



Testimony of the Environmental Defense Fund

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Harrisburg, Pennsylvania

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Chairman Vitali, Chairman Causer and Members of the Committee, thank you for inviting me to testify today on the critical issue of well plugging and orphaned and abandoned wells in Pennsylvania. I am Adam Peltz with the Environmental Defense Fund, and I have been working on mitigating environmental impacts from the oil and gas industry across the country, including in Pennsylvania, since 2011.

EDF welcomes this opportunity to discuss how Pennsylvania can maximize the benefits of the new federal orphan well closure funding opportunity, and curb future orphan well burden from today's active and idle well fleet.

I. Introduction

Pennsylvania is home to some of the first hydrocarbon wells in the world and has been a major supplier of fossil fuels for the past 170 years. One unfortunate aspect of this legacy is a history of orphaned oil and gas wells, for which estimates range from 250k to 500k wells in western and northern Pennsylvania, of which around 25k have been documented with respect to location. A large (though unknown) number of these wells were abandoned prior to the late 1950s, when the first well regulations were adopted in Pennsylvania – before which there were no standards for reporting or well construction, let alone for well plugging. But well orphaning has continued steadily through today, primarily due to lax financial assurance requirements, leaving the public responsible for the closure of those wells. Using a conservative figure of 250k orphan wells and a realistic \$70k/well for closure, the total cost of closing all of these wells approaches \$17.5 billion.

Until the passage of the Infrastructure Investment and Jobs Act of 2021, the Pennsylvania Department of Environmental Protection (hereafter “DEP”) only had \$500k-\$1m/year to deal with orphan well closure, which it reserved for very expensive emergency plug jobs necessary to protect human health and safety or to address significant leaks to the environment – at this rate, it would have taken the Commonwealth tens of thousands of years to address the orphan well problem.

Now, with new federal funding dedicated to orphan well closure, Pennsylvania is in line to receive hundreds of millions of dollars over the next several years to plug and remediate orphan wells, starting with the documented population of 20-25k. In order to maximize those resources, it is incumbent on Pennsylvania to steward those dollars efficiently, to find and document the

vast population of undocumented orphan wells, and, crucially, to adopt policies that reduce orphan well burden from the state's population of ~117k active and idle wells with responsible parties.

All of this amounts to a huge opportunity for Pennsylvania to invest in its oil and gas counties, generate significant job creation in the oilfield services sector (especially in rural parts of the Commonwealth), enhance property values where orphan wells are found, and facilitate beneficial use of orphan well sites and geology for clean energy projects – all while protecting public health and safety, reducing climate and traditional pollution, and avoiding ground water and surface water contamination for the benefit of today's residents and future generations.

II. Maximizing the benefit of federal orphan well closure funding

Pennsylvania has received its first \$25m in "initial grant" funding from the Department of Interior over the past six months, and is in line to receive the first chunk of the "formula grant" funding sometime this year. Between these two tranches of funding and the third tranche of "performance grants," EDF expects Pennsylvania to be eligible for approximately \$400 million through 2030 to plug and remediate orphan wells – which is orders of magnitude more than Pennsylvania has had available to plug orphan wells to date. Nevertheless, with the high cost of plugging, which in December 2021 the Pennsylvania DEP estimated to be around \$68k/well (and which has risen since then), Pennsylvania DEP estimated that it would need \$1.83 billion to plug the 26,908 documented orphan wells count it submitted to the DOI at the time. Even if Pennsylvania does receive the full \$400 million, this would only cover 22% of the documented orphan well count, and does not begin to touch the undocumented orphan well population.

In order to make the most of the money Pennsylvania will receive, and to potentially induce additional federal dollars for well closure, the Pennsylvania DEP and its legislative partners should consider action in the following areas:

- *Pennsylvania DEP staffing*

Overseeing the well plugging program at the scale envisioned requires a lot of personnel. This includes inspectors, who should witness every plug job in order to ensure quality control on an otherwise invisible-from-the-surface construction projects; contract procurement specialists who can manage the panoply of well plugging contractors, remediation contractors, methane emissions quantification and groundwater contamination specialists who will be involved with this work over the coming years; and staff who can visit county courthouses and pursue cost recovery action against responsible parties who have walked away from their plugging obligations.

It takes an adequately staffed DEP for this work to be done right, and to harness the power of Pennsylvania private industry that is ready, willing and able to go out in the field and do this work. Without sufficient staff, the DEP will not be able to spend the federal dollars quickly enough, and they will be rerouted to other states. Insufficient staff also runs the risk of low-quality plugging work going undetected. And staff that is dedicated to recovering funds from scofflaws will hopefully pay for itself.

- *Cost-saving measures to extend available dollars*

Between personnel shortages, rig shortages, cement shortages and generally above-average inflation, the cost of plugging is only going up. The DEP will have to weigh many factors in selecting contractors, and should not sacrifice quality or supporting local businesses where

possible. At the same time, the DEP should consider options for keeping total costs contained. One avenue for this is contracting out larger areas for plugging and encouraging contractors to minimize rig movement, which is expensive and time-consuming. This may mean plugging some lower priority wells adjacent to higher priority ones, and DEP will have to balance this with the imperative to close wells that threaten health and safety, immediate environmental harm, and those with high emissions profiles. The DEP maintains close contact with oil and gas regulators in neighboring states, and should share cost information to ensure contractors are charging regionally consistent rates.

- *State/industry partnership on job training/apprenticeship*

Perhaps the most proactive opportunity on cost savings has to do with workforce development. If plugging contractors cannot find people to do the work, then the work will necessarily be slow and expensive, and/or conducted by out-of-state contractors. Plugging work can pay upwards of \$100,000 a year. There are retraining pathways certainly for people already in the oil and gas sector, but also for many people who work in outdoor occupations. However, EDF is not aware of systematic efforts to recruit and train people into the well closure industry in Pennsylvania. Pennsylvania policymakers should facilitate collaboration between Pennsylvania's oilfield services companies, the unconventional and conventional E&P industries, the Penn State system and other colleges, universities and technical schools across the Commonwealth, chambers of commerce and the DEP to help bring more workers into this growing and long-term remediation industry.

- *Finding undocumented orphan wells*

Pennsylvania's undocumented orphan well population dwarfs the documented orphan well population by an order of magnitude. Undocumented orphan wells are especially problematic because of the danger they pose to public health and safety when they are discovered under residential and commercial buildings (a frequent occurrence in Pennsylvania), and because they stymie other uses of the geology. The Pennsylvania DEP has a requirement for operators to evaluate wells in proximity to planned hydraulic fracturing, but if an undocumented orphan well is not in an official database or even on old farm maps, it is unlikely to be picked up in the evaluation and can result in the sorts of geysers Pennsylvania was infamous for in the early days of the shale boom. Further, as Pennsylvania considers incorporating carbon sequestration and hydrogen storage into its climate mitigation strategy, the presence of orphan wells, especially undocumented orphan wells, threatens the security of geologic storage of CO₂ and hydrogen and renders much of the state off-limits to such projects.

The federal orphan well closure funding allows states to commit resources toward finding, characterizing and prioritizing undocumented orphan wells, and indeed, the Pennsylvania DEP has been a national pioneer in that field, partnering with universities and the National Energy Technology Lab to conduct drone surveys, using magnetometers, to find these wells (at least the ones with casings, many of which were removed as part of the war effort in the 1940s). There are also citizen science groups that go out into places like the Allegheny National Forest to find orphan wells, either by sight or by smell. The DEP should harness the work that the Department of Energy is doing to develop new methodologies for well hunting, and make a point of finding as many wells as it can.

Doing so would not only have immediate positive effects for health and safety and economic development, but also, by increasing documented orphan well counts, Pennsylvania could bolster its case for additional federal dollars should the demand from other states fall below expectations, or possibly through new federal funding vehicles in the future.

- *Policy reforms to unlock the \$70 million available through the federal orphan well closure program's regulatory improvement grants*

Approximately 20% of the funding that Pennsylvania is ultimately eligible for, up to \$70 million, is dependent on Pennsylvania adopting policy reforms to reduce future orphan well burdens from the population of 117k active and idle wells. This funding falls into three categories.

First, Pennsylvania is eligible for \$20 million if it enhances its technical plugging rules in Chapter 78(d). The current rules have not been updated in a long time. The Pennsylvania DEP has had intention to update them for years, but it has not happened yet. The time for that to happen is soon, though – better plugging rules means more reliable plugs that do their jobs of preventing fluid migration between geologic layers and to the surface. Plugs are supposed to last for a very long time, essentially indefinitely, and in order for them to have a chance of achieving that goal, the cement quality must be high-quality, regularly tested and emplaced correctly and in the right zones. Pennsylvania has complex geology, and in coal mining areas, it is especially important to prevent gas migration that could threaten worker safety. Too many of Pennsylvania's plug jobs have failed, and use back-up vents that emit methane to the atmosphere. If Pennsylvania is going to be plugging tens of thousands of wells in the coming years, now is the time to upgrade plugging rules to meet the moment. And, doing so makes the Commonwealth eligible for significant extra funds.

