REDWATER

THE IMPLICATIONS FOR THE ENERGY SECTOR

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Introduction

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INTRODUCTION

- ***Redwater* was a decision of Chief Justice Neil Wittmann of the Court of Queen's Bench of Alberta released on May 19, 2016**

- **The case involved the conflict between**
  - Federal *Bankruptcy and Insolvency Act* (the *BIA*)
    - power of receivers and trustees to disclaim environmentally contaminated property – in particular, inactive wells
    - priority of environmental remediation claims of regulators
    - power of receivers to sell wells
  - Provincial regulatory laws
    - abandonment, reclamation and remediation obligations in the oil and gas sector
    - transfer of well licenses

INTRODUCTION

- **According to a report of RBC Dominion Securities published October 4, 2016**
  - The discounted cost of abandoning wells and facilities is $7.3 billion
  - 93,000 suspended wells (formerly producing but inactive for at least 6 months) in the Western Canadian Sedimentary Basin
  - 4,000 wells were abandoned in 2015
  - RBC projected increased spending on abandonment and reclamation has become structural given the large number of inactive wells and low production wells
  - In 1989, some have estimated that there were only 25,000 suspended wells in Alberta

INTRODUCTION

- **Provincial legislation in Alberta:**
  - Alberta Energy Regulator (AER) oversees oil and gas exploration and production
  - AER argued that receivers and trustees deemed to be licensees and have a public duty which:
    - requires that they perform the abandonment obligations of licensees
    - prevents them from disclaiming unsellable or contaminated wells
    - prevents them from selling wells without either
      - performing abandonment and reclamation obligations wells
      - posting security for abandonment and reclamation obligations from the gross proceeds of sale

INTRODUCTION

- **Under section 14.06 of the federal *BIA*:**
  - Receivers and trustees are not personally liable for
    - pre-receivership/pre-bankruptcy environmental damage or contamination
    - Post receivership/bankruptcy environmental damage or contamination, unless arising as a result of the receiver/trustee's gross negligence or wilful misconduct
  - Receivers and trustees have the right to disclaim environmentally contaminated property
  - If contaminated property disclaimed, remediation costs cannot be a cost of administration
  - Environmental remediation claims are secured by a super-priority charge against the contaminated property, or property contiguous to the contaminated property and related to the activities causing contamination

- **Receivers are able to sell property subject to court approval**

Regulation of Oil and Gas Industry

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REGULATION OF OIL AND GAS INDUSTRY

- **Development and exploitation of Alberta's oil and gas reserves is provincially regulated under a number of different statutes: *Responsible Energy Development Act* (*REDA*), *Oil and Gas Conservation Act* (*OGCA*), *Pipeline Act* and *Environmental Protection and Enhancement Act* (*EPEA*)**

- **AER, the principal regulator, is empowered to:**
  - Issues licenses to producers
    - Licensees must hold mineral leases (crown or freehold) for development and exploitation of oil and gas reserves
  - Regulates the efficient, safe, orderly and environmentally responsible development of energy resources
  - Exercises environmental regulatory powers over the oil and gas industry
  - Controls the disposition of public lands for private oil and gas production
  - Regulates the suspension, abandonment, reclamation and remediation of wells and associated facilities (Abandonment Work)

REGULATION OF OIL AND GAS INDUSTRY

- **AER attempts to mitigate the risk of Producers not performing Abandonment Work through:**
    - Licensee Liability Program (LLR) – Directive 006 under *OGCA*
        - Under which the AER attempts to measure a licensee's ability to carry out its abandonment obligations
        - Measurement is carried out by the AER on a monthly basis and on receiving an application to transfer licenses
    - The Orphan Well Association (OWA)
        - independent corporation whose board includes representatives of the AER and industry
        - administers the orphan well fund, which carries out Abandonment Work on "**orphan wells**", which are wells that are owned by insolvent licensees
        - funded through industry levies on licensees
        - The Orphan Fund will abandon wells where the licensee and working interest participants are "defunct"

REGULATION OF OIL AND GAS INDUSTRY

- **LLR Program**
  - AER calculates ratio of deemed assets to deemed liabilities
    - Deemed assets - licensee's trailing 12 months of reported oil and gas production from licensed wells, at a sales value per production unit established by the AER, normalized pursuant to industry netbacks
    - Deemed liabilities - AER's estimate of the average cost of carrying out Abandonment Work in location of licensee's wells and facilities

