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The Problem with Industry Control of the OWA, and OWA Control of Oil and Gas Insolvency

By: Drew Yewchuk & Shaun Fluker

Regulatory Memo Commented On: Internal Alberta Energy Regulator Memorandum, Unintended Consequences of Ministerial Order 043/2023 in Insolvency April 11, 2024

The focus of this post is an internal memorandum written by the Alberta Energy Regulator (AER) Orphaning and Insolvency team: the AER Memorandum on Unintended Consequences of Ministerial Order 043/2023 in Insolvency (the Unintended Consequences Memo). We describe a regulatory problem with potentially serious consequences for municipalities and the public that has not been disclosed to the public by the AER. The Unintended Consequences Memo was obtained in records obtained by the Faculty's Public Interest Law Clinic in its ongoing closure liabilities access-to-information project under the *Freedom of Information and Protection of Privacy Act,* RSA 2000, c F-25 (*FOIP*).

In short, the AER has passed control of appointing insolvency trustees for defunct oil and gas corporations to the industry-controlled Orphan Well Association (OWA). This is obstructing the efficient handling of defunct oil and gas licensees and their assets, as the OWA's board has an economic interest in preventing oil and gas infrastructure from being sent to the OWA's inventory and, by extension, preventing increases in the orphan fund levy paid by industry.

Background: Insolvencies and Closure Liabilities

Alberta has a major issue with unfunded closure liabilities due to a mixture of deliberate but poor policy choices and errors in the implementation and supervision of those policy choices. This post looks specifically at the issue of who initiates oil and gas licensee insolvencies. For fulsome background on the closure liability problem generally, readers are referred to the paper we wrote with Martin Olszynski: *A Made-in-Alberta Failure: Unfunded Oil and Gas Closure Liability*, *(A Made-in-Alberta Failure)* or the brief summary of that paper here, or Drew Yewchuk's 2022 blog post explaining the Orphan Fund Levy.

Alberta's orphan well program was established in 1986 and gradually developed into its current form (see *A Made-in-Alberta Failure,* especially at 20-23). Since the early 2000's, the OWA has managed the orphan fund for the purposes of closing orphan oil and gas assets in Alberta. We (with Nigel Bankes and Martin Olszynski) previously wrote about problems with the governance structure of the OWA in Governance and Accountability: Preconditions for Committing Public Funds to Orphan Wells and Facilities and Inactive Wells. In that post, we noted that while the OWA has a public mandate, it is by design industry-controlled. In 2022/2023, the OWA's six-member board consisted of representatives of the Canadian Association of Petroleum Producers,

Pathways Alliance, Canadian Natural Resources Limited, Ember Resources, Paramount Resources, and the AER. In that earlier post, we also noted that while the orphan fund was originally intended to be fully industry-funded, the OWA has received significant amounts of public monies over the past 15 years or so (roughly half a billion in the form of low or no-interest loans), and the OWA is not subject to the usual accountability mechanisms applicable to other governmental agencies, boards or commissions (ABCs):

> In our view, the current governance arrangements for the OWA are inappropriate given the extent to which the OWA is exercising delegated governmental powers and responsibilities and spending public monies. In particular, it is unacceptable that the majority of the members of the board are appointed by industry associations, that there is no representation of civil society, and that it is effectively insulated from the normal review and accountability mechanisms that apply to ABCs fulfilling similar functions. The public needs to know, for example, that the OWA has in place appropriate procedures for ensuring that its process for allocating contracts for operations on orphan sites and facilities is competitive, delivers results at least-cost, and is free of political favouritism. Audited financial statements do not provide these assurances. Moreover, the AER has a long history of being dismissive of concerns raised by landowners and municipalities in relation to energy development on their lands. Neither group should be expected to have any faith that the OWA can deliver on the recent promise that landowners will have the ability to nominate and prioritize wells for remediation, and that funding will be prioritized to companies that are in good standing with respect to municipal taxes.

In 2017, the AER took the unprecedented step of petitioning Lexin Resources Ltd into bankruptcy due to safety issues with Lexin's unmonitored wells. But after Lexin, the AER appears to have decided the OWA ought to take the role of petitioning licensees into bankruptcy, and the AER stopped petitioning licensees into bankruptcy.