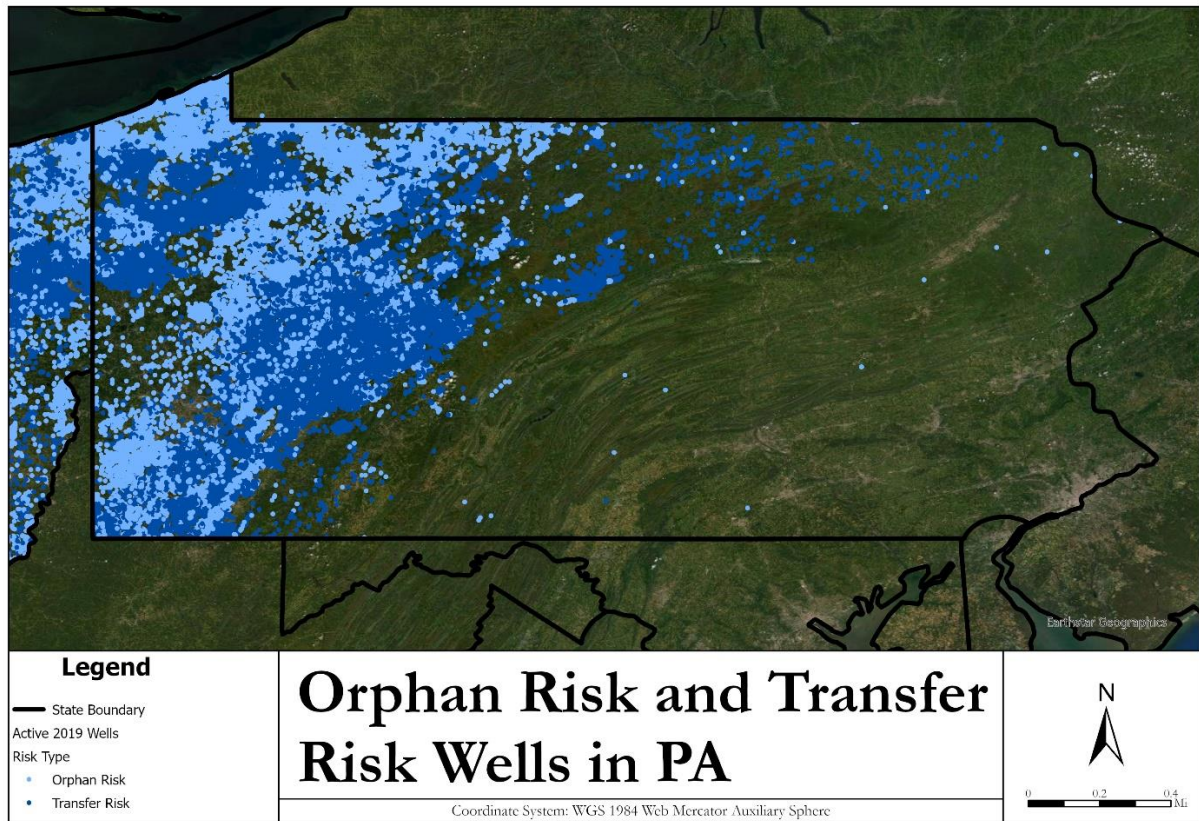
Second, Pennsylvania is eligible for \$20 million for enhancements to the Commonwealth's financial assurance, idle well management and well transfer programs, which will be discussed in detail in the next section. Suffice it to say, Pennsylvania has one of the weakest programs in the nation on these issues, and stakeholders need to take a hard look at what will happen to the currently active and idle well population if these regulations are not strengthened. The Department of Interior, and the public, will be watching Pennsylvania closely on these issues in the years to come, and a lot of money is on the line.

Third, Pennsylvania is eligible for up to \$30 million in federal matching funds for increased state orphan well closure spending. That is to say, if Pennsylvania were currently spending \$1 million a year of state funds on closing orphan wells, and it were to increase that spending to \$5 million a year, that \$4 million increase would be matched by the federal government at \$4 million/year through the end of the program for a total of \$30 million. Lower increases will result in less funding. The next section will provide insight into how much Pennsylvania will likely need to collect from industry in order to cover likely future orphan wells.

III. Pennsylvania policy reforms to reduce future orphan well burden

On top of Pennsylvania's existing burden of several hundred thousand orphan wells that need to be properly plugged and remediated, serious attention must be paid to the active/idle population of 117k wells, many of which will likely become orphan wells in the absence of policy reform.

EDF has analyzed Pennsylvania's active and idle well population and divided that population into three buckets based on orphan risk through 2050. Low risk wells are those that have positive net present value – Pennsylvania has approximately 11,500 of these wells, and they are unlikely to be transferred or orphaned in the near future. Transfer risk wells are those that have negative net present value, but are operated by relatively solvent, financially healthy operators – Pennsylvania has approximately 51,000 of these wells. Finally, orphan risk wells are those with negative net present value, and are operated by relatively insolvent, financially unhealthy operators – Pennsylvania has approximately 55,000 of these wells.



This means that according to our analysis, fully 90% of the wells in the state have a negative net present value (when taking into account likely revenue, likely operating costs and likely closure costs) – these wells are at an increased risk of either being transferred down the value chain to increasingly bankruptcy-proof entities that ultimately orphan their wells, or, if they are already owned by such operators, of simply becoming orphan wells outright.

EDF calculates that the burden on the Commonwealth if all of the transfer risk wells became orphan wells would be \$3.5 billion, and if all of the orphan risk wells became orphan wells, the burden would be an additional \$3.7 billion, for a total of \$7.2 billion (this is on top of the \$17.5 billion EDF estimates is needed to cover Pennsylvania’s population of existing documented and undocumented orphan wells).

This is a worst-case scenario, and hopefully not all of these wells will be orphaned. According to data submitted by the Pennsylvania DEP to the Interstate Oil and Gas Compact Commission, around 500 wells a year are plugged in the state by operators.¹ Were that trend to continue, that would equate to 13,500 wells plugged by 2050. Given that the vast majority of today’s 117k wells are already low-producing, it seems highly likely that many tens of thousands of them will be no longer producing by 2050 and require plugging. If industry’s plugging rate does not rapidly accelerate in the coming years, it is hard to see how the orphan well population does not dramatically increase.

¹ Idle and Orphan Oil and Gas Wells: State and Provincial Regulatory Strategies 2021, IOGCC, https://iogcc.ok.gov/sites/g/files/gmc836/f/iogcc_idle_and_orphan_wells_2021_final_web.pdf, p. 31

In order to defend against this outcome, Pennsylvania needs to pursue a combination of policy reforms to ensure the Commonwealth is adequately funded to quickly close orphan wells as they arise from today's active and idle well population. Some of the current federal funding for orphan well closure depends on such reforms (see last section), and EDF does not envision much appetite for additional federal expenditures on Pennsylvania's orphan wells if the Commonwealth does not take serious steps to curb future orphan well burden.

This section will describe policy options for Pennsylvania in this regard.

- *Bonding / financial assurance*

The primary mechanism for states to avoid future orphan well burden is adequate financial assurance, or bonding. Financial assurance takes the form of some amount of money that operators set aside for the benefit of the state in case no solvent responsible party is available to plug the well at the end of its useful life.

Ideally, this amount of money is risk-targeted so as not to overspend or underspend the amount needed for well closure. States are increasingly pursuing risk-targeted financial assurance policies to that end, including Colorado, which bases bonding requirements based on average production; Utah, which contemplates basing bonding amounts on operator finances; North Dakota, which limits the number of idle wells that can be covered on a blanket bond; and Arkansas, which requires essentially full-cost bonding for marginal wells on transfer.

Pennsylvania's current bonding framework is famously lax compared to its 30 oil and gas producing peer states, and likely has the lowest average bond amounts in the country, largely because wells drilled before 1985 are exempt from bonding entirely.

As a general matter, no wells should be exempted from bonding, because future orphan risk only increases with older vintage wells. Single-well bonds, when applicable, should be based on actual plugging and remediation costs, using a combination of average industry plugging costs and average state orphan well plugging costs, and updated regularly. Blanket bonds, when applicable, should be based on risk, and eligibility should be predicated on the financial wherewithal of the operator, which can be determined a variety of ways as discussed above.

EDF recognizes that the sudden imposition of large bonds on marginal wells would likely induce an immediate wave of well orphaning, for which Pennsylvania is not prepared. Changes to the bonding framework, which are absolutely essential, must be developed in consultation with all stakeholders and phased in appropriately. Nevertheless, failing to reform Pennsylvania's financial assurance framework essentially guarantees high levels of well orphaning in the decades to come, a shameful legacy for a proud energy-producing state.

