDA*) permits the AER to apply to the Court of Queen’s Bench for an order prohibiting a person from continuing an activity for which an approval, order or direction is required. Section 19(2) of *REDA* provides:

19(2) Where a person commences, undertakes or continues an activity for which an approval, order or direction is required but has not been obtained, the Regulator, in addition to any other action or proceeding it may be authorized to take, may apply to the Court of Queen’s Bench for an order prohibiting that person or that person’s employees or agents from continuing the activity until that person has obtained the required approval, order or direction.

Justice Tilleman emphasizes that s 19(2) is “not a rubber stamping procedure”:

The Court must be satisfied that the AER’s legislative mandate requires issuing the order. This residual discretion is apparent based on the language of s 19(2) and there is nothing in that language to suggest that the Court’s discretion is otherwise circumscribed. The Court must be satisfied based on the facts before it that the order should issue. (at para 54)

Accordingly, the AER must show both that: (i) person(s) were continuing an activity in contravention of the Equipment Direction; and (ii) the Equipment Direction was within the

AER's legislative mandate. Justice Tilleman reaches a number of fact-based conclusions, specifically that:

(1) AER personnel had to attend on site three times to ensure that proper safety procedures were followed when equipment was removed without authorization; (2) the removal of equipment presented a real likelihood of health and safety issues; and (3) the risk associated with removing equipment substantially increased if proper removal procedures [such as obtaining Regulator approval] were not followed. (at para 51)

It is not disclosed whether the sites referred to by Justice Tilleman involved 'sour gas' (i.e. gas containing significant amounts of hydrogen sulfide).

Justice Tilleman also finds that the AER had jurisdiction to issue the Equipment Direction. Justice Tilleman specifically references s 7.001 of the *OGCR* which requires approval prior to the construction or modification of select sour gas batteries, waste management facilities and compressor stations. Further, s 39 of the *OGCA* requires AER approval for major modifications to existing schemes for the processing of gas.

Based on these provisions, Justice Tilleman finds that "AER approval is required in order to remove equipment such as compressors from or to make major modifications to Lexin's sites" (at para 35).

However, Justice Tilleman emphasizes that "all persons" have not engaged in the Unauthorized Activity and a separate analysis is required to determine whether s 19(2) permits the AER to apply to the Court with respect to "all persons" (as opposed to Lexin and its employees and agents). In reaching his decision that "all persons" should be included in the Order, Justice Tilleman relies on s 14 of *REDA*, which he summarizes at para 24:

REDA is part of the governing legislation of the AER. According to s 14(1) of *REDA*, the AER, "in the carrying out of duties and functions imposed on it by this Act or any other enactment, may do all things that are necessary for or incidental to the carrying out of any of those duties or functions". Further, under s 14(2) of *REDA*, the AER, "with the approval of the Lieutenant Governor in Council... may make any order ... that the Regulator considers necessary to carry out the mandate of the Regulator... that... [is] not otherwise specifically authorized by this Act or any other enactment".

Justice Tilleman reviews a number of statutory provisions of the *OGCA*, the *Pipeline Act* and *REDA* and concludes that, when read together, the statutes establish the AER's legislative mandate – to ensure that "the oil and gas industry is conducted in a safe manner with respect to humans and the greater environment". (at para 30) Specifically, Justice Tilleman finds that "public safety, health and the environment are integral to the AER's legislative mandate" (at para 64). Justice Tilleman further concludes that the Unauthorized Activity presents a real likelihood of health and safety issues and by issuing and enforcing the Equipment Direction against 'all persons', the AER is attempting to ensure safety on Lexin's Sites – which is within its legislative mandate (at para 65).

Accordingly, Justice Tilleman concludes that "[r]eading s 19(2) in concert with s 14 of *REDA*, I find that the AER has the ability to apply to the Court with respect to 'all persons'. To conclude otherwise would prevent the AER from fulfilling its mandate." (at para 66)

And in the event Justice Tilleman is incorrect in his interpretation of s 19(2) of *REDA*, he determines that he can rely on the inherent jurisdiction of the Court to grant the Order. (at para 68).