Court applications to appoint bankruptcy receivers or petition corporations into bankruptcy under the *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 are used to pass control of a corporation to a receiver (typically an accounting organization) so that the assets can be sold to pay creditors. Ordinarily, the creditors of an insolvent corporation will petition it into bankruptcy. However, because the assets of insolvent oil and gas licensees in Alberta are typically required to pay for the licensee's closure liabilities (since at least *PanAmericana de Bienes y Servicios v Northern Badger Oil & Gas Limited*, 1991 ABCA 181 (CanLII), and reaffirmed in *Orphan Well Association v Grant Thornton Ltd.*, 2019 SCC 5 (CanLII)), there is essentially no incentive for creditors to petition those companies into bankruptcy, which leaves the AER or OWA to do so. If no party starts the bankruptcy process, oil and gas infrastructure of defunct licensees are not transferred to a new licensee or to the OWA. Simply put, a bankruptcy process is needed to decompose defunct oil and gas licensees and address their physical infrastructure.

In 2020, amendments to section 70 of the *Oil and Gas Conservation Act*, RSA 2000, c O-6, (*OGCA*) clarified that the orphan fund could be used to pay the costs of a receiver, receiver-manager, trustee or liquidator and specifying that the AER could apply to the court "for the appointment of a receiver, receiver-manager, trustee or liquidator of the property of a licensee"

(*OGCA* at s 106.1) (see Nigel Bankes' post on Bill 12). This was followed by changes to the *Orphan Fund Delegated Administration Regulation*, Alta Reg 45/2001 (*Delegated Administration Regulation)* that specified that the OWA could enter agreements to pay the costs of an insolvency professionals (*Delegated Administration Regulation* at s 4(2)(c)) (see Nigel Bankes' post on the changes to the regulations).

The result is that the AER has allowed the OWA to take over decisions about when to apply to court for insolvency orders in relation to oil and gas corporations for the purpose of creating orphaned assets. For instance, it was the OWA who brought the application to appoint a receiver for Everest Canadian Resources Corp in 2023, and the OWA noted their role in applying to court to appoint receivers for bankrupt oil and gas companies in their 2022/2023 annual report (on page 22).

Background: AER control of License Transfers and Unpaid Municipal Taxes

Pursuant to statutory authority and the Alberta Liability Management Framework, the AER conducts a licensee capacity assessment on companies that hold a license and companies who seek to acquire a license, either by application for a new licence or the transfer of an existing license. The purpose is to assess whether a licensee will meet its ongoing regulatory and closure liabilities. In cases where a licensee is considered at risk to not meet its obligations and liabilities, the AER has the power to deny or restrict eligibility to acquire or hold licenses, impose conditions on licenses, require the payment of a security deposit, and other conditions to mitigate the risk (see *A Made-in-Alberta Failure,* especially at 13-19). The AER has published two directives and one manual to explain how it conducts assessments and exercises its powers thereunder: Directive 067: Eligibility Requirements for Acquiring and Holding Energy Licences and Approvals; Directive 088: Licensee Life-Cycle Management; and Manual 023 - Licensee Life-Cycle Management. The AER describes Directives 067 and 088 as integral components of its holistic assessment of the financial and operational capacity of applicants and licensees to meet their regulatory obligations throughout the entire development life-cycle:

> The licensee capability assessment (LCA) is the backbone of our holistic assessment of companies throughout the energy development life cycle in the oil and gas sector. Introduced through Directive 088: Licensee Life-Cycle Management, the LCA considers a variety of factors to help us evaluate a company, including their financial and liability risk, their performance compared with similar companies, and other operations, closure, and administrative factors, with compliance history being considered throughout.
>
> The information that feeds into the LCA comes from several sources, including financial information that companies are required to provide us through Directive 067. (see here)

In *A Made-in-Alberta Failure* (at 19), we noted that licensee capacity assessments are not publicly disclosed by the AER, and that this high level of secrecy had undermined previous policies on closure liabilities and would likely undermine the new Liability Management Framework as well. The Faculty's Public Interest Law Clinic works on projects which challenge this secrecy, and in a

recent case the AER has shown significant reluctance to disclose licensee capability assessment information, even to a person who is "directly affected" by a proposed energy project (see here for a description of the case and the AER's non-transparent position). Too much secrecy allows the AER to avoid legal and democratic scrutiny on shortcomings and failures.

Unpaid municipal property taxes have received special attention in the implementation of the Liability Management Framework. Drew Yewchuk has previously commented on unpaid municipal taxes and the orphan well problem here. Rural municipalities in Alberta rely heavily on industrial property tax revenues to pay for infrastructure and services. Since about 2014, rural municipalities have seen a rise in unpaid property taxes by some oil and gas operators. As of the end of 2023, the Rural Municipalities of Alberta reported a total of $252 million in unpaid taxes by the oil and gas industry, and $43 million in unpaid taxes for the 2023 year alone (see also here).