- *Idle well management*

Idle, or non-producing wells, are required to be plugged in Pennsylvania after one year without production. However, operators are eligible for essentially indefinite extensions of inactive status, and unfortunately, this is a common way that operators avoid plugging obligations around the country. While there are legitimate business reasons for temporarily idling a well, the vast majority of idle wells are never returned to service.²

² A Dynamic Model of Cleanup: Estimating Sunk Costs in Oil and Gas Production, Muehlenbachs, Int'l Econ. Rev. Vol. 56, No. 1, p. 162, Table 2, February 2015

In order to mitigate the risk of idle wells causing pollution or ultimately becoming orphaned, Pennsylvania should consider a combination of the following:

- Strengthen criteria Pennsylvania DEP uses to determine whether a well does indeed have future utility that justifies an exemption from the general plugging requirement for inactive wells.
- Institute fees for idle wells that escalate over time. This both encourages idle wells to be plugged and is a potential revenue source for orphan well closure. Louisiana, for example, charges operators \$250/well per year for idle wells and is proposing to raise the fee to \$500/well per year for idle wells with no future utility (although, those wells ought to be plugged, and operators should not be able to buy their way out of plugging obligations so cheaply). California charges \$150/well per year for wells idled between 3 and 8 years, \$300/well per year for wells idled between 8 and 15 years, \$750/well per year for wells idled between 15 and 20 years, and \$1500/well for wells that have been idled for 20 years or longer. Were Pennsylvania to institute California's structure, EDF estimates the DEP could raise \$2 billion toward orphan well closure through 2050.
- Idle wells are at the highest risk for becoming orphan wells and should be bonded appropriately. Ideally, idle wells would be bonded for their full closure cost, which could be released if the well were returned to service – Utah is considering this approach. North Dakota has limited the number of idle wells that can be covered by a blanket bond to seven, and the rest must have single-well bonds. New Mexico has a separate blanket bonding schedule for idle wells that is higher than its blanket bonding schedule for producing wells (both, unfortunately, are too low). And Colorado has strictly limited blanket bonding for idle wells.
- Idle wells should be regularly tested for mechanical integrity to ensure they are not contaminating the environment. This is already required under Pennsylvania law, although compliance with this requirement appears to be limited.³ The Pennsylvania DEP should be empowered to enforce its rules in this regard.

- *Well transfer*

As wells begin to produce less over time, they are frequently transferred to increasingly small operators who can operate marginal wells profitably because of low overhead. However, without adequate bonding in place, the risk of these smaller operators orphaning their wells is significant. It is possible that many well transfers would not take place were operators required to materially internalize future decommissioning costs in the form of a bond that could guarantee closure in the event of bankruptcy.⁴

Because well transfer is a gateway to orphaning without proper guardrails, EDF strongly recommends that the Pennsylvania DEP evaluate the financial wherewithal of transferees and use risk metrics to determine appropriate bonding amounts on well transfer. Alternatively,

³ See generally Governor's Lapsing Statement Report, December 29, 2022, https://files.dep.state.pa.us/OilGas/BOGM/BOGMPortalFiles/Governor's_Lapsing_Statement_Report_2022-12-29.pdf.

⁴ See Anya Litvak, "Lawsuit alleges Diversified and EQT played hot potato with abandoned oil and gas well responsibility," Pittsburgh Post-Gazette, July 25, 2022, <https://www.post-gazette.com/business/powersource/2022/07/25/diversified-eqt-lawsuit-abandoned-deteriorating-wells-oil-gas/stories/202207240048>.

Pennsylvania can follow Arkansas' lead, which in 2018 adopted regulations requiring essentially full-cost bonding for marginal wells on transfer – this policy has led to a significant reduction in the rate of well orphaning in that state.

Given that half of the expected future orphan well burden in Pennsylvania comes from “transfer risk” wells, Pennsylvania could obviate billions of dollars in future orphan well closure expenditures by adopting this straightforward risk-oriented rule with a track record in oil and gas producing states (Colorado adopted a similar rule just last year).⁵

- *State orphan well fund*

Pennsylvania is the only oil and gas state in the country without a severance tax, notwithstanding its impact fee. Partially for that reason, the Commonwealth has historically had very little money to devote to plugging orphan wells to date.

As discussed, Pennsylvania's orphan well burden from both existing and potential future orphan wells is vast. But merely to cover the \$3.7 billion modeled burden from current wells likely to become orphaned in the coming decades, Pennsylvania would need to assess an \$1100/well per year fee – though that fee would be reduced to \$490/well per year if the Commonwealth also adopted an idle well fee as described above.

These dollar amounts are sobering, but they speak to the magnitude of the problem in Pennsylvania. Whatever the amount, though, an orphan well fund fee needs to be part of the policy mix. As discussed in the previous section, the federal government will match state orphan well closure spending increases up to \$30 million through 2030, and it is incumbent on Pennsylvania policymakers to take advantage of that funding facility.

IV. Conclusion

While the scale of the problem is daunting, Pennsylvania has the wherewithal to tackle orphan wells in a way that benefits both the economy and the environment. EDF has calculated that if Pennsylvania adopts policies that effectuates all oil and gas wells being plugged in a timely fashion, at the end of their useful lives, with private resources, nearly 15,000 oilfield services job-years (i.e. one job for one year) would be created through 2050 – and that does not count jobs created in service of plugging the existing orphan well population, which is several times the size of the currently active and idle well population.

Eliminating orphan well burden will also raise property values – a study from the University of Pittsburgh found that the existence of orphan wells depresses building development by 50%, harming the local tax base.⁶ And alternative subsurface uses like CO2 storage and hydrogen storage will be difficult to pursue unless the orphan wells that penetrate the geology are properly plugged.

⁵ See Colorado Oil & Gas Conservation Commission, Financial Assurance SB 19-181 Rulemaking Fact Sheet, March 1, 2022,

https://cogcc.state.co.us/documents/media/Fact_Sheet_FA_Rulemaking_20220301.pdf.

⁶ Harleman, Max and Harleman, Max and Weber, Jeremy and Berkowitz, Daniel, Environmental Hazards and Local Investment: A Half-Century of Evidence from Abandoned Oil and Gas Wells (September 14, 2020). USAEE Working Paper No. 20-470, Available at SSRN: <https://ssrn.com/abstract=3692098> or <http://dx.doi.org/10.2139/ssrn.3692098>.

Policy tools that have been battle-tested in other states can be applied to the Pennsylvania context, as discussed throughout this testimony and in the attached comment documents EDF has recently filed in Louisiana and Utah, which are both pursuing improvements to their financial assurance, idle well and well transfer governance frameworks.

Given the intense attention being paid to the issue of orphan wells on the national and state level, Pennsylvania's unfortunate status as the locus of the orphan well problem in the United States, the funding opportunities presented by the new federal orphan well closure funding mechanism, and the desire of Pennsylvania policymakers to use the Commonwealth's geology for alternative purposes, now is the moment to adopt reforms needed to tackle the existing orphan well problem and to prevent today's active and idle wells from becoming tomorrow's orphan wells.



March 20, 2023

Department of Natural Resources
Office of Conservation, Environmental Division
617 North Third Street, Room 874-D
Baton Rouge, LA 70802
c/o F. Jonathan Rice

In re: Docket No. R A 2023-10

Dear Mr. Rice, Commissioner Ieyoub, and interested parties:

EDF appreciates the opportunity to comment on the Department of Natural Resources Office of Conservation proposal to amend Louisiana Administrative Code 43:XIX, Subpart I, Chapter 1. We understand the amendments are intended to “restrict the Commissioner’s ability to grant an extension or exemption to Inactive, Future Utility Wells.” See Louisiana Register, Vol. 49, No. 2, p. 428, February 20, 2023.

We commend your intent to address Louisiana’s large, aging inactive well population, and we share your interest in eliminating persistent orphan wells in the State. In particular, we commend the Governor Jon Bel Edwards Administration’s commitment to managing orphan wells as part of its 2022 Climate Action Plan, which proposes four key actions to reduce the impact that orphaned oil and gas wells have on Louisiana’s climate footprint. In addition to this rulemaking tightening the definition of “future utility” for inactive wells, the Administration also proposes to hold former well operators accountable for orphaned wells, strengthen financial security requirements for plugging wells, and providing workforce training to plug legacy wells.¹ EDF strongly supports this slate of activity, and the general principle of cleaning up after yourself in the oilfield.

Louisiana has a population of around 4600 documented orphan wells, which the state estimates will cost \$400 million to close and remediate. Federal well closure funding from the Infrastructure Investment and Jobs Act has begun to flow to Louisiana – EDF estimates total eligibility for Louisiana at approximately \$180 million through 2030. Even coupled with the State’s existing remediation funds through the Louisiana Oilfield Site Restoration Fund, Louisiana will likely be several hundred million dollars short of necessary funding to tackle these documented orphan wells, which are only part of the picture. The state also has an unknown number of undocumented orphan wells, i.e. orphan wells

¹ Louisiana Climate Action Plan, February 2022, *available at* https://gov.louisiana.gov/assets/docs/CCI-Task-force/CAP/Climate_Action_Plan_FINAL_3.pdf, Strategy 7, pp. 65-67.

without confirmed locations and orphan wells for which the state has not determined whether there is a responsible party who can contribute to closure cost. And directly relevant to this proceeding, the state also has approximately 28,000 non-producing wells that, while not considered orphaned wells right now, are at high risk of becoming orphan wells in the absence of policy change. All told, EDF estimates that Louisiana could become responsible for as much as \$3.5 billion in closure costs over the next several decades from wells likely to become orphaned without policy intervention – and another \$5.2 billion from wells with negative net present value that are likely to be transferred to owners insufficiently solvent to cover closure costs, and thus face an elevated orphaning risk in the future.

Solving this problem in a meaningful way, per the Governor’s Climate Action Plan, would involve addressing the state’s financial assurance requirements – particularly around blanket bonding – and collecting sufficient funds from the industry to cover orphan wells that slip through the cracks. The current rulemaking is limited to idle wells, but the State has the opportunity to make significant progress right now toward a goal of all oil and gas wells being plugged in a timely fashion, at the end of their useful lives, with private resources.

