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Polluter Pays Principle at Risk: Auditor General Finds Alberta's Oil and Gas Liability Regime Still Badly Deficient

Regulatory Documents Commented on: Auditor General of Alberta, "Liability Management of (Non-Oil Sands) Oil and Gas Infrastructure", March 2023

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Late last week, the Auditor General of Alberta released a scathing report that concludes that, notwithstanding some ongoing reforms, the management and regulation of end-of-life oil and gas liabilities by the Alberta Energy Regulator (AER) remains seriously deficient in several key areas. This assessment of the AER is one of four components of the Auditor General's March 2023 report, and is set out as Section 2 Liability Management of (Non-Oil Sands) Oil and Gas Infrastructure (AG AER Report). The AG AER Report audited AER operations to assess (1) whether the AER's current liability management system effectively mitigated the risks associated with the closure of oil and gas infrastructure and (2) whether the AER appropriately identified the risks and gaps in the previous liability management system and prepared an implementation plan for changes to effectively mitigate those risks and gaps. This comment focuses on the findings that the AER's oil and gas liability management regime remains deficient in key areas. The timeframe for this assessment in the AG AER Report (August 2018 to June 2022) is important because it includes pre- and post-implementation of the new Liability Management Framework from Alberta Energy in July 2020, which is supposed to (but has not yet) replace the previous and failed Licensee Liability Rating Program (LLR program), and thus offers the first independent assessment of the effectiveness of that new Framework. Readers should note that the AG AER Report does not assess the Mine Financial Security Program (MFSP) for oilsands mines and coal mines, which has already been subject to two of its own highly critical audits (2015 and 2021) and recently underwent government review (the results of which are not yet known).

The audit of the AER in the AG AER Report was based on a review of applicable legislation and several methods of data and evidence collection, including: (1) interviews with AER staff and relevant third parties; (2) review of AER policies and procedures; (3) examination of transaction records; and (4) site visits to active, abandoned, and reclaimed sites (for a glossary of these and other common terms, see here). The audit reveals several areas where oil and gas liability management remains deficient, and our commentary here focuses on the following:

- Performance Measurement and Public Accountability

  Key AG finding: Public reporting and external performance measurement on liability management are insufficient to assess whether results are being achieved and risks are being effectively managed. AER has an industry-wide closure liability estimate but does not regularly update it or communicate it to Albertans.

- Sufficient Financial Security and Minimized Risk of Inappropriate Licence Transfer

Key AG finding: The Licensee Liability Rating Program, which has historically failed to properly identify financial risks and to ensure sufficient security is collected, remains in place despite its known failures. AER's licence transfer process is also too discretionary and lacks sufficient monitoring of licensee conditions.

- Inactive Site Closure

Key AG finding: There are still no legislated timelines for the abandonment or reclamation of sites. Inactive well sites continue to grow in numbers, abandonment work has remained flat, and licensees have focused more of their clean-up activities on low-risk and lower-cost sites.

- Monitoring and Compliance on Site Closure Work

Key AG finding: AER has not completed well-suspension compliance assurance activities for the past three years. AER completes proactive inspections on abandoned wells; however, there is no assurance process to ensure routine abandonments are complying with directives. AER has increasingly automated its approval process for reclamation certificates, but improvements are needed to ensure approvals are consistently valid. Manual reviews for reclamation certification are occurring; however, improvements are needed to ensure judgments and reviews are properly evidenced. AER lacks processes to ensure that third-party professional declarations meet requirements. AER audits reclamation post-certification; however, the process has been inconsistent and there is a 16 per cent rate of non-compliance. AER did not consistently complete reviews of remedial action plans.

- Orphan Well Levy and the Orphan Well Association (OWA)

Key AG finding: The AER did not scrutinize the orphan levy proposed by the OWA prior to 2022 and has never analyzed the longer-term sustainability of the Orphan Fund.

ABlawg has explained deficiencies with the AER's liability management program since at least *Redwater* in 2016, with comments on the secrecy of the reform process in late 2020, including updates in February 2021, and again in July 2021; complaints about the orphan fund in May 2022; and discussion of the mandatory closure spend in July 2022. These blog posts have argued that there are major problems with how the AER designs and implements liability management programs, and so while the Auditor General's findings in the AG AER Report are not unexpected, they do provide additional evidence-based confirmation of these deficiencies. The AG's findings are truly stunning.

Performance Measurement and Public Accountability

The AG AER Report confirms the serious lack of transparency in how the AER is implementing the new Liability Management Framework. This problem manifests in two ways: (1) a lack of external performance measures on closure work; and (2) failure to report meaningful information to people in Alberta. The absence of transparency makes it difficult for the public to hold the AER accountable for its regulatory functions in this area.

