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A Self Funding Mechanism for Abandonment and Reclamation Liabilities

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Leadership in environmental stewardship

Issues with the status quo

- AER estimates 191,228 wells require abandonment and reclamation (ST37 report, March 2017)
- Alberta LMR (April 1, 2017), total security deposits of $239.6 million (0.8% of Total Deemed Liabilities)
  - industry average (4.47) appears healthy, however, 341 (45%) of 756 licensees have LMR <1 (523 (69%) have LMR <2)
- Issues with the status quo
  - are we upholding the principles of individual responsibility and "polluter pays" ?
  - LMR does not adequately measure financial capacity or the ability to fund future abandonment liabilities
  - LMR is not a rigorous DCF methodology, LMR not reconciled to the ARO/Decommissioning Liability (IFRS)
  - security deposits represent "dead capital", a higher rate of return is available in the capital program
  - the industry does not set aside segregated funds to finance future decommissioning liabilities
  - decommissioning costs are funded from future cash, cash flow and credit capacity, which is uncertain
  - increasing credit and legal implications, crown priority in insolvency (Redwater, Lexin cases)
  - OWA "pooling of funds" transfers responsibility to the broader industry, OWA funding inadequate
  - security deposits/OWA are not direct sources of financing to fund the obligations of going-concern operators (aggregate deemed liabilities of $30 billion)
  - abandonment liabilities eventually represent non-discretionary cash costs or become an unfunded liability
  - there is currently no financial incentive to incur abandonment and reclamation costs, rather than defer
  - is it the role of the AER to assess the financial health and future capacity of individual licensees?

An alternative self-funding mechanism

Previously adopted in the pipeline, nuclear waste and mining sectors

- An alternative to the status quo is to self-fund abandonment and reclamation liabilities by depositing a small portion of cash flow into a trust fund that compounds over the producing life of the asset
- Qualified Environmental Trusts ("QETs") have been previously adopted in other sectors
  - trust funds must be maintained in a segregated account (not commingled with general corporate funds)
  - trust funds are protected from misuse, or for uses other than abandonment expenditures
  - trust funds are managed by independent third parties (trustee, portfolio manager, custodian)
  - trust investments are subject to a Statement of Investment Policies and Procedures (SIPP) to be jointly established by the sponsor, trustee and portfolio manager
  - permitted investments include cash, GIC's, government/investment grade bonds and listed securities (although securities of the sponsor are not permitted)
  - trust funds are protected from creditors, not available to settle creditor claims in the event of insolvency
  - trust funds are subject to a clearly defined approval process for accessing the funds
  - subject to a regular review of the abandonment cost estimate (ACE), contributions and withdrawals
  - ACE is a rigorous DCF estimate of future abandonment costs, reflecting the unique characteristics of each operator's assets, abandonment schedule and estimated costs
  - annual fund contributions are based on individual ACE's, SIPP, risk tolerance and expected returns
  - corporate oversight, internal governance model similar to a corporate pension plan
  - QET contributions are tax deductible, but not generally royalty deductible (may be deductible under the oilsands royalty regime)

Qualified environmental trusts (QETs)

Key characteristics

- First introduced in the 1994 Federal budget, established under the Income Tax Act for the sole purpose of funding reclamation costs from mining (1994) and waste disposal sites (1997)
- Expanded (2011) to include trusts funding reclamation in the operation of a pipeline
- QET is a tax-efficient structure designed to be cash neutral to the sponsor
  - to qualify, there must be a law or tribunal ruling requiring maintenance of the QET
  - contributions are tax deductible by the sponsor, there is no limitation on contributions
  - income and gains earned within the QET are taxed as if earned by the sponsor
    - income and gains are taxable at the underlying sponsor's corporate rate
    - no double taxation – taxes paid within the QET are offset by refundable tax credits to the sponsor
    - excess tax credits are refunded to the sponsor
    - non-taxable sponsors are unlikely to pay current tax on income/gains within the QET
  - trust withdrawals are included in the sponsor's taxable income in the year of withdrawal
  - taxation of future withdrawals is essentially offset by the deductibility of actual abandonment expenses
- A financial incentive arises from the tax deferral of QET contributions that separately generate financial returns from third party, professional portfolio management of the trust funds
- Subject to a policy change, QET funds could be additive to the LMR numerator to reduce security deposit requirements, and may fully replace the security deposit system over the long term

Self funding abandonment and reclamation liabilities

Summary of QET characteristics

Strengths

- Segregated funds are set aside to directly finance future abandonment and reclamation liabilities
- A self-funding model, funded throughout the producing life of the asset
- A tax efficient structure, already embedded in the Income Tax Act
- Creditor protected, reduces uncertainty around the funding of reclamation claims in an insolvency
- Rigorous DCF methodology, the ACE reflects individual corporate assets, economic life and cost estimates
- Reinforces principle of individual responsibility and "polluter pays", no pooling or transfer to taxpayers
- Funds independently managed by an arm's length Trustee and portfolio manager under a SIPP
- Established governance and reporting models
- Trust funds reported as a financial asset offsetting the ARO/Decommissioning Liability
- Credit capacity is enhanced
- Potential to strengthen the LMR ratio
- Potential for royalty deductibility

Challenges

- QET contributions reduce cash flow and the funds otherwise available for capital spending
- QET portfolio returns will likely be lower than the returns available from a development drilling program, but are also less risky and less volatile
- A phased-in implementation may be required in the short term while cash flows are deeply constrained
- A period of contributions are required before withdrawals commence (QET's are not a funding source for the current backlog of orphaned sites)
- Requires establishment of a trustee, portfolio manager, SIPP and ACE
- Annual audit, tax returns, administrative costs
- Policy changes would be required to reduce LMR deposit requirements or to achieve royalty deductibility

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