Idle well management plays a key role in this process. As described below in detail, temporary abandonment is most often a way station on the journey to becoming an orphan well that must be cleaned up with public funds. While there are legitimate reasons for a well to be placed in such status to smooth out supply and demand fluctuations (and, for example, horizontal wells completed within the Haynesville shale prior to 2017 may be good candidates for recompletions with tighter frac spacing), in a significant majority of cases, idle wells are never put back on production, and instead sit unused for decades, threatening groundwater, surface water, public health and the climate, until the operator either disappears or goes bankrupt, leaving the public on the hook for taking care of the improperly abandoned infrastructure.

Key to solving this conundrum is limiting the circumstances under which wells can remain idle for lengthy periods of time, charging idling fees commensurate with environmental and orphaning risk, requiring regular integrity testing to ensure the wells remain in good working order during the pendency of their temporary abandonment, and imposing higher levels of financial assurance for idle wells to backstop against the likely scenario of the majority of those wells becoming orphaned.

These comments propose steps Louisiana can take along those lines, with examples of how other states are pursuing solutions to these same issues that all oil and gas states face.

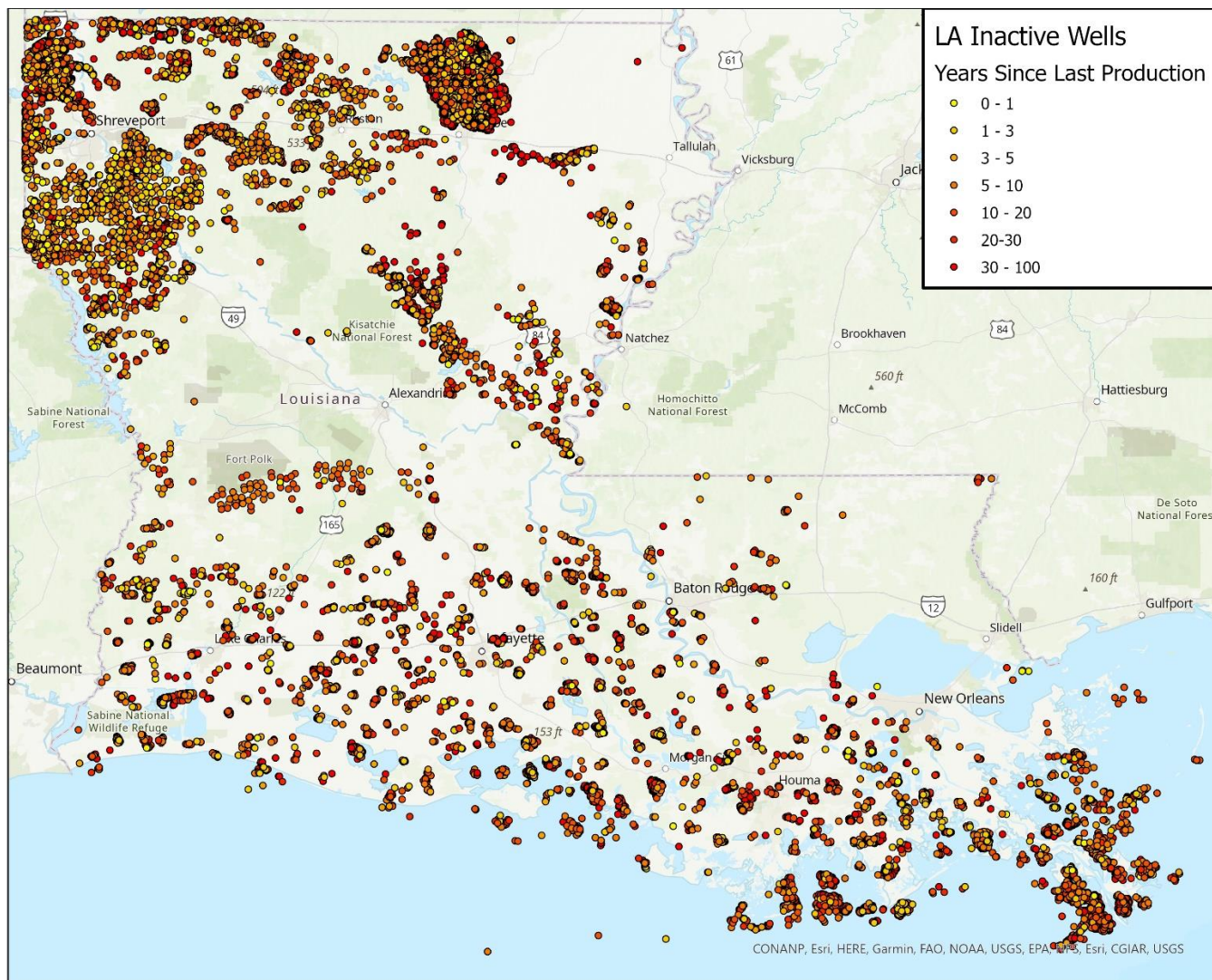
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As a prelude to EDF’s substantive recommendations, we provide here a discussion of the fate of idle wells that illustrates why it is so important for Louisiana to pursue robust and protective rules around idle well management.

Our analysis of Enverus data indicates that more than half of Louisiana’s 28,000 inactive wells have been idled for at least five years, and almost 40% have not produced hydrocarbons for ten years or more.² Further, 73% of the State’s inactive wells are at least 30 years old and many are much older.

² The set of inactive wells includes the following Enverus well statuses in the state of Louisiana: Shut-In, Inactive, Temporarily Abandoned, and Drilled.

Research and experience tell us inactive wells with these characteristics almost never return to beneficial use – according to one analysis of 84,000 conventional oil and gas wells, less than 4% of inactive wells are ever plugged, abandoned, and reclaimed. See *A Dynamic Model of Cleanup: Estimating Sunk Costs in Oil and Gas Production*, Muehlenbachs, Int’l Econ. Rev. Vol. 56, No. 1, p. 162, Table 2, February 2015 (attached to these comments as an appendix). The proportion of inactive wells that remain inactive is greater than 80% for inactive wells less than 10 years old. *Id.* For all wells more than 10 years old, this fraction is over 90%. *Id.* See also EDF bar chart of Louisiana’s inactive well population by age and years since last production, attached to these comments as an appendix, and this map of Louisiana’s inactive wells by years since last production, below:



Finally, the main results from the Muehlenbachs analysis provide compelling evidence that temporary closure largely implies permanent closure. It is rarely economical to return inactive wells to production. The modelled results in Table 5 of the Muehlenbachs report show that even under ideal operating conditions, such as higher prices and higher recovery rates, the fraction of inactive oil and gas wells that return to production is at most 12% higher compared to the baseline analysis. The main benefits from

ideal operating conditions are higher production rates from currently active wells, and not a return of idle wells to service. Muehlenbachs, pp 162, 177.

* * *

LDNR's proposed rule change is a modest step toward ensuring that Louisiana's oil and gas operators, and not its taxpayers, bear the plugging, abandonment, and reclamation costs of tens of thousands of long-term inactive wells. EDF supports the proposed rule changes, but we urge LDNR to make several additional changes to greatly amplify its efforts to reduce or eliminate future orphan wells. Each of our recommendations is based on regulations in place in other states, and each would improve Louisiana's opportunity to avoid a looming orphan well crisis.

1. Define "Future Utility." At present, "future utility" is not defined, nor are there any express criteria by which an operator, LDNR, or the public can evaluate a well's potential future use. Consequently, an operator can classify its wells as having future utility arbitrarily and on an ad hoc basis. We understand a district manager can require an operator to justify a future utility classification (see § 137.B.2.), but when and why such a request would be triggered, or what further information might be sought, is unclear. Accordingly, we urge LDNR define the term "future utility" in this rulemaking. At the very least, LDNR should specify criteria it will use to evaluate whether a well warrants that classification, as the Colorado Oil and Gas Conservation Commission ("COGCC") did recently. The COGCC uses the following criteria to assess whether a well is used or useful or has an identified future beneficial use:

a. Production trends for the Well; **b.** Plugging and Abandonment, Remediation, and Reclamation costs in relation to the Well's gross revenue generation; **c.** Failure to use or develop a facility; **d.** Remaining economic viability; or **e.** Other relevant evidence. See COGCC Rules, 2 CCR 404-1, 100 Series Definitions, "Used or Useful."

In Alabama, the Oil and Gas Board requires operators seeking temporary abandonment status for a well to submit a "written request to the Supervisor describing its future utility," and extension requests "must be justified in writing and include a statement when the well is scheduled to be utilized." See AAC 400-1-4-.17(1).

In Arkansas, the AOGC provides that "[w]ells which have not produced for more ten (10) years are not eligible for approval by the Director of temporary abandonment status, unless the well is in an approved waterflood/enhanced oil recovery unit that remains active. Temporary abandonment status for these wells may only be granted by the Commission after notice and a hearing..." See AOGC B-7(h)(2).

In Indiana, the IDNR provides that "the application for temporary abandonment shall include sufficient information to demonstrate that the engineering, geologic, or economic reasons for retaining the well on temporary abandonment status outweigh the potential benefit of either (1) operating the well; or (2) plugging the well." See 312 IAC 29-33-4(b).

LDNR may consider these and other criteria to be relevant to future utility, and it should state those criteria expressly in Part XIX, § 137.