It is a basic element of any regulatory regime to have explicit objectives and performance measures. The AG AER Report observes that the AER has failed to satisfy this element in relation to its implementation of the Liability Management Framework. The absence of stated objectives means it is difficult for the AER to correct course or implement continuous learning to improve the Liability Management Framework, and more crucially, it is impossible to assess what level of closure and reclamation work is needed to meet long term sustainability outcomes for Alberta.

Public disclosure by the AER is woeful. The AG AER Report notes that while the AER publishes data on inactive site closure activity, there is no meaningful reporting on total inactive sites. Similarly, the AG AER Report notes that the "AER has an industry-wide closure liability estimate but does not regularly update it or communicate it to Albertans" (at 22-23). The AG AER Report notes that the AER's June 2022 estimate of total closure liability, including both inactive and active, wells, facilities, and pipelines is $60 billion (at 23, footnote 1).

The $60 billion figure includes "pipelines and more recent information" (at 23). However, the AG AER Report notes that the "AER does not regularly update (i.e., annually) its liability estimate to include all key components and the best and most recent data" (at 23). So it is not clear if all "key components" are included or how recent the data used to generate that estimate is.

Complete disclosure from the AER (or Alberta Energy) of the best currently available industry-wide closure liability estimate, along with an explanation of how that estimate is being calculated, is long overdue.

Obtaining Sufficient Financial Security

First, the AER was unable to effectively collect security owing because of a fundamental flaw in the previous LLR program that left the AER attempting to collect "more security when the licensee lacks the financial ability to post more" (at 30). The AG AER Report says "our analysis of 10 operators with the largest difference between security owing and security held by AER found all but one of those companies was already either bankrupt or in receivership. The collective amount of security owed by these companies to AER was $417 million" (at 30). For context, in March 2019, the LLR program held $231 million in security – so the AER appears to have collected less than half of what it should have collected under the LLR program. The AER identified this problem, but has not solved it, as their new framework did "not provide direction as to when and how security should be collected." (at 21)

One shocking paragraph of the Report must be reproduced in full:

> AER did an analysis in 2019 that shows the considerable impact when updated information *and pipelines* are included in the calculation of deemed assets and liabilities. For example, at the time of the analysis, deemed *assets would have dropped from $148 billion to $93 billion*, while deemed liabilities would have increased *from $30 billion to $62 billion*. Using these figures within the LLR program security calculation would have resulted in an

> increase of security owing to AER from *$475 million to $17 billion*, a 36-fold increase, further reinforcing the inherent flaws in the LLR program overall given the inability for the highest risk operators to post the necessary security to begin with. (at 30, emphasis added)

Calculating from the numbers provided, the prior LLR program was overvaluing assets by a factor of 1.59, and liabilities were being underestimated by about half. Because of the liability only being collected when a company was below a fixed ratio (1.0 prior to June 2016 and 2.0 after), the LLR formula did not under-collect in a linear manner (i.e. in direct relationship) to those errors – it collected nothing at all from companies that should have been required to post large security deposits. The LLR was showing security owing at less than one twenty-fourth of the security it should have and, as noted above, the AER was failing to even collect that amount.

The asset-to-liability approach used by the LLR meant that errors in the value of assets or liabilities had a gigantic and non-linear impact on the calculated security owing. Consider this example of the impact of the 2019 LLR improvements on a hypothetical oil and gas company:

	Actual LLR Program	Adjustment to improve estimate accuracy	2019 Proposed LLR Calculation Improvement
Deemed Assets	$200 million	÷ 1.59	$126 million
Deemed Liabilities	$100 million	x 2	$200 million
LMR/LLR score	2.0	(2.0 requirement)	0.63
Security owing to the AER	$0		$74 million

The hypothetical company would go from owing $0 in security to owing an amount estimated to be more than half the actual total value of the company's oil and gas assets. At the risk of stating the obvious, the LLR program, in use in Alberta since 2002, was a total failure at obtaining a protective amount of security.

Despite these glaring deficiencies, "[t]he Licensee Liability Rating Program, which has historically failed to properly identify financial risks and to ensure sufficient security is collected, remains in place while AER determines a future approach to security" (at 29). At the start of March 2023, the AER still held less than $285 million in security under the LLR program.

The AG AER Report goes on to note that the AER has since announced its Inventory Reduction Program, which sets out an annual mandatory spend for industry on closure activity, but cautions that whether this program "does encourage timely closure, particularly for higher risk sites, is something AER will have to evaluate over the coming years" (at 28). Already, there are hints that the mandatory closure spend amounts are too small to be effective and will face challenges in enforcement. The Inventory Reduction Program uses the failed LLR program's faulty inactive liability estimate for calculating the Mandatory Closure Spend. The targets for 2023 are 6.7% (for most companies) and 3.6% (for financially distressed companies) of deemed inactive liability *under the LLR*, which (as noted above) the AG AER Report reveals is half what it should be. This means that the percentages of inactive liability that oil and gas companies must clean up under the Inventory Reduction Program is actually about 3.4% (for most companies) and 1.8% (for financially distressed companies) of the AER's actual best estimate of inactive liabilities. And because around 1/3 of assets in Alberta are currently inactive, the Mandatory Closure Spend is requiring companies to handle about 1.5% of the provinces total oil and gas liabilities per year.