- **AER calculates LLR of each licensee**
  - Monthly (link to reports - http://www.aer.ca/data/facilities/LLR_Report.pdf)
  - Upon receiving application to transfer a license

REGULATION OF OIL AND GAS INDUSTRY

- **If LLR of licensee is less than 1.0, the AER will require a Security Deposit**

- **Where there is an application to transfer a license, AER will calculate the post transfer LLR, and if it is less than 1.0, AER can refuse transfer, or require a Security Deposit (Post *Redwater*, under Bulletin 2016-16, the transferee's LLR generally must exceed 2.0)**

- **Amount of Security Deposit – difference between:**
  - deemed asset value (plus any previously provided Security Deposits); and
  - deemed liabilities (the Deficiency)

- **LLR is not indicative of a licensee's ability to abandon wells**

REGULATION OF OIL AND GAS INDUSTRY

- **Other powers of the AER**
  - No AER license can be transferred without the approval of the AER
  - The AER may cancel or suspend a licence for contravention of the OGCA, the Pipeline Act or the regulations or directives thereunder
  - The AER can require that a well, facility or pipeline be suspended or abandoned by the licensee or working interest participant, in order to protect the public or environment, or when required under the regulations are rules
  - The AER can directly or through an agent abandon a well, facility or pipeline and recover the costs from the working interest participants
  - The AER has a lien against wells, facilities, pipelines, land or interests in lands, and any equipment and petroleum substances, for any amounts owing to the AER on account of costs, levies, fees, penalties or other amounts
  - The AER can require a person to discontinue operations, or seize wells, facilities and pipelines and take over operations, and sell production to recover costs

REGULATION OF OIL AND GAS INDUSTRY

- **Other powers of the AER**
  - Where there is a contravention, the AER can:
    - make a declaration against a licensee or working interest participant, or any directors, officers, agents or other persons in control of the licensee or working interest participant
    - suspend the operations of the licensee
    - refuse to consider an application for licenses or identification costs
    - refuse any application to transfer licenses
    - require security deposits
  - The AER can also prosecute licensees, working interest participants and principals thereof for contraventions of the OGCA, the Pipeline Act and the rules, regulations, orders or directions thereunder
  - Fines are $50,000 fines for individuals, $500,000 fines for corporations

REGULATION OF OIL AND GAS INDUSTRY

- **How are Receivers and Trustees caught by provincial laws?**
  - *OGCA* and *Pipeline Act* deem receivers and trustees to be the licensee
  - Effect:
    - Receivers and trustees are liable for all obligations of licensee
    - Since there is no provision in the *OGCA* or the *Pipeline Act* permitting disclaimer of wells, the AER claims that receivers and trustees cannot disclaim wells
  - Receivers are unable to sell wells without paying Abandonment Obligations to AER
  - Administrative position of AER
    - liability of receivers and trustees is limited to the extent of licensee's assets
    - relevant statutes do not support that limitation

Background to Redwater Decision

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BACKGROUND TO REDWATER DECISION

- **Redwater Energy Corp. was a publicly listed junior oil and gas producer in Alberta**
- **Alberta Treasury Branches (ATB) was its secured lender**
- **Loans were in default, so ATB applied to Court to appoint receiver**
- **Court appointed Grant Thornton Limited as:**
  - receiver in May 2015
  - trustee in bankruptcy in October 2015

BACKGROUND TO REDWATER DECISION

- **Redwater assets:**
  - 71 shut in non-producing wells and facilities
  - 19 producing wells and facilities

- **Receiver reviewed the marketability of the producing and non-producing wells and based upon that review, the receiver:**
  - Disclaimed the 71 non-producing wells
  - Retained 20 wells

- **In response, AER issued Abandonment Orders with respect to disclaimed wells**

BACKGROUND TO REDWATER DECISION

- **AER and OWA applied to the Court for an order:**
  - declaring the receiver's disclaimer void
  - compelling the receiver to comply with the Abandonment Orders
  - compelling the receiver to fulfill all duties as deemed licensee of the disclaimed wells

- **The receiver applied to the Court for an order:**
  - approving the sales procedures for the retained wells
  - declaring certain provisions of the *OGCA*, the *Pipeline Act* and Directive 006 issued pursuant to the *OGCA* to be unconstitutional to the extent they conflicted with the federal *BIA*
  - declaring the Abandonment Orders to be invalid and that the receiver was not required to comply with them
  - declaring the receiver was entitled to disclaim under 14.06(4) of the *BIA*

