

THE NEGOTIATOR

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Friction Inside

Negotiating from the Inside Out

The Saskatchewan LLR Program One Year In

What do you mean we have to send a
cheque to SER for a Security Deposit?

The Power of a Positive "No"

Is "No" the New Yes?

The Saskatchewan LLR Program, One Year In

What do you mean we have to send a cheque to SER for a Security Deposit?

IT'S LIKE DÉJÀ VU ALL OVER AGAIN. Corny statement I know, but I can just see it coming. I am of course speaking of the April 30, 2010 deadline to make the first 25% installment payment to Saskatchewan Energy and Resources (SER) under the Saskatchewan Oil and Gas Orphan Fund and Licensee Liability Rating Program (LLR Program).

Forgot about that, didn't you? The SER Notification Letter has just been sitting on someone's desk for a year. Hint, hint, it was addressed to the company's Chief Financial Officer, which will explain why no one in Land ever saw it. Someone will finally remember you have to pay, and "pow" you have a problem. Here comes the kicking and screaming.

Phone calls are just starting to come in at our shop with a very familiar refrain. How dare they? It's not fair. This could put us under. That's not even our well. Where did this number come from?

The déjà vu feeling arises because this is exactly the same thing that occurred in Alberta when the EUB (now the ERCB) introduced the Alberta LLR Program many moons ago. The difference is that:

- this is not a new program, but essentially a copy of the Alberta LLR Program and should not be a surprise to anyone; and
- the SER went painfully out of their way to be extremely clear on when the security deposit requirement would be due, and waited a year to enforce it, and then spread the payment of the security deposit amount over a 4 year period (25% per year).

Inevitably, I expect some poor little companies will get stuck being the licensee of some bad wells or facilities, will not be able to pay the security deposit, and the SER will issue a closure order on all the companies licensed wells and facilities. This will be bad for the operator and will have trickle down problems for any non-operator joint venture partners who have an interest in the particular well or facility.

Makes me feel old when I can start guessing what will happen in the future. Maybe this is what they call wisdom.

Your Quick Guide to the SER LLR Program

The SER website has a fantastic single page portal entitled "The Licensee Liability Rating Program" which includes: full SER contact information; a link to the monthly security adjusted corporate LLR ratios; a nice PowerPoint presentation; and a copy of the Saskatchewan Licensee Liability Rating (LLR) Program Guideline (Guideline PDG01) (the "Guideline").

There is also a link on this page to the "LLR Licensee Homepage", which provides company access to the specific asset and liability values of individual wells and facilities. You will need an ID and password to access this page. Might be time to get one.

I also had the opportunity to talk directly with Tom Coleridge (the listed SER contact person) regarding a specific file matter. Tom picked up the phone on my first try and answered all of my questions in about five minutes. It is an excellent resource. Speaking to Tom also finally alleviated my fear that if Marcy Hill (the SER well and facility transfer person and knower of all things) ever gets hit by a bus, SER will grind to a halt.

The rest of this article will sound suspiciously like my January 2009 *Negotiator* article "The ERCB LLR Trap" because, well, the Alberta and Saskatchewan LLR Programs are very, very similar. However, this article will focus on the unique elements of the Saskatchewan system, especially the issue of the phased in security deposit. Please refer to my prior article for a more detailed (and funnier) analysis.

In a Nutshell

The LLR is company specific and is based upon the wells and facilities licensed in a company's name. The resultant LLR ratio is calculated based upon a set of deemed assets/deemed liabilities for all of the wells and facilities licensed to a particular company. The LLR Program and calculation parameters are set out in the Guideline, which is a very easy read (only 15 pages long). Some important aspects are as follows:

The 1.0 Rule

Just like in Alberta, every licensee is required to maintain a monthly LLR of 1.0 or greater, and must have a pre and post transfer LLR above 1.0. If you fall below 1.0, a security deposit must be paid to SER.

However, under the 4 year phase in period, if an initial security deposit is payable because of a corporate LLR ratio of less than 1.0, that amount is payable over 4 years with the first 25% due on April 30, 2010. Be careful though, this nice phase in payment plan only applies to companies that have an initial LLR of below 1.0. If you subsequently fall below 1.0, your full security deposit is immediately payable. This can occur due to A&D deals (as discussed below) or simply due to production declines or miserable gas prices. The Guideline states as follows:

Should a licensee's LLR fall below 1.0 following the initial assessment, their resultant security deposit can not be deferred over the 4 year payout period but rather must be submitted within 90 days of a notice provided by the ministry (Guideline, part 3.2, paragraph 1).

Licensee Specific

The licensee (operator) assumes 100% of the assessed LLR for any particular well or facility. It is irrelevant to SER if you beneficially own only 5% of the crappy underperforming oil well. As operator you are responsible for 100% of the deemed liability value for that well license.

Deemed Assets and Deemed Liabilities

The asset value (the numerator) is "... calculated by multiplying a licensee's reported production of oil and gas from the proceeding 12 calendar months in cubic meters oil equivalent by the 3 year rolling average industry netback by the return period which is equivalent to 3 years" (Guideline, part 2.1, paragraph 1).

The liability value (the denominator) is the SER established abandonment and reclamation cost for all wells and facilities held by a particular licensee. There are cost parameters in the Guideline and its Appendixes.