Minimizing the Risk of Inappropriate Licence Transfers

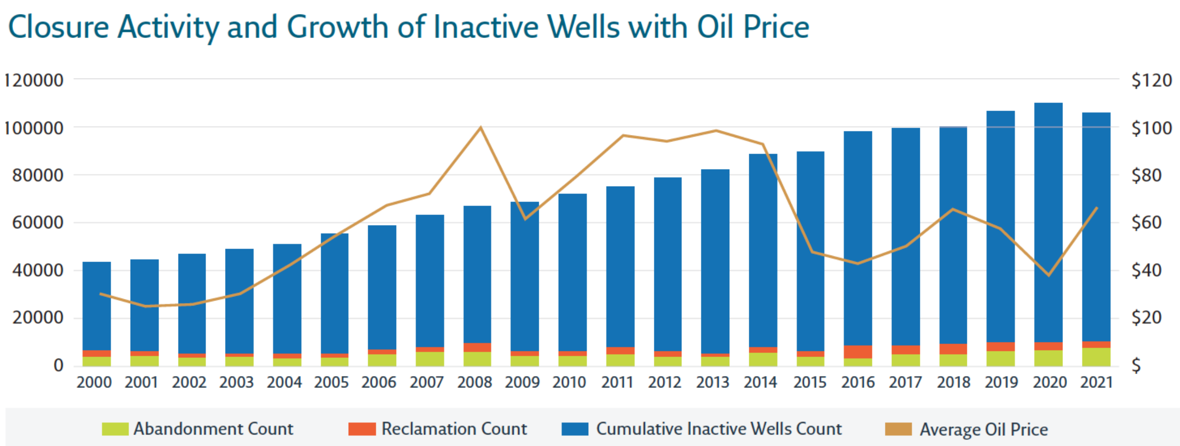
The AG AER Report noted that the AER had failed to address a form of inappropriate transfer where corporate owners could purchase "good assets" (high production/low liability wells) from a bankrupt company while leaving "bad assets" (non-production/high liability) with the bankrupt company" (at 31). [This situation has been described on ABlawg before] in relation to *Sequoia* (see [ABlawg's discussions of the ongoing litigation]). Referencing *Sequoia*, the AG AER Report says that "[t]he licence transfers for these wells did not need to be approved by AER as the corporate transactions were considered outside the scope of AER's regulatory approval framework at the time" (at 32, footnote 28). Another problem that contributed was that: "[w]hile AER does regulate the transfer of licences, it does not control or regulate the commercial transfer of ownership interests" (at 29). The LLR considered only the licensee of record and not their ownership share, which gave [a distorted view of the assets and liabilities] being transferred.

The AG AER Report notes that the AER has not developed clear delegation of authority for handling discretionary license transfers. This deficiency is [increasingly important] under the more discretionary new Licensee Capability Assessment approach to handling transfers (at 32-33).

Inactive Site Closure

The Government of Alberta has known about the 'inactive site' problem in the oil and gas industry for decades. Generally speaking, an 'inactive site' is a facility, such as a well or pipeline, that has not been in use for a specified time period (usually between 6 and 12 months, depending on the type of facility), and has not been properly abandoned or reclaimed. In other words, an inactive site is not producing and has not been cleaned up. The absence of stringent rules in applicable legislation imposing timeline requirements for abandonment and reclamation has allowed industry to both (1) keep facilities 'active' by only operating them periodically and (2) leave 'inactive' facilities on the landscape for decades.

The AG AER Report graphically illustrates the scope of the inactive site problem with respect to just one type of facility – wells:



As noted by the AG, in 2020 the federal government provided a $1 billion grant to Alberta to provide the oil and gas industry money to perform closure work on inactive sites. The AG credits this grant for the slight reduction in the inactive well inventory in 2021. We note, however, that this funding was premised on a commitment from Alberta to make regulatory and policy changes intended to meaningfully address the inactive and orphan site problem and ensure industry complies with the polluter pays principle, a commitment that the AG AER report has certainly cast in doubt.