BACKGROUND TO REDWATER DECISION

- Declaring that the AER, in exercising its discretion to approve transfers of licenses, was not entitled to base its decision on:
  - the compliance history or Redwater
  - Redwater's LLR rating
  - the failure of the Receiver to comply with the abandonment orders
  - any amounts owing by Redwater to the AER or the Crown

Decision of Chief Justice Wittmann

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DECISION OF CHIEF JUSTICE WITTMANN

- **The Court applied the constitutional doctrine of federal paramountcy to find that:**
  - The trustee and receiver were entitled to disclaim wells under section 14.06(4) of the *BIA*
  - Neither the trustee nor receiver was required to perform the obligations of Redwater with respect to the disclaimed wells
  - The sales process was approved
  - The AER cannot require, as a condition to approving applications to transfer licenses, that the receiver abandon wells, perform the abandonment orders, or post security
  - The AER was not permitted to include the deemed asset and deemed liability values associated with disclaimed wells in its calculation of Redwater's LLR in considering applications to transfer licenses

DECISION OF CHIEF JUSTICE WITTMANN

- **Constitutional doctrine of federal paramountcy:**
  - When otherwise validly enacted federal and provincial legislation cover the same or similar subject matter, but:
    - there is a conflict or genuine inconsistency between the legislation; or
    - the operational effects of the provincial legislation are incompatible with the federal legislation,

    the federal legislation prevails, and the provincial law is rendered inoperative to the extent of the inconsistency
  - Two branches to test:
    - Operational Conflict - it impossible to apply the provincial law while complying with the federal
    - Frustration of Purpose - it is possible to comply with both the federal and provincial legislation, but the provincial legislation is incompatible with or frustrates the purpose of the federal legislation

DECISION OF CHIEF JUSTICE WITTMANN

- **Disclaimer of wells and facilities**
  - Purpose of disclaimer power in section 14.06(4)
    - Permits receivers and trustees to make rational economic assessments of the costs of remedying environmental conditions
    - Gives receivers and trustees the discretion to determine whether to comply with orders to remediate property affected by environmental conditions
    - Personal liability is not a condition precedent to the right to disclaim under 14.06(4)
  - Court noted that Parliament made the policy choice of limiting super-priority for environmental remediation to the contaminated property and any contiguous property
    - Not for courts to re-define this policy
  - Court rejected argument that 14.06(4) does not apply to disclaimer of licenses
    - Licenses and abandonment orders are tied to real property

DECISION OF CHIEF JUSTICE WITTMANN

- **Operational Conflict – Disclaimer Power:**
  - *OGCA* and *Pipeline Act* do not permit licensees to disclaim wells and therefore, as deemed licensees, receivers and trustees remain liable for abandonment obligations
  - Section 14.06(4) permits a receiver or trustee to disclaim wells
  - This is a direct conflict
    - the *OGCA* and *Pipeline Act* stipulate one thing, and the *BIA* stipulates the opposite
    - Dual compliance is not possible

DECISION OF CHIEF JUSTICE WITTMANN

- Effect of applying paramountcy test – the receiver and trustee
  - are not licensees of the disclaimed wells
  - ought not to be required to assume any liabilities for disclaimed wells
  - are not bound by the Abandonment Orders relating to disclaimed wells in seeking approval of the sales process to market and sell the assets it retained
  - cannot be obliged to remediate the disclaimed wells by performance or posting security

DECISION OF CHIEF JUSTICE WITTMANN

- **Frustration of Purpose – Disclaimer Power:**
  - Purpose of 14.06
    - Sets out the scope of the liability of trustee and receiver liability for environmental matters
    - Provides for disclaimer of property affected by environmental conditions or damage
    - Allocates burden between creditors and the Crown of the cost of remediating affected property, with a limited super priority
  - If Abandonment Orders are regulatory as opposed to monetary, no conflict with the *BIA*
    - The question is, whether the duty to abandon, remediate and reclaim is regulatory or monetary

