November 15, 2017

Orphan Well Association v Grant Thornton Limited: What's at Stake in *Redwater*

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Case Commented On: Orphan Well Association v Grant Thornton Limited, [2017 ABCA 124 (CanLII)] ([leave granted])

I. Introduction

This week, the Supreme Court of Canada (SCC) granted leave to the Alberta Energy Regulator (AER) to hear its appeal of *Orphan Well Association v Grant Thornton Limited* (*Redwater*) (for more on the *Redwater* decision, see Nigel Bankes' post). The Court of Appeal's decision in *Redwater* has punched a hole in the AER's program for ensuring that licencees of oil and gas wells have the capital necessary to satisfy their reclamation and abandonment obligations. The ruling effectively allows trustees in bankruptcy to disclaim worthless assets (e.g., non-producing wells where the abandonment process is not yet complete), while selling valuable assets (e.g., producing wells). *Redwater* grants secured creditors the best chance possible to be compensated from the bankrupt's assets, while guaranteeing that Alberta's oil and gas industry (and potentially taxpayers) pay the cost for the bankrupt's reclamation and abandonment obligations. As things stand today, if *Redwater* is not reversed, even more wells will be orphaned, adding to the already alarming number on the books of the Orphan Well Association (OWA).

Redwater is only the tip of the iceberg for the problems facing the AER. Following the collapse in oil prices in 2014, the weakness of the AER's regulatory framework became apparent. Last month, the C.D. Howe Institute released a report, documenting that the number of orphan wells has jumped in Alberta from less than 100 to over 3,000 in 5 years. Moreover, of the 450,000 wells in Alberta today about 35% (i.e., approximately 155,000 wells) are neither producing nor remediated. After applying a variety of stress tests to these wells, the researchers reported the potential "social cost" for orphan wells could range from $130 million to $8 billion. Social cost is a term of art in economics that does not equal the cost to taxpayers, rather it means the sum of private costs (buyer's costs) plus external costs (other than buyer's costs).

Who pays what portion of these future external costs is still undecided, but as things stand today, these external costs will be paid by the solvent oil and gas companies operating in Alberta. However, if the more dramatic scenarios within the C.D. Howe Report come to pass, it is hard to imagine that Alberta's taxpayers would not be on the hook for at least a portion, considering the provincial government has stepped in to help in the past (*Re Redwater Energy Corporation*, 2016 ABQB 278 (CanLII) at para 34).

The below outlines how *Redwater* complicates the daunting challenge facing the Alberta government and the AER to deal with the problem of orphan wells. Part Two sketches the AER's current regulatory framework for abandoning, remediating, and reclaiming wells. Part Three explains how *Redwater* adds to the reform challenge. Part Four offers some concluding thoughts.

II. The AER's Regulatory Framework

The centerpiece of the AER's regulatory framework is the Licensee Liability Rating Program (LLR) (AER Directives 006 & 011). LLR has been designed to ensure that the Alberta government and landowners do not get strapped with the external costs of oil and gas production. In other words, it is designed to help ensure the public does not foot the bill for the cost of abandonment and reclamation for wells, oil and gas facilities, and pipelines that have come to the end of their economic life.

Generally speaking, to abandon a well, permanent plugs are placed in the wellbore and all wellhead equipment must be removed. To reclaim the wellsite, the land must be returned to its original condition.

The LLR does not require a performance bond (i.e., a deposit of money that guarantees the fulfillment of abandonment and reclamation obligations), unless a company's Liability Management Ratio (LMR) (i.e., total deemed assets over total deemed liabilities) is less than 1.0. The LMR is assessed on a monthly basis (AER Directive 006). The 1.0 ratio has been increased to 2.0 for the purpose of license transfers. It was implemented as an interim measure in June 2016 after the Alberta Court of Queen's Bench issued its judgement in *Redwater* (AER Bulletin 2016-16).