The AG AER Report describes the AER inventory reduction program and notes that the AER expects this program will significantly address the inactive site problem. However, the AG AER Report cautions that the effectiveness of the program will depend on strong monitoring, compliance, and enforcement systems at the AER – systems which are not apparent today. The AG AER Report also observes that Alberta and the AER have still not addressed the most significant shortcoming in the applicable legislative framework: the absence of a legislated timeline for closure activities such as abandonment and reclamation (at 27) (although beyond the scope of the AG AER Report, a modified form of closure timelines, closure nomination, is set to start in April 2023). Moreover, and rather predictably, the audit reveals that closure work has been directed at the sites that were cheapest and simplest to close:

> Our audit found that licensees tend to focus on completing low-cost well abandonment and reclamation activities. For example, 36 per cent of well licences abandoned by licensees and 74 per cent of reclamation certified well sites had never been brought into production. Hence, they were relatively easy and inexpensive to abandon or reclaim. The lack of timelines for abandoning or reclaiming sites makes it possible for licensees to focus on less costly sites, leaving more complex and contaminated sites in a suspended or abandoned state. (at 28)

Because Alberta has 133,000 certified reclaimed wells, that means less than 35,000 wells that ever produced oil or gas have been certified reclaimed in Alberta.

Monitoring and Compliance on Site Closure Work

Closure work begins with the suspension of an active site, followed by abandonment, then remediation (if needed), and finally reclamation of the surface lands. Since these are legal terms, it is a mistake to use any common understanding of their meaning: suspension involves steps to check for substance releases and temporarily secure an inactive site (see AER Directive 013); abandonment includes permanently dismantling surface infrastructure, as well as sealing or isolating wells and pipelines to preclude subsurface contamination (see here for a discussion of well abandonment); remediation and reclamation is the process of removing contaminants such as hydrocarbons and other toxic substances, and restoring soil, vegetation, and other surface attributes to a pre-disturbance equivalency.

A major conclusion from the AG AER Report is the confirmation that AER has failed to undertake adequate monitoring and compliance at all stages of site closure work. Remarkably, the AER paused their well suspension compliance assurance work in 2019, and "did not have a timeline for restarting" (at 34). This is despite the effectiveness of that program in bringing a large number of suspended wells into compliance with regulatory requirements but also that approximately 17,000 wells remained not in compliance. The AER does not administer a process to confirm that routine (i.e. in the normal course) abandonment work is in compliance with AER regulatory requirements (at 35).

The most glaring deficiencies in oversight are with respect to remediation and reclamation work, much of which is regulated and approved by the AER using its automated OneStop review process. The AG AER Report included sample testing of reclamation applications approved by the automated OneStop process. This testing revealed that OneStop has approved incomplete reclamation applications, incorrectly describes cancelled reclamation certificates as valid, and automates approval for reclamation applications even for applicants with an established record of non-compliance with requirements (at 36). The AG AER Report also examined manual AER reviews. In the sample testing, 20% of reviewed files did not contain any evidence of the review assessment (at 36). Finally, the entire system relies on third-party professional certification that the remediation and reclamation work was done properly. The AG AER Report found that 20% of applications in the representative sample did not include professional certification, and the AER does not maintain a process to monitor the record of third-party professionals or licensees with respect to non-compliance or cancelled reclamation certificates (at 37).

Simply put, this portion of the AG AER Report calls into serious question whether the AER can still claim the confidence of the public that it is fulfilling its mandate: to ensure the polluter pays principle is being upheld in Alberta and to administer the remediation and reclamation requirements set out in the *Environmental Protection and Enhancement Act*, RSA 2000, c E-12.

Orphan Well Levy and the Orphan Well Association

Over thirty years ago, Alberta's oil and gas industry agreed to the creation of an industry fund to finance the clean-up of orphaned assets (assets licensed to companies who went bankrupt). This fund is currently administered by the Orphan Well Association (OWA), which sets and collects a wholly inadequate annual levy from industry to finance its work.

The AG AER Report notes that while the AER receives an Annual Report and three-year budgets from the OWA, the Auditor General "did not see evidence that AER uses OWA information to inform AER whether the OWA is achieving its goals and objectives or is estimating industry's orphan liability" (at 25) In addition, prior to 2022, there was "no examples of AER suggesting modifications to the amount or evidence of AER doing an analysis of the proposed levy" (at 26). In other words, until 2022 the Orphan Levy had apparently been set by the industry-run OWA without any oversight from the AER. Further, the AER did not model "how long it will take OWA to complete closure work on its current inventory" (at 26). This aligns with previous posts on ABlawg. The AG AER Report also notes that the coming 2023/2024 orphan levy is now expected to be $135 million (at 26).

Conclusion

Alberta's liability management policy to address end-of-life liabilities in the oil and gas sector has been an overall failure since the problem was initially considered in the mid-1980s. In recent years, this failure has led to the infusion of more than $1billion in public taxpayer money to begin to tackle the problem. Unfortunately, the magnitude of the unfunded liabilities dwarfs this amount. The polluter pays principle has been stymied by poor policy and even worse implementation by the AER. The AG AER Report confirms that significant improvements to policy design and implementation will be needed if the polluter pays principle is to be upheld and implemented in Alberta.

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