2. LDNR must have express authority to determine future utility. Operators have an inherent conflict of interest in declaring their own wells to have no future utility. Consequently, if LDNR determines, based on defined criteria, that a well has no legitimate future use it must have express authority to intervene and overrule the operator's classification. Proposed § 137.A.2.a implies that the Engineering Enforcement Section Manager or the district manager may have this authority, but it is not express. LDNR's determination should be accompanied by procedural safeguards, such as a hearing or

an opportunity for the operator to appeal the determination. States that provide discretion for the oil and gas agency to conduct their own future utility analysis include but are not limited to Alabama, Kentucky, Michigan, West Virginia and Wyoming.

3. The fees for deferring plugging and abandoning inactive wells are still too low. LDNR's proposal to impose a \$500 annual fee on an inactive well with no future utility if the well is not plugged within 90 days of such classification is a significant change to the existing rules. See current § 137.A.3.b., c. and proposed § 137.A.2.b. Nonetheless, EDF urges LDNR to reevaluate the annual fees for *all* inactive wells, both with and without future utility. As proposed, the rules would allow an operator to defer plugging and abandoning an inactive well *ad infinitum* for \$250 annually beginning in year five if the well is classified as future utility, and \$500 per annum beginning in year one if the well has no future utility. These fees are tremendous bargains for operators compared with the costs to plug and abandon the wells. LDNR should raise the fees to create incentives for operators to plug their long-idled inactive wells, which otherwise are likely to be orphaned. We recommend LDNR consider an escalating fee that increases the longer a well remains inactive. California uses this strategy, as shown below, on each well that has *been idle at any time* in the prior calendar year.

- One hundred fifty dollars (\$150) for each well that has been an idle well for three years or longer, but less than eight years.
- Three hundred dollars (\$300) for each well that has been an idle well for eight years or longer, but less than 15 years.
- Seven hundred, fifty dollars (\$750) for each well that has been an idle well for 15 years or longer, but less than 20 years.
- One thousand, five hundred dollars (\$1,500) for each idle well that has been an idle well for over 20 years or longer.³

It is worth commending Louisiana for instituting a minimum initial idle well fee of \$250, which is higher than California's initial idle well fee of only \$150. We certainly do not recommend Louisiana lowers its proposed fee structure, but instead recommend that Louisiana raise its fees in the out years commensurate to the increased risk that long-term idle wells impose. Nevertheless, using California's structure as is, we estimate that LDNR could generate \$1 billion toward plugging orphan wells, which as stated earlier, we believe will cost Louisiana \$3.5 billion through 2050 for the highest risk wells alone.

4. Financial assurance requirements for inactive wells must be right-sized. Aging inactive wells are at high risk of being orphaned. This risk, and the peril that Louisiana's taxpayers will be compelled to pay plugging, abandonment, and reclamation costs, can be effectively abated only by requiring operators to post adequate financial assurance. The current and proposed rules can be improved in this regard, because LAC 43.XIX § 104.C. places no limit on the number of inactive wells that may be covered by blanket financial assurance. This is an orphan-well ticking time bomb.

Multiple states have recognized and addressed this danger.

³ Available here: https://www.conservation.ca.gov/calgem/idle_well/Pages/idle-well-operators.aspx

Utah requires single well financial assurance for shut-in or temporarily abandoned wells that have not demonstrated mechanical integrity or have not been approved for inactivity beyond five years. Utah Rules 649-3-1.4.1.3, 649-3-36.

In North Dakota, no more than six wells, in total, that are temporarily abandoned for more than seven years, not properly plugged, or not properly reclaimed can be covered by blanket financial assurance. N.D. Admin. Code 43-02-03-15.2.

Colorado also limits the number of inactive wells that can be covered by blanket financial assurance based on an operator's average production per well. See 2 CCR 404-1 Rules 702.d.(1)B.ii, 702.d.(2)B.ii.. Operators with very low average production per well must have single well financial assurance for all wells. 2 CCR 404-1 Rules 702.d.(3), (4).

Arkansas requires that wells receiving temporary abandonment status provide single well bonds in the amounts of \$35,000 for dry natural gas production wells or \$15,000 for liquid hydrocarbon production wells, and requires such bonds remain valid until the well is put back into sustained production, plugged or transferred. See AOGC Rule B-7(h)(3)(a). (It is worth noting that these dollar amounts may need to be adjusted upward in the Louisiana context to accommodate actual costs. It is further worth noting that Arkansas also pioneered a requirement for essentially full-cost bonding for marginal wells on transfer, which Louisiana should strongly consider as a way to fully compensate the state for future orphaning of currently active wells, see AOGC Rule B-4(h)(4).)

Louisiana should add its name to the growing list of states proactively addressing a looming deluge of orphan wells. Potential solutions could include requiring single well financial assurance for all inactive, no future utility wells; or all wells that have been inactive for some period, regardless of future utility. LAC XIX § 104.C.5 grants the Commissioner discretionary authority to increase the baseline amount of financial security. Rather than rely on this discretionary authority, LDNR should mandate increased financial security for inactive wells to reflect the greater orphan well threat they pose.

5. Require a minimum production threshold before a well is deemed active. Under both current and proposed rules, an inactive well that produces *any volume* of hydrocarbons for three consecutive months is no longer inactive. See proposed rule § 137.A.1.d. Unless LDNR interprets this as 90 days of continuous production, the bar is too low. A well that is shut-in for 362 days a year but manages to produce a *de minimis* quantity of oil or gas one day a month for three consecutive months is almost certainly not economically viable and should not be allowed to masquerade as an active well. This is a loophole that allows functionally inactive wells to avoid paying idle well fees and avoid LDNR's scrutiny. We recommend that LDNR require a minimum threshold of production over the three-month window or extend the window to six or more consecutive months. For example, Texas provides that "[i]n the case of a well that has been inactive for 12 consecutive months or longer and that is not permitted as a disposal or injection well, the well remains inactive for purposes of this section, regardless of any minimal activity, until the well has reported production of at least five barrels of oil for oil wells or 50 Mcf of gas for gas wells each month for at least three consecutive months, or until the well has reported production of at least one barrel of oil for oil wells or at least one Mcf of gas for gas wells each month for 12 consecutive months." See TAC Rule §3.15(a)(1).

6. All inactive wells should be tested periodically for mechanical integrity. Long-idled wells present a separate risk from becoming orphaned: they can pose undue threats to public health and the

environment because mechanical integrity failures often go undetected. Because they are not producing, inactive wells may not be inspected or monitored for months or years. To ensure that Louisiana's numerous aging and inactive wells are not leaking fluids into soil or groundwater or emitting methane or volatile organic compounds into the air, LDNR should require periodic monitoring and testing for **all** inactive wells.

We recommend monthly bradenhead monitoring of casing and annular pressures, and an annual bradenhead test. See COGCC Rules, 2 CCR 404-1, 400 Series, Operations and Reporting, Rules 419.b.(4), 419.c. A mechanical integrity test should be required soon after a well is shut-in and at regular intervals thereafter, until the well is plugged and abandoned. See COGCC Rules, 2 CCR 404-1, 400 Series, Rules 417.b., c.; *see also* Utah Rule 649-3-36 (operator must provide data demonstrating mechanical integrity for any well shut in or temporarily abandoned more than 12 months).

Many other states require mechanical integrity assessments for wells to enter or stay in temporary abandonment status. Aside from Colorado and Utah, they include but are not limited to: Alaska, Alabama, California, Kansas, Kentucky, Mississippi, North Dakota, Nebraska, New Mexico, Ohio, Pennsylvania, Texas, and Wyoming.

Any observed irregularities in bradenhead pressure or mechanical integrity should be promptly reported to LDNR and remedied as soon as practicable.

* * *

Thank you again for proposing these important rule changes to improve management of Louisiana's idle wells. We look forward to constructive engagement with LDNR as it works to ensure that industry operators timely and properly plug and abandon all oil and gas wells at the end of their useful lives.

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Table 1: Louisiana's Inactive Well Population by Age