This interim measure compromised a few sales but it has not had much impact because it has not been strictly enforced. Enforcing the 2.0 ratio would push some existing zombie companies (i.e., companies in the vicinity of bankruptcy) – and there are more than a couple in Alberta – into bankruptcy. A bankruptcy in Alberta today allows the trustee to take the bankrupt's valuable well assets for the secured creditors, which pre-*Redwater* would have been used to pay for the abandonment and reclamation of the bankrupt's financially exhausted wells. If the AER now pushes a zombie company into bankruptcy, the AER will only be left with the zombie's liabilities, which will in turn be forced upon solvent oil and gas companies. So, if the AER strictly enforced the interim measure, it might only make the orphan well problem worse.

The LMR is used to assess whether an application for a new licence or the transfer of an existing licence to a purchaser will be approved (AER Directives 006 & 067). It also is used to determine whether or not a company will have to post a performance bond, called a "Security Deposit" (AER Directive 068). Non-compliance with an order for a Security Deposit could result in an abandonment or a closure order (AER Manual 013). But again, if such enforcement leads to bankruptcy it will likely make matters worse, not better, in the post-*Redwater* world.

At the end of a well's economic life, the licencee must abandon the well in accordance with regulatory requirements (*Oil and Gas Conservation Rules*, Alta Reg 151/1971, part 3.0). The licencee may also be required to abandon the well if other conditions that endanger the public interest occur (*Oil and Gas Conservation Rules*, part 3.0). The problem is that, as a general rule, these obligations do not specify a timeframe for when the well must be abandoned.

After a well is abandoned and the well site is reclaimed in accordance with the regulations, the AER will issue a reclamation certificate (*Environmental Protection and Enhancement Act*, RSA 2000, c E-12, sections 136, 137). Such a certificate does not release the licensee from future liabilities, which are associated with the well. Even though the wellbore reverts back to the lessor (i.e., usually either a private landowner or the province), the licensee remains liable in perpetuity for any future costs associated with the well, unless the well is transferred to a new licensee, who assumes the liability (*Oil and Gas Conservation Act*, RSA 2000, c O-6 section 29). So, considering the high costs of abandonment in a tight market, companies have an incentive to leave wells un-remediated even when they have come to the end of their economic life.

The AER will deem some wells that are neither producing nor remediated as "orphan wells" (*Oil and Gas Conservation Act*, section 70). After a well is designated as an orphan well, it is added to the list of wells to be abandoned and reclaimed. The OWA is responsible for such abandonment and reclamation activities. The OWA is a non-profit organization created under the authority granted to the AER (*Oil and Gas Conservation Act*, section 70). It is funded by the "orphan fund", which is capitalized by the industry actors through the "orphan fund levy" (*Oil and Gas Conservation Act*, sections 73-77; *Oil and Gas Conservation Rules*, part 16.5). For instance, in 2017-2018, the AER prescribed a levy of $30 million upon the industry (AER Bulletin 2017-14). The OWA's board is comprised of members from Alberta Environment and Parks, the AER, the Canadian Association of Petroleum Producers, and the Explorers and Producers Association of Canada.

If an industry actor does not pay their portion of the levy by the prescribed date (*Oil and Gas Conservation Act*, section 73), then the delinquent actor is liable to pay a penalty, which can equal up to 20% of the levy (*Oil and Gas Conservation Act*, section 74). The provincial government has also, at times, contributed money to the OWA (*Re Redwater Energy Corporation* at para 34). Once the abandonment of a well is completed, the OWA is eligible to be reimbursed from the monies held as a security deposit for the well by the AER – that is, if such a deposit exists (*Re Redwater Energy Corporation* at para 34). Reclamation of a well by the OWA does not release any of the defaulting parties from any of their liabilities, and if any money is recovered for any such liabilities for said parties, then it must be paid to the AER (*Oil and Gas Conservation Act*, section 71).

Before *Redwater*, if a company went into bankruptcy, the trustee in bankruptcy had to take steps to ensure that the abandonment, remediation and reclamation obligations of the bankrupt licencee were satisfied before the AER would approve the transfer of the bankrupt licencee's producing well assets from the trustee in bankruptcy to a purchaser (*Oil and Gas Conservation Act*, section 24). As mentioned, the LMR was checked on a recursive basis to see that all licencees maintained a 1:1 ratio, so in theory, the bankrupt's licenced assets ought to have just about covered the outstanding obligations, creating what could be considered a "super priority" for the AER to satisfy the debts owed for bankrupt licencee's outstanding abandonment, remediation and reclamation obligations (*Re Redwater Energy Corporation* at para 53).

