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The AER is Seeking Public Input on its Proposed Regulatory Solution for the Growing Orphan Well and Other Unfunded Liabilities Problem in Alberta's Oil and Gas Sector

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Matter Commented On: Proposed amendments to AER Directive 067: Eligibility Requirements for Acquiring and Holding Energy Licences and Approvals

On January 13, 2021 the Alberta Energy Regulator (AER) issued Bulletin 2021-01 seeking public comments on proposed amendments to Directive 067: Eligibility Requirements for Acquiring and Holding Energy Licences and Approvals. These amendments are an implementation component of Alberta's policy initiative, announced in July 2020 as the new Liability Management Framework, to improve the effectiveness of laws intended to address Alberta's growing (and already enormous) problem of unfunded end-of-life closure and reclamation liabilities in the energy sector. The proposed amendments to Directive 067 constitute the details of the Licensee Capability Assessment System – the AER's replacement for the catastrophic failure known as the Licensee Liability Rating program used in the oil and gas sector. The AER will receive public comments on the proposed changes to Directive 067 until and through February 14, and this post constitutes our comments – which will be submitted to the AER in its requested form (which can be downloaded here and sent via email to Directive067@aer.ca - alternatively you can submit the comments form by mail to the AER, Directive 067 Feedback, Suite 1000, 250 – 5 Street SW, Calgary, AB T2P 0R4).

A Short introduction to the End-of-Life Liabilities Problem

The failure of Alberta's Licensee Liability Rating program to avoid the end-of-life liabilities problem was not the issue before the Supreme Court of Canada in *Orphan Well Association v Grant Thornton Ltd*., 2019 SCC 5 (CanLII), but the Court was alive to the fact that the program was the underlying reason for why it was being asked to adjudicate the actual dispute before it:

> During this appeal, there was significant discussion of other regulatory regimes which Alberta could have adopted to prevent environmental costs associated with the oil and gas industry from being offloaded onto the public. What Alberta has chosen is a licensing regime which makes such costs an inherent part of the value of the licensed assets. This regime has the advantage of aligning with the polluter-pays principle, a well-recognized tenet of Canadian environmental law. This principle assigns polluters the responsibility for remedying environmental damage for which they are responsible, thereby incentivizing companies to pay attention to the environment in the course of their economic activities (*Imperial Oil Ltd. v. Quebec (Minister of the Environment)*, 2003 SCC 58, [2003] 2 S.C.R. 624, at para. 24). The

> Licensee Liability Rating Program essentially requires licensees to apply the value derived from oil and gas assets during the productive portions of the life cycle of the assets to the inevitable cost of abandoning those assets and reclaiming their sites at the end of those life cycles. (*Orphan Well Association* at para 29)

As most ABlawg readers will know by now, the Supreme Court's description of the Licensee Liability Rating program is far too generous. Sure, the program was supposed to ensure that oil and gas wells, facilities, and pipelines are removed and the land they are on is remediated and reclaimed. But there is a chasm between what the program said it would accomplish and what actually happened on the ground. The Licensee Liability Rating program was a kind of a pseudo-financial security program: the stated intention was to make sure the polluter kept sufficient funds available to comply with end-of-life remediation and reclamation work, but evidence keeps building to support the view that the program was only ever going to ensure that either the landowner, the taxpayer, or the Orphan Well Association pays – not the polluter.

The problems with the Licensee Liability Rating program are widely understood (see a summary here, and a discussion of proposed solutions here), and the AER itself acknowledges the deficiencies on its website:

> A company with an LMR of 1.0 – meaning they have the same amount of assets as liabilities – avoids having to post security for future closure work. When a company has more liabilities than assets, their rating would then drop below 1.0, and we would focus on collecting security. At this point it is often too late in the life cycle to collect security because the company may already be in financial distress. Some companies that are in distress eventually become insolvent, and some of their liabilities could ultimately be managed by the industry-funded Orphan Well Association (OWA).
>
> We have seen companies become insolvent with ratings above 2.0, and some as high as 30, which highlights the need for change. With this, a more holistic review—aside from mere information on assets and liabilities—is needed to assess whether companies can meet their regulatory and liability obligations and safely clean up their sites.

This approach was so catastrophically bad we cannot get ourselves to even call it a "compliance" system. Essentially under this approach, the AER steps in when an energy company is either already bankrupt or is circling the drain of bankruptcy and it is too late for the AER to take effective enforcement action. The problems in the Licensee Liability Rating program are directly responsible for Alberta's enormous orphan well problem.