Commentary

Justice Tilleman concludes that “[t]he AER’s Equipment Direction applies to all of Lexin’s sites and operations”. (at para 71) Yet, according to the Interim Order, the Equipment Direction defines “Equipment” quite broadly as equipment associated with a well or facility. Justice Tilleman’s analysis in the *Lexin* Decision appears to focus on the removal of equipment which would constitute a modification of select sour gas batteries, waste management facilities and compressor stations or major modifications to an existing scheme for the processing of gas. Thus the analysis conducted by Justice Tilleman – as required by s 19(2) of *REDA* – is somewhat narrower in scope than his ultimate order. Further, although Justice Tilleman notes that the sole issue before the Court is whether the Equipment Direction should only apply to Lexin’s sour gas wells and facilities, Justice Tilleman does not analyze the relative safety of removing equipment from sour gas sites versus non-sour gas sites. We can only conclude that Justice Tilleman found the removal of equipment without approval from either type of facility or well unsafe and thus within the mandate of the AER.

From a health and safety standpoint, undeniably the people of Alberta are better off not having unknown persons tinkering with and removing equipment from oil and gas wells facilities - regardless of their hydrogen sulfide content.

The Economic Implications

It was unnecessary for the Court to address the economic impact of prohibiting equipment removal from Lexin Sites, however, it is worthy of a brief comment. Compressors and other well and facility equipment have a significant dollar value – the likely reason they were being removed in the first place. It is likely that the AER or the Orphan Well Association (OWA) will be required to carry out and pay for the bulk of the abandonment costs of the Lexin Sites. (This fact is the genesis of the title of this post – even if successful in the *Lexin* Decision, the AER/OWA will likely sustain considerable fiscal losses in the ultimate abandonment and reclamation of the Lexin Sites.) As a general creditor of a bankrupt Lexin, the AER/OWA will likely only receive cents on the dollar. If valuable equipment is being removed from the Lexin Sites, sold and the proceeds disappearing into unknown pockets, Lexin’s creditors – both statutory and otherwise – will receive even fewer cents on the dollar. Thus the AER also receives an economic benefit from the *Lexin* Decision.

Lexin’s Working Interest Participants

In Canada, more than one party often holds an undivided beneficial interest in an oil and gas leasehold estate (specifically the rights to drill for and produce, save and market petroleum and natural gas from the lands) and accompanying property. This co-ownership can exist with respect to the land, but also in the chattels, oil and gas facilities, funds and other kinds of personal property. Schedule “B” of the Interim Order identifies 51 ‘known’ working interest participants (WIPs) who own a beneficial or legal undivided interest in the Lexin Sites.

The Interim Order and *Lexin* Decision restrict the property rights of these WIPs. Justice Tillman recognizes in the *Lexin* Decision that there may be operational difficulties with the application of

the Order. However he notes that any person subject to the Order – such as those with a working interest in the Lexin Sites - can apply, on notice, to vary it.

Even though their property rights are restricted, the Interim Order and the Lexin Decision may offer some comfort to third parties with a working interest in the Lexin Sites. The Closure Order effectively shut in all of Lexin’s Sites – whether they were still commercially producing or not. WIPs may still apply to the AER to amend the Closure Order, transfer a well or facility license and start producing as the new Operator and licensee. WIPs may be reluctant to assume Operatorship, believing that they may incur more liability, but according to the legislative schemes of the *OGCA* and *EPEA*, it is doubtful that such concerns are warranted (beyond a possible change to a company’s liability management ratio in relation to its assets). Under the *OGCA* and *EPEA*, WIPs are already liable for the cost of abandonment and clean-up of the Lexin Sites, regardless of who is actually operating the Sites. And it would be much better for a working interest owner to assume Operatorship of a property with all of the equipment still in place, than to arrive at a well or facility site and find compressors removed, the pipes not blinded and oil leaking into the ground (as was the case with one reported Lexin Site in the Lexin Decision). (at para 48)

This post may be cited as: Heather Lilles “Upholding the Lexin Equipment Order – The AER Wins the Battle, But Most Likely Will Lose the War” (20 April, 2017), online: ABlawg, http://ablawg.ca/wp-content/uploads/2017/04/Blog_HL_AERvLexin_Equipment.pdf

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