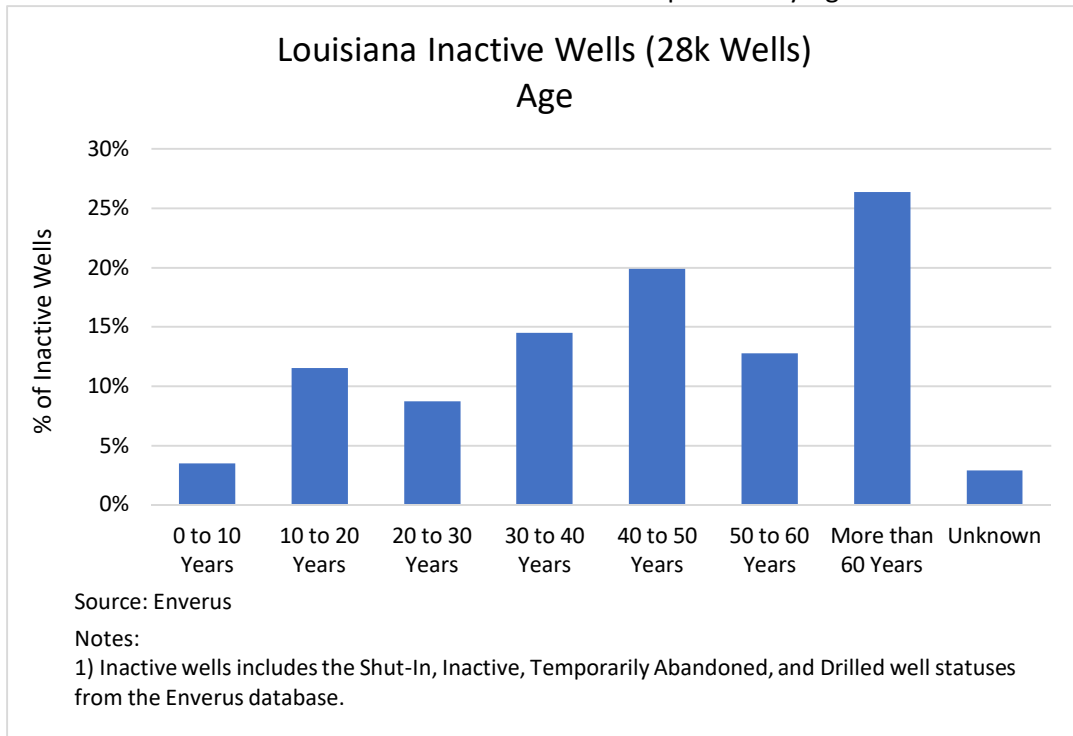
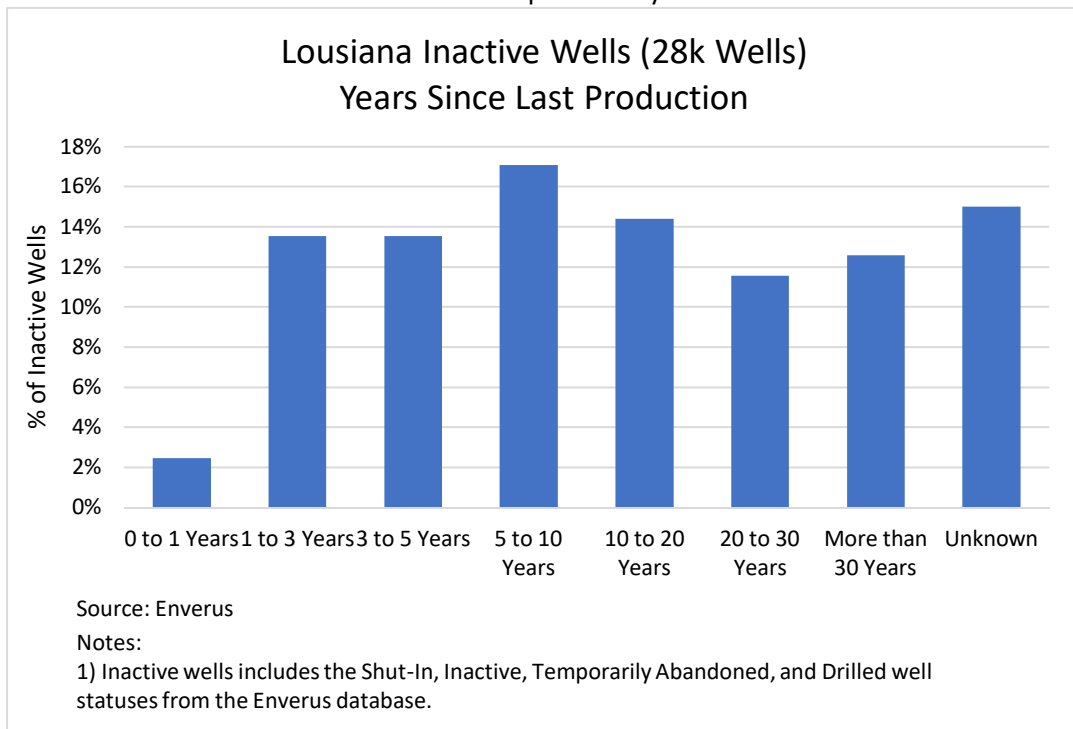


Table 2: Louisiana's Inactive Well Population by Years Since Last Production



A DYNAMIC MODEL OF CLEANUP: ESTIMATING SUNK COSTS IN OIL AND GAS PRODUCTION*

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The environmental remediation required to permanently decommission most industrial projects is an expensive, irreversible investment. Real options literature shows that temporary closure has value under uncertainty. However, even if there is no intention to restart operations, there is an incentive to label a closure as “temporary” to avoid having to remediate ongoing or future environmental externalities. I estimate a dynamic discrete choice model of closure under price and quantity uncertainty to evaluate the likelihood of reactivation. The model reveals that the option to temporarily close is being widely used to avoid environmental remediation of oil and gas wells in Canada.

1. INTRODUCTION

Once an industrial project, such as a landfill, nuclear power plant, mine, or oil field has reached the end of its life, the costs associated with permanently decommissioning operations tend to be very high. Literature on real options has shown that inertia is optimal in dynamic decisions involving sunk costs in uncertain environments (Dixit, 1989, 1992; Dixit and Pindyck, 1994). If there is a chance that a project will be restarted in the future, there is value to temporarily closing it and postponing the investment needed to decommission it. However, once a project is temporarily closed it could remain in a state of hysteresis; there is a sunk cost to reactivate, so even if the forces behind the project’s closure are reversed the project may still not be reactivated.

There are high sunk costs associated with decommissioning industrial projects because of the requirements to remediate existing environmental damages and implement measures to prevent ongoing or future damages. Therefore, by not decommissioning a project, a mothballed, or temporarily closed, state carries environmental risks that might not be internalized by the owner of the project. A difficulty, however, arises because regulators not wanting to cut the life of a viable project short will allow projects to be temporarily closed. It therefore could be the case that the value of the option to reactivate is zero or negative, but an owner “temporarily” closes a project as a way to avoid paying for decommissioning. Using a temporary closure in lieu of a permanent closure is facilitated by regulators not having perfect information on the costs or expectations of the operators.

In this article, I find evidence to help disentangle whether a temporary closure is indeed being used to avoid environmental cleanup. To the best of my knowledge, this is the first attempt to understand the true motivations behind temporary closures. To do so, I first build a dynamic programming model of the choice to temporarily close, decommission, or reactivate under uncertainty in prices and quantities. I then estimate the structural parameters in the model

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¹I am indebted to John Rust for his advice and encouragement throughout all stages of this project. I also thank Robert Cairns, Timothy Fitzgerald, Steven Gabriel, Adan Martinez-Cruz, Marc Nerlove, Lars Olson, Jim Quehl, Mar Reguant, Sirish Shah, Stefan Staubli, Chris Timmins, and Seth Wechsler for helpful suggestions and Kenneth Judd and Che-Lin Su for introducing me to the optimization software. A previous version of this article was entitled “Testing for Avoidance of Environmental Obligations” and “Idle Oil Wells: Half Empty or Half Full?” Please address correspondence to: Lucija Muehlenbachs, Department of Economics, University of Calgary, 2500 University Dr. NW, Calgary, Alberta, T2N 1N4, Canada. E-mail: “mailto:lmuehlen@ucalgary.ca” *lmuehlen@ucalgary.ca*.

using data on historical operating decisions and changes in prices and productivity. Assuming prices and productivity are believed to follow the same path as in the past, I can use the fully specified model to predict how likely a reactivation is when presented with ideal operating conditions. In doing so, I demonstrate that data on closure decisions can be used to structurally estimate a real options model, which can be used to test the likelihood that a temporary closure is in actuality permanent.

I apply this framework to the oil and gas industry. Currently, there are hundreds of thousands of “temporarily abandoned” oil and gas wells scattered across North America, including over 3,700 temporarily abandoned wells in the Gulf of Mexico.² Permanent decommissioning of wells is required;³ however, regulators, not wanting to impede production, make temporary closure an option despite the potential environmental externalities of not decommissioning.⁴ Postponing permanent decommissioning also increases the risk that a firm will declare bankruptcy before undertaking the expense of the environmental cleanup. The inventory of “orphaned wells,” or wells without a party responsible for plugging, is quite startling: New York for example has 44,600, Pennsylvania has over 100,000, and Texas has roughly 10,000.⁵ Furthermore, the current boom in drilling for shale oil and gas makes it ever more important for policymakers to understand firms’ incentives to environmentally remediate wells once they have reached the end of their productive life. Therefore, I use data on the decisions made for 84,000 conventional oil and gas wells in Alberta, Canada, to estimate the structural parameters of the dynamic programming-real options model of well-operating decisions. This article has two main contributions.

The first contribution is in testing the goodness-of-fit of a real options model to actual firm behavior. Real options models extend the Black and Scholes (1973) and Merton (1973) theory for financial options to that of irreversible real investments. Unlike the case of financial derivative models, empirical investigations testing the fit of real options models to data are rare. Gamba and Tesser (2009) note that this is due to two factors: The values of the state variables are often not observed and there is quantity uncertainty. In this article, I circumvent these two issues through the use of a data set on the reserve estimates of oil and gas pools over time. This is the first time these data have been used in the economics literature, and they provide annual estimates for the remaining reserves of over 42,000 oil and gas pools. These data provide me with information not used in previous studies: an estimate of a project’s current productivity as well as a way to estimate uncertainty in its productivity in the future (i.e., technological advances in enhanced recovery methods that might increase recoverable reserves). This information is key in determining the likelihood that a well will be reactivated; without data on reserves, I would not be able to distinguish whether a well is inactive because the decommissioning costs are high or because the remaining reserves are significant enough to warrant reactivation in the future.