III. The Redwater Challenge

Before *Redwater*, *PanAmericana de Bienes y Servicios v Northern Badger Oil & Gas Limited*, 1991 ABCA 181 (CanLII) (*Northern Badger*) was the leading case on the issue of the enforceability of provincial abandonment and reclamation obligations upon a bankrupt well licencee. Chief Justice Laycraft, writing for the majority, argued:

> When the citizen subject to [an] order complies, the result is not the recovery of money by the peace officer or public authority, or of a judgment for money, nor is that the object of the whole process. Rather, it is simply the enforcement of the general law. The enforcing authority does not become a "creditor" of the citizen on whom the duty is imposed. (para 33)

Accordingly, Chief Justice Laycraft held that the predecessor to the AER could not be characterized as a creditor, who ought to be subject to the claims process under bankruptcy, concluding that its abandonment and reclamation regulatory framework was not subordinate to the Federal *Bankruptcy and Insolvency Act* (*BIA*). To put differently, Chief Justice Laycraft determined that the obligations were enforceable even when a bankruptcy was being conducted.

Redwater overturned *Northern Badger*, rendering the AER's decommissioning regulatory framework inoperable to the degree that it interfered with the operation of the *BIA*. As a result, a trustee in bankruptcy now can sort through a bankrupt's well assets scavenging what is valuable to satisfy the debt of secured creditors, while leaving Alberta's oil and gas industry and taxpayers with the bankrupt's decommissioning liabilities. *Redwater* helps ensure that the banks, who were operating under the presumption that they could not separate a bankrupt's valuable oil and gas assets from their environmental liabilities when they issued the debt in question, can now do so.

The outcome of this case was by no means inevitable. The Alberta Court of Appeal had other options. In my full article on *Redwater* entitled "How to Deal with a Fickle Friend? Alberta's Troubles with The Doctrine of Federal Paramountcy" (Janis P. Sarra & Barbara Romaine, eds., 2017 Annual Review of Insolvency Law (Toronto: Carswell, 2018)), I outline how the majority's reasoning of the complex constitutional issues and its treatment of energy law at play are respectfully vulnerable to being overturned.

As *Redwater* demonstrates, the certainty that *Northern Badger* provided was removed by the SCC in *Newfoundland and Labrador v AbitibiBowater Inc*, 2012 SCC 67 (CanLII) (*AbitibiBowater*). Mr. Justice Slatter, who wrote for the majority, interpreted *AbitibiBowater*, and *Northern Badger* in light of *AbitibiBowater*, in a manner that demonstrates that the SCC's intervention is clearly warranted.

Hopefully, the SCC will provide greater clarity to the cursory comments in *AbitibiBowater* as to the potential application of the first requirement of the SCC provable claims test, being in full: "The only determination that has to be made at this point is whether the regulatory body has exercised its enforcement power against a debtor" (*AbitibiBowater*, para 27). At first blush, this suggested application – in the context of the case as a whole – creates what amounts to a presumption which cannot be rebutted. In other words, a regulator is always a creditor. But this interpretation must be misguided, since it is directly at odds with the application of the doctrine of co-operative federalism as determined by *Canadian Western Bank v Alberta*, [2007 SCC 22 (CanLII)] (*Canadian Western Bank*) and *O'Grady v Sparling*, [1960] SCR 804, [1960 CanLII 70 (SCC)] (*O'Grady*). Respectfully, greater clarity as to the relationship between *AbitibiBowater*, and cases such as *Canadian Western Bank,* and *O'Grady* will be welcome.

After carefully weighing what was a stake in *Redwater*, under a section of reasoning forebodingly entitled "'Fairness' of the Outcome", Slatter concluded with asserted confidence that fairness "is not the issue" (*Redwater*, para 99). Respectfully, it is a bit disconcerting that Justice Slatter brushes aside issues of fairness, suggesting that it was "perhaps in the eye of the beholder" (*Redwater*, para 98). Such dismissal of fairness is discomforting knowing that the ruling employed some debatable reasoning and contentious interpretations of SCC precedent to reach its conclusion.