Please keep in mind that you never need to do any math. The SER system does it for you. All of these well and facility asset and liability values are calculated monthly and can be accessed through the LLR Licensee Homepage. The only time you will ever want to work through the numbers is if you think the SER has made an error.

What to Do If You Have A Security Deposit Issue

Since a LLR ratio is based upon the full corporate profile of well and facility licenses, you cannot pass a security deposit cost onto your non-licensee joint venture partners (in my humble view). A few people tried to issue AFEs or JIBs for LLR Program security deposit amounts when the Alberta program got going. This process was not very well received by non-operating partners.

If you are a small operator with an LLR Program security deposit you cannot pay, my recommendation is to contact your larger joint venture partners and see if they will take over operatorship and the license. Larger operators can often absorb a large liability value without having to pay a security deposit. While it may be tough to get people interested, but if you are really stuck, it is a better answer for all parties involved. Becoming noncompliant affects both the licensee and all partners in the well or facility.

Alternatively, if you hold a well or facility 100%, there are some enterprising companies out there that will take on a well license in exchange for a share of the working interest in the lands or some other type of consideration. I have seen this a few times in Alberta, and so long as everything is above board, this is a possible option to having to tie up a significant amount of cash in a security deposit.

The LLR Trap With a Twist

So here we are, Spring is in the air, and new optimism abounds in our industry, especially in the oil friendly province of Saskatchewan. Companies are either starting new, or reinventing themselves as oil companies (instead of gas companies) and buying up oil wells and facilities in the jurisdiction of our friendly neighbor to the east.

I don't want to rain on anyone's parade, but you need to remember that significant A&D issues arise when the asset specific LLR profile of the licensed assets being bought and sold "tips" the LLR of either the vendor or purchaser below 1.0 post transfer. This is made clear in part 3.3 of the Guideline:

Liabilities of both companies is calculated on the basis that the transfer has been approved. If the post transfer LLR is less than 1.0 and less than the pretransfer LLR for either party, then a security deposit or deposits must be submitted before the ministry will transfer the licenses. Licensees will be notified in writing of security deposit requirements and provided with 30 days [from] the dated notice in which to submit the deposit.

This can lead to some odd and unexpected results in Saskatchewan due to the impact of a License Transfer Application on the 4 year phased in payment for initial security deposits.

Let's pretend that your boss has finally located the SER Notification Letter mentioned above and tells you to sell some junk so we don't have to pay such a big security deposit in April. You find a willing Newco (or at least new Saskatchewan licensee) purchaser to buy some assets and take some of the bad well licenses that are creating your security deposit payment problem.




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You close a deal, take the cash and submit the SER License Transfer Application. This triggers a SER license transfer assessment, and if your luck is really bad, the result could be as follows:

- You sell some, but not all, of your bad wells and/or facilities. This lowers your total liability amount, but also results in a post transfer LLR less than your pretransfer LLR. Not a good decision. This will result in your full post transfer security deposit amount being payable, not just 25% of the pretransfer amount. Not what your boss wanted.
- Since this is crappy stuff, the asset specific LLR of the sold wells and facilities is less than 1.0. This means your Newco purchaser

must pay the full security deposit amount to get a security adjusted LLR to 1.0 or they are offside the Guideline. I am a bit fuzzy on the exact regulatory consequences of nonpayment but it must be bad. At the very least the transfer will not go through and the wells and facilities will remain in the vendor's name.

The only way to avoid these potential problems is to do your due diligence in advance. You also need to consider custom Sale Agreement drafting. If you are interested, both of these matters are discussed in my prior *Negotiator* article. 

Paul Negenman
Enerlaw

Friends of Mosoronchon Family


Dear Friend of Bob Mosoronchon,

Bob has cancer which has spread to various internal organs. He is presently taking Chemo treatments to hopefully delay the cancer's aggressive progression. This letter is a request to assist Bob and his wife Monica in setting up an Educational Trust Fund for their three children (Sophie 15, Liam 14 and Sean 12). This will provide the family with the initial financial boost needed to attend post secondary institutions in the future.

Bob has worked as a landman for 26 years with Dome, Crestar, CNRL, Tasman and Neo, but is presently on long term disability. Bob was very active in the CAPL on various committees and also a Director for 4 years. Throughout his career Bob has maintained a reputation as a solid, honourable landman and a true gentleman. We are asking you to look into your hearts and generously donate to this worthy cause that will bring peace of mind to Bob and his family. Bob will be comforted by the fact that his children are presented with an opportunity to further their education which he sadly will not witness.

Please send a cheque in an amount of your own discretion by June 15, 2010 to Alberta Treasury Branch, 100, 801 – 6th Ave. S.W., Calgary, AB T2P 3W2, Attention: Leigh Lyons and make the cheque



payable to "Monica Mosoronchon – In Trust for Mosoronchon Children" where it will be put in an Educational Trust Fund for Bob's three children. (The donation will not be tax deductible and will be administered by Bob's wife). Upon submitting your cheque please email mosoronchon@shaw.ca to advise that you have submitted a cheque for future feedback on fund raising results and acknowledgement of appreciation. Please forward this email to friends of Bob who may wish to participate in the fund raising. 

Sincerely,
Clark Drader, Chris Soby and Tony Smith

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