Much of the literature on real options relies on examples from the natural resource industry, and models of many different discrete decisions in the industry have been developed.⁶ The empirical work on real options has relied on having data for the cost parameters instead of

² According to the Bureau of Ocean Energy Management’s Borehole Dataset http://www.data.boem.gov/homepg/data_center/well/well.asp.

³ In this article, decommissioning a well refers to what the oil and gas industry terms “plugging and abandoning,” which involves equipment being removed and sealing groundwater formations with cement, as well as “reclamation,” which involves revegetating the surrounding land (or bringing it to a “new use” state).

⁴ Not permanently decommissioning an oil or gas well increases the risk of contamination of the atmosphere, drinking water, vegetation, and soil; lost productivity of other wells in the same pool; erosion; forest fragmentation; and even explosions (Kubichek et al., 1997; Williams et al., 2000; Mitchell and Casman, 2011).

⁵ According to the Interstate Oil and Gas Compact Commission’s (IOGCC) Orphaned Wells State’s Progress <http://groundwork.iogcc.org/topics-index/orphaned-wells/state-progress> and Railroad Commission of Texas, (2006).

⁶ Indeed, even the same three choices presented in this article (to activate, inactivate, or decommission a project) have been modeled by Brennan and Schwartz (1985), Castillo-Ramirez (1999), Cortazar and Casassus (1998), Cortazar et al. (2001), Stensland and Tjostheim (1989), Dixit and Pindyck (1994), and Gamba and Tesser (2009). However, these authors did not apply their models to real data and treated decommissioning costs as negligible.

structurally estimating these parameters, thereby restricting investigations to small sample sizes and results to a comparison of stylized facts from the predictions of real options to the data (e.g., Paddock et al., 1988; Hurn and Wright, 1994; Harchaoui and Lasserre, 2001; Slade, 2001; Moel and Tufano, 2002, examine irreversible investments in natural resource industries and all use data on fewer than 300 projects). Exceptions are from dynamic models of the decision to drill oil wells by Levitt (2009), focusing on the effect of learning, and Kellogg (2010), on the effect of price volatility. However, these papers also do not measure quantity uncertainty.

The second contribution is in presenting a framework to understand the relative importance of the value of investment flexibility and the perverse incentive to avoid cleanup costs. The extent to which permanent closures are being labeled as temporary has not been raised or investigated before. Throughout the real options literature, the permanent closure option is often downplayed. Decommissioning costs are treated as negligible or null (Brennan and Schwartz, 1985; Dixit and Pindyck, 1994), or the option of decommissioning is completely left out of the choice set (Paddock et al., 1988; Mason, 2001; Slade, 2001; Moel and Tufano, 2002). By assuming away decommissioning costs, the previous literature has overlooked the case of firms continuing to maintain the option to reactivate a project even when they have no intention, or there is no option value, to reactivate. When the costs from mothballing a project are small relative to the decommissioning costs, this behavior would be privately optimal, but when there are environmental externalities associated with mothballing, this behavior would not necessarily be socially optimal. If there is no potential or intention to reactivate a hazardous project, regulators have reason to implement policies to ensure that environmental obligations will be met.⁷ The framework presented in this article is important because the effectiveness of any policy relies on the underlying reasons for the temporary closures at hand.

The estimated model suggests that only with a drastic, arguably implausible increase in prices and recovery rates will there be a significant increase in the number of reactivated oil and gas wells, implying that wells are typically left inactive not because of the option to reactivate but rather to avoid costly environmental obligations. This is a function of the expected value of a reactivated well being less than the expected value of an inactive well even when an operator is in an ideal state of nature. Considering that energy independence is frequently sought by policymakers, it is also important to consider the quantity of oil or gas that the reactivated wells might contribute to the energy supply. Under high oil and gas prices, the recoverable reserves increase (more so for gas than oil), but nonetheless, the number of reactivated wells remains minimal. Furthermore, the model predicts that the contribution to the oil and gas supply from these reactivated wells is only marginal. These findings have far-reaching implications for the oil and gas industry. If decommissioning costs are not being internalized, the development of oil and gas reserves would be at a rate above what is socially optimal. The policy implication would be to create stronger mechanisms to internalize the costs of decommissioning. One such mechanism is to increase bonding requirements, which are arguably too low at present.⁸ This article demonstrates that in designing policies to decommission oil and gas wells, unnecessary weight has been placed on not jeopardizing production.

2. OIL AND GAS WELL BACKGROUND

This article focuses on Alberta, the main oil and gas producing province of Canada. Extensive record keeping in Alberta has resulted in comprehensive data on the industry. Also, there is

⁷ One of the main reasons for a policy to induce prompt environmental cleanup is the risk that the firm will declare bankruptcy. The concern that oil and gas companies may walk away from their environmental obligations has been brought up by Boyd (2001), Parente et al. (2006), and Ferreira et al. (2003). While these authors discuss bonding mechanisms, the model here can be used to quantify the effect of a bond on production as well as the choice to undertake cleanup.

⁸ For example, a blanket bond of \$150,000 will cover all wells drilled on federal land in the United States. This bond amount was set in 1951 and does not reflect actual reclamation costs: between 1988 and 2009, BLM spent around \$3.8 million to reclaim 295 orphaned wells (United States Government Accountability Office, 2010). And in the case of Alberta, there are no bonding requirements.

no limit to the length of time that a well can be left inactive in Alberta.⁹ (In the United States, even when there is a time limit, permission for extended “temporary abandonment” is easily granted and the fine for leaving a well inactive without permission is usually small; for example, in Kansas the fine is only \$100; State Corporation Commission of Kansas, 2010.) Because of the externalities associated with not decommissioning a well, it is required that wells be decommissioned, but it is up to the producer to decide the time frame. The economic life span of a well is uncertain, and, by allowing temporary closure, the option to reactivate remains, should prices or technology improve. Some wells have not produced any oil or gas in the last 60 years; nevertheless, this closure is still classified as temporary because the wells have not been permanently decommissioned. The cleanup costs associated with decommissioning in Alberta range from \$20,000 to several million dollars per well (Orphan Well Association, 2008), whereas the cost that a producer must pay to keep a well inactive is usually only the payment to the owner of the surface rights.¹⁰ The sheer volume of wells that have been drilled (over 2.5 million in the United States¹¹ and in Alberta over 225,000 that will eventually need to be decommissioned) make examining the factors influencing the decision to environmentally remediate a worthwhile endeavor.

An operator might incur losses to maintain an inactive well when it is not currently profitable to produce oil or gas in the hopes that prices or technology improve. According to the data on reserves used in this article, the percentage of hydrocarbon in place that is recoverable (i.e., the recovery rate) ranges from 0.01 % to 90% for oil and from 15% to 95% for gas. However, once a well is inactive, because of the sunk cost to reactivate or decommission, even if recovery rates improve or diminish, the well may remain inactive. This hysteresis is directly modeled in this article, but there are other reasons for inactivity that are not explicitly modeled, but enter via an error term that compensates for unobservable states: (i) technical difficulties (e.g., blockage in the wellbore, a leak caused by corrosion or erosion, an external fire, or a temperature change causing mechanical failure), (ii) pipeline failure or pipeline capacity reached, (iii) gas plant capacity reached, or (iv) a mandated suspension for exceeding the maximum rate limit assigned to the well by the regulator.¹²

The development of enhanced recovery methods, including hydraulic fracturing and horizontal drilling, has brought wells back into production after many years of inactivity, and recoverable reserves have been seen to increase instead of decrease with time. Reserve growth was first examined by Arrington (1960) using his own company’s reservoir data. And since then reserve growth has been studied using state or state subdivision estimates of initial established reserves (IER) from the American Petroleum Institute (Morehouse, 1997) or a small number of pools (Verma and Henry, 2004). This is the first time that such a large data set on reserves has been used to study reserve growth.

2.1. Environmental Impacts. The fact that technological advances can increase recoverable reserves over time increases the value of waiting to decommission a well. However, without proper decommissioning (and in some cases, even after proper decommissioning) a well poses

⁹ The regulator does have the authority to order that a wellsite be decommissioned; however, this is not a common occurrence and the order is often rescinded or amended. For example, in 2007 there were only six well abandonment orders and in 2006 there were 19 well abandonment orders, but as of June 2009 only two of these wells had been abandoned (Alberta Energy Regulator, 2013a).

¹⁰ The annual payment for a wellsite is based on “loss of use” and “adverse effects” only (not land value or entry fee, which is paid one time in the first year). Compensation must be paid until the mineral rights owner has received a reclamation certificate. The annual payments range between \$167 and \$600 per acre for loss of land use and between \$117 and \$2,500 per acre for general disturbance (Alberta Agricultural and Rural Development, 2010).