It is notable that the $252 million in unpaid and *still owed* taxes understates the size of the problem, as it does not include taxes the oil and gas industry did not pay but that rural municipalities wrote off as uncollectable in order to obtain benefits under the first years of the Provincial Education Requisition Credit (PERC): for example, Big Lakes County, Paintearth County, and the County of Stettler. PERC was announced in November 2017, and was retroactive back to 2015. PERC was meant to mitigate the impact of unpaid oil and gas taxes caused by the 2015 oil price downturn by lowering the amount rural municipalities owe to the provincial government under the provincial education requisition established by the *Education Act*, SA 2012, c E-0.3, Part 6, Division 3 and 4. PERC does nothing to ensure oil and gas licensees pay their taxes. From 2017 to 2020, PERC required rural municipalities to write off the unpaid taxes of oil and gas licensees in order to receive the benefit. The government appears to have recognized this was a needless indirect subsidy to oil and gas licensees, and changes to PERC made between 2019-2021 removed that requirement. By 2021, rural municipalities could obtain the benefits of PERC for unpaid oil and gas licensee taxes without writing off the outstanding tax amounts. PERC was initially set to run until 2019, but in 2019 it was extended to 2021, then in 2021 it was extended to 2023, and in March 2024 it was extended to 2025. Oil prices rebounded by 2021, meaning a program initially intended to supposedly address an oil price downturn has run at least 4 years longer than the price downturn. PERC has become a semi-permanent part of the Albertan tax system to mitigate the impact of unpaid the oil and gas companies' taxes to rural municipalities.

In March 2023, facing pressure from rural municipalities during the lead up to the 2023 provincial election, the UCP Minister of Energy issued Ministerial Order 043/2023 under the authority of section 67 of the *Responsible Energy Development Act*, SA 2012, c R-17.3, directing the AER to address unpaid municipal taxes by doing the following:

1. consider whether the applicant for the licence, the proposed transferor of a license, or the proposed transferee of a licence has outstanding municipal tax arrears exceeding a threshold amount;

2. obtain evidence and take reasonable steps to confirm that an applicant, transferor, or a transferee has no outstanding municipal tax arrears exceeding the threshold or has adopted a payment plan acceptable to the municipality or municipalities that are owed the

outstanding municipal taxes (the Order sets out what would constitute 'evidence and reasonable steps'); and

3. if the transferor has outstanding municipal tax arrears exceeding the threshold, the AER shall require evidence that the payment of the outstanding municipal taxes exceeding the threshold be a condition of the transferor and transferee's agreement for sale of the licence.

The threshold of municipal tax arrears which triggers this requirement was set at $20,000 (see AER Bulletin 2023-22). In other words, Order 043/2023 halted licensee applications and transfers for licensee with outstanding municipal taxes greater than $20,000 unless the purchaser would agree to pay them.

In *A Made-in-Alberta Failure* (at 19), we concluded that the AER had too much discretion in deciding how and when to address closure liabilities. Ministerial Order 043/2023 (Minister of Energy) is perhaps most notable for the fact that it removed AER discretion on how and when to address unpaid municipal taxes. The Unintended Consequences Memo is the AER pushing back against this constraint.

The Internal Memorandum on Unintended Consequences of Ministerial Order 043/2023 in Insolvency

The Unintended Consequences Memo was sent from the AER's Orphaning & Insolvency Team to the CEO of the AER on April 11, 2024. The Unintended Consequences Memo notes that an unintended consequence of the municipal tax payment rule in Ministerial Order 043/2023 is that the OWA intends to stop funding receiverships if the rule is applied to oil and gas licensees in insolvency proceedings. The Memo provides three examples of insolvency distributions that will not proceed if Ministerial Order 043/2023 is applied: Alphabow Energy Ltd, Razor Energy Corp., and Sequoia Resources Corp (as an aside, the size of the liabilities at issue for those three corporations has been redacted as information "harmful to business interests of a third party" (*FOIP* at s 16(1)(a)) – a bizarre choice given the companies are already in insolvency proceedings and the information is already public as part of the insolvency proceedings. Alphabow's deemed liabilities are $155 million (see this post from March 2024), Sequoia's deemed liabilities are $233 million (see this affidavit of the bankruptcy trustee at para 20), and Razor's deemed liabilities are $123 million (see this affidavit of Razor's CEO at 5)).

Evidence suggests that the OWA followed through subsequent to the date of the Unintended Consequences Memo. The OWA initially sought to appoint a receiver for Alphabow Energy Ltd., but then did not proceed and Alphabow instead entered a *Companies' Creditors Arrangement Act,* RSC 1985, c C-36 process under a restructuring firm chosen by Alphabow. This suggests that perhaps the OWA withdrew funding for their receiver to proceed. The Perpetual-Sequoia litigation (which Drew Yewchuk most recently described here) was settled in May 2024 with court approval. As the trustee notes in its affidavit, the OWA's control of the funding for the receivership gave them leverage to push the trustee to accept the settlement terms that were negotiated between the OWA and the Perpetual group of companies (see the affidavit of the bankruptcy trustee, at paras 25 and 33-35). Both the Alphabow and Sequoia cases show the OWA has been making decisions

about oil and gas receiverships, including litigation settlements, that have major impacts on Alberta's inactive and orphan problem.