The fact that Alberta has never had an effective liability management system to address end-of-life liabilities in the oil and gas sector is one of the single greatest policy blunders ever committed in this province. Successive governments over the last several decades, and those senior bureaucrats who had the power to change policy direction but chose not to, surely wear the blame for this gigantic mess. The AER's current estimates of the liabilities are mindboggling, and even these numbers likely underestimate the true scale of the liabilities.

ABlawg has been following the end-of-life liabilities problem in Alberta's energy sector, and has commented on some of the other policy developments under the new Liability Management Framework. See here for a discussion of how much taxpayer money has already been diverted to dealing with the problem. See here for a discussion of Bill 12 and the expansion of the authority of the OWA, and here for a discussion of the regulations under Bill 12. See here for commentary about how slow and secretive the reform of the liability management system had been. On that note, this public comment process comes late in the process, but at least it is something.

Proposed Amendments to AER Directive 067: Eligibility Requirements for Acquiring and Holding Energy Licences and Approvals

The proposed changes to Directive 067 are part of the AER's shift to a more nuanced capacity assessment approach to liability management. This shift is a significant implementation component of Alberta's new Liability Management Framework. In conjunction with the release of proposed amendments to Directive 067, the AER released a video which provides an overview of the new liability management policy, the current status of implementation, and how the changes to Directive 067 fit within these overall efforts. The first 17 minutes of the video give an overview of how the various pieces are expected to fit together in the new framework and confirm that the changes to Directive 067 are the first implementation step by the AER. The last portion of the video describes how the new licensee capacity assessment is expected to function.

Directive 067 is a set of requirements imposed by the AER on persons who seek to hold AER licenses granted under an energy enactment. The AER describes the purpose of Directive 067 as follows:

> Acquiring and holding a licence or approval for energy development in Alberta is a privilege, not a right. This directive ensures that this privilege is only granted to responsible parties. It sets out requirements for applying for, maintaining, and amending licence eligibility. It also identifies the circumstances in which the AER may revoke or restrict licence eligibility.

These are additional requirements to those set out in the enactments themselves, and the authority of the AER to impose these requirements comes from its discretionary authority to grant or not grant a license, as well as its authority to make rules on eligibility requirements. For example, see sections 10(1)(nn) and 18(1) of the *Oil and Gas Conservation Act*, RSA 2000, c O-6.

Directive 067 provides for three possible categories of eligibility:

> No Eligibility − Not eligible to acquire or hold licences to drill/construct wells, facilities, or pipelines
>
> General Eligibility − Eligible to hold licences for all types of wells, facilities, and pipelines

> Limited Eligibility − Eligible to hold only certain types of licences and approvals, or eligibility is subject to certain terms and conditions.

Directive 067 sets out a number of requirements which must be met by an applicant in the eligibility assessment, including obligations in relation to insurance coverage, residency, and corporate disclosure. The AER assessment process determines whether the applicant poses an "unreasonable risk", taking into account factors such as:

- Compliance record
- Experience of the applicant, along with its directors and senior management
- Corporate structure
- Financial health

The current version of Directive 067 does not specify what "risk" is in relation to; however, we would presume (hope?) those risks have always included the likelihood a licensee will be unable to meet its end-of-life liability obligations.

So, what are the proposed changes?

The proposed amendments to Directive 067 increase the scrutiny of the AER assessment process and clarify that the assessment pertains to the entirety of the "energy development life-cycle." While there are proposed amendments throughout the Directive, our attention was captured by the new requirements associated with the assessment on financial capacity. Applicants will now be required to submit financial statements and a new schedule summarizing information contained in those financial statements. The proposed new financial information requirement is set out in section 4.4:

> 4.4 Financial Information
>
> Financial statements and financial summary (Schedule 3) will be used by the AER to
>
> • assess licensee eligibility,
> • assess the capabilities of licensees and approval holders to meet their regulatory and liability obligations throughout the energy development life cycle,
> • administer our liability management programs, and
> • ensure the safe, orderly, and environmentally responsible development of energy resources in Alberta, throughout their life cycle.
>
> Full audited financial statements must be submitted when available, matching the totals in Schedule 3. If audited statements are not available, those prepared by management may be acceptable. Upon review of the information provided, the AER may request additional information.

> In the case of an applicant that is a new company with no financial history, details of financing must be provided (Schedule 3).
>
> If the applicant is a subsidiary of another corporation, the financial summary (Schedule 3) and financial statements of the parent corporation must be submitted as well.
>
> Licensees and approval holders must submit financial statements (audited or management prepared) and the financial summary (Schedule 3) annually within 120 days of their fiscal year end, or as directed by the AER, in order to maintain eligibility (see section 5).