DECISION OF CHIEF JUSTICE WITTMANN

- **Frustration of Purpose – Monetary Claims:**
  - Court adopted decision of Supreme Court of Canada in *AbitibiBowater*:
    - Environmental claims cannot have a priority higher than given to them under federal insolvency legislation
    - Provinces cannot disturb the priority scheme established by federal legislation
    - Environmental priority limited to what is assigned under 14.06(7) – Parliament struck a balance between the public's interest in enforcing environmental regulations and the interest of third party creditors in being treated equitably
    - Subjecting environmental obligations to a claims process does not eliminate them – it only subjects them to the insolvency process
    - If environmental claims had to be paid in priority to all other claims, the polluter pay principle underlying environmental legislation would be replaced by a third party creditor pay principle
    - The question is whether environmental claims are provable claims or are simply regulatory obligations

DECISION OF CHIEF JUSTICE WITTMANN

- **Frustration of Purpose – Monetary Claim:**
  - 3 part test in *AbitibiBowater* to determine if orders or regulatory obligations are provable claims:

    1) There must be a debt, liability or obligation owing to a creditor

    2) The obligation must be incurred before the debtor's bankruptcy

    3) It must be possible to attach a monetary value to the debt, liability or obligation

  - The AER conceded the first two were met
  - Third test is applicable to contingent claims – is it sufficiently certain that the AER or the OWA will perform the Abandonment Orders and assert a monetary claim to have its costs reimbursed

DECISION OF CHIEF JUSTICE WITTMANN

- **Frustration of Purpose – Monetary Claim:**
  - Factors suggesting sufficient certainty:
    - trustee and receiver are not in possession of the disclaimed wells and have no ability to perform any kind of work
    - trustee and receiver exercised choice not to take possession under 14.06
    - trustee and receiver are not funded to comply with Abandonment Orders, which amount to over $5 million
    - If abandonment work was done, report of receiver indicated that no sale process would be carried out because there would be no benefit to the creditors
    - No evidence that Redwater will be reorganized or its activities will continue with respect to renounced assets
    - No evidence of a current or subsequent owner for renounced assets or that there is a subsequent purchaser of disclaimed assets who could be compelled to undertake work

DECISION OF CHIEF JUSTICE WITTMANN

- **Frustration of Purpose – Monetary Claim:**
  - Working interest participants in disclaimed assets are only severally liable, up to their proportionate share, and therefore cannot be compelled to bear the costs of remediating Redwater's share
  - *Redwater* distinguished from *AbitibiBowater* and Ontario Court of Appeal decisions in *Nortel* and *Northstar* because 14.06 was not at issue in those cases
  - If the receiver carried out abandonment work, it could not claim it as a cost of administration because of 14.06(6)
  - No evidence that the AER has realistic alternatives to performing the remediation work itself other than deeming the disclaimed wells to be orphaned wells

DECISION OF CHIEF JUSTICE WITTMANN

- **Frustration of Purpose – Monetary Claim:**
  - Court found that in a narrow and technical sense, situation did not meet the sufficient certainty criterion in *AbitibiBowater* - unclear whether
    - AER will perform the work itself, or
    - deem the disclaimed wells to be orphans, in which case OWA will perform work
  - But situation meets what was intended by *AbitibiBowater*
    - compliance with orders would require trustee and receiver to expend funds to perform abandonment work
    - effect of complying with Abandonment Orders would be that Province's claim for remediation costs will be given a super-priority not provided for 14.06
    - creditors deprived of the usual priority in bankruptcy will be subject to a "third-party-pay" principle in place for the "polluter-pay" principle

DECISION OF CHIEF JUSTICE WITTMANN

- **Frustration of Purpose – Monetary Claim:**
  - legislative history shows Parliament intended creditors to have the priority set out in 14.06, and therefore distribution of funds ought not to be disturbed by provincial legislation
  - therefore even though the Abandonment Orders were not expressed in monetary terms, they were intrinsically financial
  - Obligation to comply directly affects Redwater's estate
    - compliance with Abandonment Orders
    - posting of security
  - Compliance gives the AER priority over all other creditors
    - conflicts with 14.06(6), (7) and (8), which deal with the priority of environmental remediation claims, and give such claims only a priority against the affected property
    - if the trustee or receiver were required to perform abandonment work, they would incur such costs as administration costs contrary to 14.06(6)

DECISION OF CHIEF JUSTICE WITTMANN

- **Frustration of Purpose – Monetary Claim:**
  - Affect of forgoing is to frustrate
    - the primary purpose of the *BIA*, which is to process creditor claims against an insolvent debtor in an equitable and orderly manner
    - the limitation of liability in 14.06 of receivers and trustees for environmental conditions and damage