The problem is that the OWA, which is controlled by the oil and gas industry (and not in the sense of being influenced by industry, but in the clear sense of being directly controlled by a board of industry representatives), is making the decision about when to petition oil and gas licensees into insolvency and provides direction to the insolvency professionals on managing the estate of the insolvent corporation. The OWA's motivation here would seem to be to keep its orphan well inventory down to minimize the costs incurred by industry through the orphan fund levy. This is accomplished by encouraging transfers of assets to other licensees – even when those new licensees are likely to fail to perform closure work – rather than have the assets recognized as orphans and have the industry pay to close them through the orphan fund levy. The Unintended Consequences Memo suggests this is exactly what has happened. OWA-appointed receiverships for Trident Exploration, Houston Oil & Gas, Bow River, and Sanling Energy focused on moving assets to new licensees to avoid what the Memo describes as "premature closure". Simply put, Ministerial Order 043/2023 is an obstacle to worthless oil and gas infrastructure being passed to new licensees to keep it from going to the OWA for industry-funded closure.

The Unintended Consequences Memo also discloses that when the OWA told the AER about what the OWA intended to do, the AER approached the departments of Energy and Municipal Affairs "to share these consequences and to seek clarity in applying the MO." In other words, the AER asked the Minister to amend Ministerial Order 043/2023 to suit the interests of industry. Regulatory capture par excellence: another critical deficiency of the Liability Management Framework which we explained in *A Made-in-Alberta Failure.*

In the Unintended Consequences Memo, the AER uncritically repeats industry's concerns about premature closure of assets. But it is clear the premature closure problem does not exist. Alberta's problem is the opposite: overdue closure. Alberta has 78,000 inactive wells in July 2023, and around two-thirds of the active wells are marginal producers. Research by Lucija Muehlenbachs has shown that the well reactivation rate is tiny, and the Auditor General has confirmed the AER is aware the reactivation rate is very low for wells inactive more than two years (here at 28) . Concerns about premature closure are detached from reality, and yet the AER uncritically adopted industry's talking point about premature closure and presented them to government ministers.

There are two major problems behind the Unintended Consequences Memo. The first is that four years after announcing "historic reforms" Alberta still does not have an overall strategy for oil and gas liabilities. The 'new' 2020 liability management framework is still vague and missing large pieces (legacy and post-closure sites have been ignored for decades). This leads to ad-hoc changes causing unforeseen problems.

The second problem is deeper. Keeping the Orphan Fund Levy low is in industry's interest. Getting the inactive and orphaned oil and gas liabilities closed is in the public interest. Why is the AER not funding and supervising the insolvencies, as the AER did for Lexin? Bill 12 did not remove the AER's power to do so. When Bill 12 was before the legislature, the Minister of Energy noted the changes:

> "would allow the regulator or the OWA to appoint specialized insolvency professionals and to use the orphan fund to pay for those services, which could result in some sites being sold to viable operators instead of simply becoming orphans and wasted materials." (Alberta Hansard, April 1, 2020 at 320)

It seems clear the AER can appoint and pay for insolvencies. Sections 70 and 106.1 of the *OGCA* grant the AER the authority to fund and control oil and gas corporate insolvencies. There is no lack of statutory authority – the AER allowed the industry controlled OWA to commandeer part of the AER's role as the public regulator.

The Unintended Consequences Memo reveals that AER staff advocate for the OWA, which is itself an explicitly industry run organization. The OWA's board chair is a Senior Special Advisor for the Canadian Association of Petroleum Producers. This cannot be emphasized enough: the OWA is not influenced by industry – the OWA is an explicitly industry-controlled organization. Industry was given control of the OWA to allow them to supervise the expenditure of the money industry paid into the Orphan Fund, but this should never have extended to discretionary control over oil and gas licensee insolvency. Given that the OWA is directed and funded by industry, it is reasonable to expect the OWA is focused on managing the orphan and inactive asset problem in a way that minimizes costs to the oil and gas industry. The AER is supposed to be managing the orphan and inactive asset problem in a way that minimizes costs and risks to the public. The Unintended Consequences Memo reveals the AER continues to advocate for industry at the expense of the public – risking further socializing industry closure costs. That is clear regulatory capture.

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