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COMPROMISE WITH THE ALBERTA ENERGY REGULATOR: NAVIGATING A RECEIVERSHIP IN ALBERTA'S OIL PATCH

Posted on January 28, 2016

Categories: Insights, Publications

On January 25, 2016, the Court of Queen's Bench of Alberta approved a Sales and Investment Solicitation Process (the "**SISP**") requested by the Receiver of Spyglass Resources Corp and several related companies ("**Spyglass**"). Spyglass is a public oil and gas exploration and production company headquartered in Calgary, Alberta. Spyglass, like many Alberta E&P companies, was impacted by low commodity prices and put into receivership by its syndicate of lenders. The SISP attempts to provide for a more certain and economically viable sales process than has historically been experienced by insolvent producers and was achieved through a Receivership Sale Agreement between the Receiver and the Alberta Energy Regulator (the "**AER**"). The Receivership Sale Agreement entitles the AER to certain sale proceeds in exchange for its consent to the transfer of Spyglass' licensed assets in certain circumstances.

LLR Program

The AER is responsible for granting and administering licenses for oil and gas wells, pipelines, and related facilities in Alberta. As part of this mandate, the AER developed the LLR Program which assesses a licensee's ability to address the suspension, abandonment, remediation and reclamation activities at the end of the life-cycle of the particular asset. A major component of the LLR Program is the requirement for a licensee to post a security deposit if a licensee's deemed liabilities for well abandonment (denominator) are greater than its deemed assets (numerator), a ratio known as the Liability Management Rating ("**LMR**"). The LMR is calculated on a monthly basis and, if it falls below 1.0 (ie. deemed liabilities exceed deemed assets), the AER requires the payment of a security deposit by the licensee.

Before it approves the transfer of a license the AER requires that the transferor and transferee each have a post-transfer LMR of at least 1.0. Any party with an LMR of less than 1.0 will be required to post security. This can limit the pool of potential buyers, reduce the purchase price that the buyer is willing to pay and in cases where the seller has significant deemed liabilities (often the case with insolvent producers) can prevent the operating licenses/assets from being transferred at all.

The power of the AER to enforce the LLR Program in respect of insolvent licensees is currently the subject of a



constitutional challenge launched by the Receiver of Redwater Energy Corp. ("**Redwater**"). However, with a decision in the Redwater matter pending, and in anticipation of possible appeals, receivers of insolvent producers must continue to deal with the AER and the LLR Program when marketing and selling licensed assets.

Receivership Sale Agreement

The Receiver for Spyglass dealt with the uncertainty posed by the LLR Program by entering into a Receivership Sale Agreement with the AER. Pursuant to the Receivership Sale Agreement, the AER agreed to permit the transfer of licenses to third parties even if Spyglass' LMR drops below 1.0 as a result of such transfers. The Receivership Sale Agreement opens the door to limited "cherry picking" of good assets by third-party purchasers.

The agreement also provides that if Spyglass' pro forma LMR will increase, remain the same or be 1.0 or greater following a sale and transfer of certain or all of the licensed assets, all benefit of such sale proceeds will be for the benefit of Spyglass' receivership estate and then be payable to creditors with valid claims. On the other hand, if Spyglass' pro forma LMR will decrease following a sale and transfer of certain or all of the licensed assets, then the Receiver will pay to the AER from the proceeds of such a sale 50% of the maximum security deposit Spyglass would be required to post under the LLR Program.

The Receiver also agreed to hold \$5 million in trust from the net sale proceeds (after the payment of priority expenses) to be used for the suspension and, shut-in of any of Spyglass' remaining and unsold licensed assets.

Other terms of the Receivership Sale Agreement include:

- AER approval of the SISP;
- AER involvement in bid review under the SISP;
- Preference being given to bids which are for entire geographically based packages of assets, which presumably include both good and bad assets;
- The requirement that no bidder is qualified to bid on any of the licensed assets of Spyglass unless it is in good standing with the AER and has a current LMR at least 1.0; and
- AER discretion to reject bidders which the AER deems to not be operating at arm's length from Spyglass.

The parties to the Receivership Sale Agreement specifically acknowledged that the agreement was entered into pending the decision in the Redwater matter, which will determine whether the AER can apply the rules of the LLR Program to insolvent producers in the same manner they are applied to solvent producers.

The Path Ahead

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The Receivership Sale Agreement demonstrates that the commercial realities of insolvent companies may require the AER to compromise what would otherwise be required by the strict application of the LLR Program rules. It is possible that the Receivership Sale Agreement and SISP may provide guidelines for similar business resolutions in an industry which has been hard hit by low commodity prices. However, it is not clear that this solution would be available in all circumstances. For example:

- What if an insolvent company has materially more non-producing or shut-in wells than producing wells and therefore is unable to create attractive packages of assets for sale?
- Should a Receiver reject a high value bid from a non arms-length party out of concern the AER may exercise its discretion to reject the bidder?
- How would the interests of subordinated creditors be dealt with if payments to the AER meant that such creditors would receive fewer or no proceeds?
- Will this option be available to smaller producers who may not be able to generate significant proceeds from any sales process?
- Will the AER be willing to relax its requirement that an insolvent company meet all of its non-LMR obligations if there is no way for the company to sell its licensed assets otherwise?

It is clear that for the foreseeable future, AER involvement in insolvencies and the LLR Program will remain a major issue. The SISP and the compromise reached with the AER by virtue of the Receivership Sale Agreement represent a material change to the manner and methods receivership sales of oil and gas assets might be effected. Hopefully the outcome will provide helpful guidance for creditors of struggling exploration and production companies.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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