DECISION OF CHIEF JUSTICE WITTMANN

- **Frustration of Purpose – Sale Power:**
  - Including the disclaimed wells in the LLR calculation for the purpose of determining whether or not to approve an application to transfer a license frustrates the purpose of 14.06
    - prevents the disclaimer of such wells
    - by requiring that a security deposit be paid, the AER gains priority over all other creditors, including the receiver and trustee, and defeats the equitable treatment of creditors purpose of the *BIA*
    - in exercising its regulatory power to approve license transfers, the AER is not a public enforcer taking steps to enforce the general law, but an “enforcing authority clothed as a creditor”

Implications of Decision

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IMPLICATIONS OF DECISION

- **The decision of Chief Justice Wittmann was appealed by the AER and OWA**
- **The appeal was argued on October 11, but the Court of Appeal reserved its decision**
- **The AER issued Bulletin 2016-16, increasing the required LLR of transferees to 2.0**
  - Reduces field of possible purchasers by two thirds
  - AER will entertain limited, grand fathered exemptions
  - Purports to be interim, pending a more permanent policy response
- **Notwithstanding the appeal**
  - Courts have begun to include in Receivership Orders the power to disclaim property

IMPLICATIONS OF DECISION

- **What does *Redwater* not mean?**
  - Licensees cannot walk away from their abandonment obligations
    - Section 14.06 is only available to receivers and trustees in bankruptcy
    - Most companies will attempt to avoid insolvency at all costs
      - Their directors and officers have a “black mark”
      - Their shareholders generally lose all or most of their equity
      - The assets of their company are generally broken up
  - While the matter is uncertain, section 11.8 of the *Companies’ Creditors Arrangement Act*, which is derived from section 14.06, only permits monitors to disclaim property, not the company itself

IMPLICATIONS OF DECISION

- **What does *Redwater* not mean?**
  - The AER has many tools to deal with people who use insolvency law to "game" the system:
    - director and officer liability
    - preventing certain designated officers, directors or security shareholders who have a history with the AER from being involved in a licensee
    - significant regulatory powers over "bad players"
    - the AER can prevent buyers that are "related" to the insolvent licensee from purchasing wells

IMPLICATIONS OF DECISION

- **So what does it actually mean?**
  - If an insolvent debtor has both marketable and unmarketable wells
    - *Pre-Redwater*, in this economic climate the bad could not be sold with the good, because buyers would not take on liabilities
    - Therefore, lenders were having to walk away, or in some cases pay portions of the sale proceeds to the AER
    - Now, receivers can disclaim the unmarketable wells, and sell the marketable wells
    - Generally, it is better for a responsible receiver to go in, figure out what wells can be preserved, and disclaim the rest

IMPLICATIONS OF DECISION

- **What is not addressed, however *Redwater* is decided in the Court of Appeal?**
  - What happens to the 93,000 inactive wells?
  - In 1989, there were 25,000 inactive wells. Why did that number increase?
    - unless the AER ordered a well to be abandoned, there was no positive obligation to abandon inactive wells
    - generally, producers did not want to abandon wells because it was a significant expense
    - the province and landowners continued to receive royalties on inactive wells
    - municipalities continued to collect tax revenue
    - abandonment costs with respect to inactive wells were generally not considered by lenders in calculating lending value, as that analysis focused on the productive wells

IMPLICATIONS OF DECISION

- **Is there a solution?**
  - 93,000 inactive wells are not going to be abandoned in a year
  - A long term plan is needed, that will not destroy the entire industry
  - A regulatory framework should distinguish between
    - inactive wells that are uneconomic in the current price environment, but can be economic in another price environment
    - Unproductive or depleted wells
  - Onus should be on licensees to abandon wells at a reasonable rate, subject to the ability to mothball wells
  - Orphan Well Fund could be based upon insurance principles, which would ultimately be less burdensome than companies having to fully fund their abandonment obligations

IMPLICATIONS OF DECISION

- **Areas of continuing uncertainty**
  - Redwater at least permits the sale by Receivers of some of an insolvent Producer's wells, rather than having all of its wells declared orphans
  - Are Producers going to be able to walk away from their obligations to abandon wells as a result of Redwater?
  - No company actively seeks insolvency
  - Directors and senior officers remain at risk for Abandonment Obligations in the event of a receivership
  - The AER will not approve well license transfers to purchasers sharing common directors, officers or shareholders with the insolvent Producer

QUESTIONS?

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