Yet, if fairness is an issue, banks calculate default risk better than any other actor in the market. Even if no one, including the banks, predicted the dramatic collapse of oil prices in 2014, banks are best positioned to weather such events. They set the interest rate of a given loan in proportion to the risk of lending (which includes such unforeseeable contingencies as the notorious volatility of oil markets). *Redwater* has been very generous to the banks, changing the rules in hard times to give them a financial boost by offering them additional assets of their bankrupt creditors. These additional assets that *Redwater* grants to the banks are being taken from the AER, compromising its financial capacity to cope with the Orphan Well Crisis. Fairness is "perhaps in the eye of the beholder", but it is hard to see how subsidizing banks in this way and at this time is fair.

Redwater has made a bad situation potentially much worse. If the AER attempts to fortify the regulatory framework using the LMR mechanism, zombie companies will go bankrupt and any value that the company had will be snatched by secured creditors to the detriment of the AER's regulatory framework.

Another fallout from *Redwater* is that banks no longer have to consider abandonment, remediation, and reclamation obligations of the debtor, when they approve the loan application of oil and gas companies. If the banks can take the valuable oil and gas assets and sell them to pay the debt obligations, while leaving the wells that are neither producing nor remediated with the AER and OWA at no expense to them, then as far as the banks are concerned, such liabilities are not risks that they need to consider when calculating the risk of lending.

The operational effect of *Redwater* is to reallocate the risk of lending from banks to solvent industry actors. If a creditor goes bankrupt, a secured creditor with priority over the AER will be made whole before the cost of abandonment and reclamation becomes a consideration. Moreover, as Justice Slatter prudently pointed out, "The recognition of the actual and contingent obligations of the potential borrower does not, however, mean that the creditor is prepared to subordinate its interests to those obligations..." (para 98).

In fact, taking it one step further, banks will not subordinate their interests to reduce the default risk of others. In other words, if a bank can issue a loan and the borrower has enough assets to properly collateralize the debt as to make the risk of default low for the bank, it will issue the loan and profit from the interest. It is not a concern of the bank that the loan, which it issues to the borrower, increases the risk of default to other creditors, who have lower priority in bankruptcy, and who issued said loan without the proper contractual assurances from the borrower that it would repay the debt. The contractual failure of other lenders is not the concern of a for-profit bank, nor should it be.

By this same logic, *Redwater* incentivizes banks to lend to exploration and production companies, who can meet their financial obligations to the bank, without any consideration for whether they can also fulfill their abandonment and reclamation obligations. Before *Redwater*, these obligations had priority over the repayment of bank debt, accordingly the incentives were in place so that the banks could be relied on by the AER to be an effective gatekeeper. A bank had to calculate abandonment and reclamation obligations into the potential borrower's default risk. By doing so, the banks helped to ensure that only those companies that could pay their abandonment and reclamation obligations would be granted debt financing to develop oil and gas assets. *Redwater* has now shifted these incentives, and banks no longer calculate such obligations into their default risk estimations, since such obligations have no impact on said risk. Thus, banks will issue debt with no consideration of abandonment and reclamation obligations, increasing the risks of orphan wells moving forward.

Redwater has shifted the regulated space by shifting the incentives for key actors. This fact ought to be a grave concern for the Alberta government and the AER.

IV. Conclusions

Redwater makes it far more challenging to deal with the orphan well crisis. However, it could still be overturned by the SCC. The first step was for the SCC to grant leave to the AER.

Regardless of the fate of *Redwater*, it will take significant coordination between the oil and gas industry and the AER to cope with the orphan well crisis successfully. Likewise, the AER and the Alberta government will have to make significant reforms to shore up the regulatory framework for orphan wells, mitigating its weaknesses without pushing zombie companies into bankruptcy.

A version of this post will be published in Canadian Association of Petroleum Landmen's "The Negotiator" in January 2018.

This post may be cited as: Fenner L. Stewart "*Orphan Well Association v Grant Thornton Limited*: What's at Stake in *Redwater*" (15 November, 2017), online: ABlawg, http://ablawg.ca/wp-content/uploads/2017/11/Blog_FS_Orphan_Well.pdf

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