Section 4.5 adds new assessment factors which speak directly to capacity, liabilities, and Alberta's growing orphan well problem:

- the assessed capability of the applicant, licensee, or approval holder to meet its regulatory and liability obligations throughout the energy development life cycle;
- the assessed ability of the applicant, licensee, or approval holder to provide reasonable care and measures to prevent impairment or damage in respect of a pipeline, well, facility, well site, or facility site;
- outstanding debts owed to AER or the Orphan Fund by the applicant, licensee, or approval holder, or by current or former AER licensees or approval holders that are directly or indirectly associated or affiliated with the applicant, licensee, or approval holder, or its directors, officers, or shareholders.

Commentary

In its overview video, the AER describes how the financial capacity assessment under Directive 067 will be combined with a liability assessment to produce an overall assessment on the risk of financial distress and the ability of a licensee to meet ongoing and end-of-life liabilities. Perhaps the key message delivered here is the AER's assertion that this assessment will happen long before the licensee is circling the drain of bankruptcy. We are told the AER will collect "business intelligence" on a licensee by reviewing financial statements, calculating ratios, working capital, debt levels, and examining liquidity, to assess its potential for financial distress in conjunction with its ongoing and end-of-life regulatory and liability obligations, and trigger the need for regulatory intervention. Whether this paradigm shift actually occurs, of course, remains to be seen. The proposed new additions to Directive 067 provide reason for optimism, however there are some troubling shortcomings in this proposal.

The AER should take some direction from the Alberta Securities Commission (ASC) in relation to financial reporting and compliance assessment. Indeed, we would suggest the efficacy of this proposed new capacity assessment approach depends on the willingness of the AER to learn from the institutional expertise of the ASC in this regard. As part of its mandate, the ASC regulates persons who are in the business of trading or advising in securities. A significant aspect of that regulatory function is an oversight and compliance program which seeks to ensure these capital market participants are solvent and can meet their ongoing liabilities and other commitments. While there are obvious differences between the objectives of securities regulation and the implementation of a reclamation liability management framework, there is significant overlap in relation to financial assessment of regulated persons.

Even a quick glance at the Financial Condition requirements set out in Part 12 of National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations will illustrate how woefully simplistic and weak the AER's proposed financial information requirements are in Directive 067, as compared to what the ASC requires of dealers and advisers in the capital markets. In particular, Directive 067 is far too soft on the requirement for audited financial statements. This should be an absolute requirement, along with the filing of interim financial statements, just as is required by section 12.10 in NI 31-103 for capital market participants. The ASC also requires the overwhelming majority of companies in the oil and gas sector to prepare, file, and disclose audited financial information when they seek investment financing. Exemptions are available, but they must be applied for and justified. In short, there is no credible excuse for such a soft rule on financial disclosure by the AER here.

Another bit of experience that we expect the ASC would share with the AER is the importance of requiring firms to designate a compliance officer who is responsible for ensuring the firm establishes policies and procedures designed to achieve compliance with the requirements of the Liability Management Framework. Again, with reference to NI 31-103, the ASC requires its regulated licensees to appoint a compliance officer who is accountable to the regulator for the compliance activities of licensees, and who helps to create an overall culture of compliance within the industry.

The absence of requirements such as the foregoing in the proposed Directive 067 suggests a much more pessimistic view is warranted on the potential for a "paradigm shift" in regulatory approach here. And even if these requirements are strengthened, will the AER have the people capacity to implement the compliance program needed to actually conduct this oversight on an ongoing and timely basis?

"Paradigm shift" is also inaccurate because the compliance program is merely a patched-up version of the old approach. The AER still takes no default security, the AER still imposes no fixed closure timelines (though something like this may be implemented later as part of the promised inventory reduction program), and the AER still aims to enforce once a company shows financial red flags – exactly the point at which it is often too late.

The new approach also fails to account for busts in a boom and bust industry. When the price of oil crashes, the financial situation of every oil and gas licensee instantly gets worse. The last two spikes in orphan wells were caused by oil-price crashes in 2008 and 2020. The new system offers no protection against future oil-price crashes.

And where is the public disclosure and transparency in all this assessment work? If (when?) the AER's attempt to resolve the growing Orphan Well and other end-of-life liabilities problem fails, taxpayers (and not just Albertans) will almost certainly be left to pay the majority of the bills. The polluters will be long gone. At the very least, the AER should be fully transparent in its efforts to avoid that unfortunate (yet increasingly likely) outcome.

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