¹¹ U.S. Energy Information Administration’s U.S. Crude Oil, Natural Gas, and Dry Exploratory and Developmental Wells Drilled: http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=E_ERTWO_XWC0_NUS_C&f=A

¹² Various wells must conform to maximum rate limitations set by the industry regulator. These limits are to ensure that the cumulative amount of oil or gas extracted is maximized. In this model, I do not truncate by the maximum rate limit because only about 10% of the wells have limits placed on them, and for only a portion of those wells is the rate limit binding.

a risk to vegetation, soil, surface water, and underground aquifers. Many wellbores extend thousands of meters underground, and it is often only a steel casing or cement that isolates the different formations. The casing might rust out or crack (especially when sand or salt water is lifted along with the hydrocarbons), and contaminants such as uranium, lead, salt, iron, selenium, sulfates, and radon may enter into formations that contain fresh water (Kubichek et al., 1997). The likelihood of this occurring increases when injection from disposal or enhanced recovery builds pressure (Canter et al., 1987). The most prevalent contaminant, methane, poses the risk of explosion if migration accumulates in adjacent buildings (for a list of explosions in Pennsylvania, some leading to fatalities, attributable to fugitive methane, see Pennsylvania Department of Environmental Protection, 2009). Decommissioning a well does not guarantee that there will not be any leaks, but the risk is much lower than that from active or inactive wells. Unplugged wellbores would also prevent the future use of a reservoir for carbon capture and storage (Watson and Bachu, 2009). Furthermore, by not reclaiming the land there is not only the opportunity cost of an alternative land use but unreclaimed well pads and related infrastructure can contribute to habitat fragmentation (Schneider et al., 2010). And finally, revegetating may also reduce turbidity in downstream rivers and streams caused by wellsites (Olmstead et al., 2013).

In Alberta, it is required that all wells eventually be decommissioned; however, it is, in effect, left up to the firm to decide when to decommission. Decommissioning a well entails plugging and abandoning and reclamation. Plugging and abandoning refers to leaving the wellbore in a permanently safe and stable condition so that it can be left indefinitely without damaging the environment. It is required that all nonsaline water formations be shut off with cement (Alberta Energy Regulator, 2010b). Reclamation includes removal of any structures, decontamination of land or water, and reconstruction of the land (Alberta Environment, 2000). Because the risk of environmental contamination is lower after plugging and abandoning, a company's liability is lower; however, it is not completely eliminated. Companies retain ongoing responsibility for wellbore integrity after plugging and abandoning a well (Province of Alberta, 2000).

The Alberta Energy Regulator estimates that abandonment costs range from \$9,067 to \$84,659 and land reclamation costs from \$13,200 to \$33,700 (Alberta Energy Regulator, 2013b); however, abandonment and reclamation costs can dramatically surpass these figures. For example, the Orphan Well Association spent over \$2 million to reenter and repair one orphan well (Orphan Well Association, 2008) and has spent on average \$23,000 per site in reclamation costs (Orphan Well Association, 2013). Although plugging and abandoning a well might prevent litigation or remediation costs associated with fluid or gas leakage (National Petroleum Council, 2011), it is difficult to quantify the cost of the ongoing environmental damages from unplugged, unreclaimed wells. The externalities associated with these wells depend on the well location (e.g., if the well intersects the range of the woodland caribou or is near any houses¹³), whether there is any groundwater contamination or fugitive emissions of methane (a potent greenhouse gas) to the atmosphere. However, methane leakage is poorly quantified (Alvarez et al., 2012) as are the existence values of threatened species. Litigation for groundwater contamination¹⁴ provides insights into the cost of groundwater contamination in the worst cases; however, it is difficult to value the externalities from a given inactive well. Therefore, this article proceeds under the assumption that the regulation requiring decommissioning is in place because the averted environmental impacts outweigh the costs of decommissioning.

3. DATA

The data collected on the oil and gas industry in Alberta are unrivaled in their comprehensiveness and accessibility. Here, five data sets of the Albertan oil and gas industry are used. The first data set is a panel of production from the universe of oil and gas wells in Alberta. Obtained

¹³ "Leaky Calmar well forces demolition of homes," CBC News, December 6, 2010.

¹⁴ "Calgary judge hears \$33M lawsuit over natural gas drilling," CBC News, January 18, 2013.

through IHS Incorporated, which distributes the records collected by the Alberta Energy Regulator, this data set contains monthly oil and gas production information dating back to 1924, with complete records starting after 1961. There is information on a well's location (latitude and longitude as well as the name of the field and pool it is on¹⁵), depth, license date, spud date (the day the drill hit the ground), and on-production date, plus the names of the current and original operators (unfortunately, there is no information on whether a well switched hands between these operators).

The second data set is a panel of official reserve estimates of all nonconfidential pools in Alberta from both the Alberta Energy Regulator and the National Energy Board of Canada.¹⁶ The data set spans 2000–2007 and contains 67,142 oil and gas pools, although not observed in every year. The year that the estimate was last reviewed is listed, and therefore the data are extended to years prior to 2000 if the last review date of the pool was before 2000. This data set contains (i) initial oil or gas in place; (ii) recovery factor, which is the fraction of the oil or gas in place that can be extracted “under current technology and present and anticipated economic conditions” (Alberta Energy Regulator, 2008); (iii) IER, which is equal to the initial oil or gas in place multiplied by the recovery factor; and (iv) remaining established reserves, which is the IER minus the cumulative production and surface loss. Each pool contains information on characteristics of the pools and hydrocarbons in those pools, such as porosity, initial pressure, area, density, temperature, and water saturation.

The third data set is a list of all wells that were permanently decommissioned (plugged and abandoned and reclaimed). To decommission a well entails that the well has met abandonment standards set by the Alberta Energy Regulator (2010b) and reclamation standards set by Alberta Environment (1995) and received a reclamation certificate from Alberta Environment or Alberta Sustainable Resource Development or was exempted from certification. The data set contains both wells that were abandoned, along with the date of abandonment, and the wells that received a reclamation certificate or were reclamation exempt.

The fourth data set consists of GIS shape files that designate areas that, according to the Petroleum Services Association of Canada (PSAC), have similar costs in production and drilling (the areas are further described in the Appendix Figure A1 and Table A1). The PSAC boundaries and well locations were entered into ArcView GIS to assign a PSAC area to each well.

The final data set is the average wellhead price of crude oil and natural gas in Alberta, obtained from the Canadian Association of Petroleum Producers' Statistical Handbook (CAPP, 2009). The wellhead price is inflated to 2007 dollars using Statistics Canada's quarterly machinery and equipment price index for mining, quarries, and oil wells.

A panel is created where each well is classified as active, inactive, or decommissioned for each year from when it was drilled until 2007. A well is classified as active if it produced any volume of oil or gas within that year, classified as inactive if it did not produce oil or gas in 12 months or more, and classified as decommissioned if it appeared in the data set of decommissioned wells.

The full data set of the universe of wells in Alberta is pared down to a subsample that is used for the estimation. Excluding coalbed methane, heavy oil, injection, and water wells, there are 350,457 wells in the production data set. The decision to decommission, stop production, or reactivate a well depends on the remaining oil and gas reserves, and so the full sample is restricted to only those wells that have a reserve estimate. Of the 350,457 wells, 105,207 are in a pool that is listed in the reserves data set. The result of this restriction is that the analysis corresponds to wells that are, or once were, deemed producible, that is, not “dry holes.” Wells that are drilled but do not tap into an oil or gas pool are more likely to be decommissioned without being completed, and they will also not show up in the subsample. More than 45% of the wells that are decommissioned in Alberta are decommissioned immediately after being drilled.

¹⁵ An oil field is the geographical area where a well is drilled. A field can have multiple pools, but each pool is a distinct reservoir that is confined within impermeable rock or water.

¹⁶ All pools eventually lose their confidential status (usually after one year), and so this data set contains nearly all pools in Alberta.

TABLE 1
SUMMARY STATISTICS

Variable	No. of Obs.	Mean	Std. Dev.	Min	Max	Unit
\bar{Q}_{gas}	118187	15.23	62.95	0	8800	E ⁶ m ³
\bar{Q}_{oil}	54523	27.09	237.07	0	43871	E ³ Barrels
Wellhead price _{gas}	37	111.90	64.76	25.89	293.91	2007C\$/E ³ m ³
Wellhead price _{oil}	37	30.16	12.12	12.88	64.45	2007C\$/Barrel
Age _{gas}	61876	19.86	15.76	1	104	Years
Age _{oil}	31430	16.58	12.15	1	94	Years
Q_{gas}	118187	32.97	297.79	0	51271	E ⁶ m ³
Q_{oil}	54523	135.64	1026.83	0	104866	E ³ Barrels
No. of wells in pool _{gas}	118187	3.59	47.02	1	4117	Wells
No. of wells in pool _{oil}	54523	4.44	17.91	1	699	Wells
q_{gas}	322907	1.68	8.27	0.0001	568.39	E ⁶ m ³
q_{oil}	155773	7.27	14.51	.001	822.95	E ³ Barrels
Depth	93239	1197.53	690.36	90.9	6552	m
Porosity _{gas}	22452	.20	.08	0.01	0.4	Fraction
Porosity _{oil}	25894	.16	.07	0.01	0.36	Fraction
Density _{gas}	22452	.64	.08	0.54	2.03	kg/m ³
Density _{oil}	25894	868.64	48.01	708	999	kg/m ³
Initial Pressure _{gas}	22452	9038.08	7564.57	130	99625	kPa
Initial Pressure _{oil}	25894	12568.80	5688.37	1442	61097	kPa
Temperature _{oil}	25894	50.14	20.34	9	350	°C
Water Saturation _{oil}	25894	.31	.12	0.06	0.82	Fraction
Wells per Firm	1196	281.93	2015.26	1	44095	Wells
Pool Discovery Year _{gas}	22452	1989.67	13.90	1904	2007	Year
Pool Discovery Year _{oil}	25894	1988.31	12.40	1910	2006	Year
Area of Pool _{gas}	22452	854.43	9908.34	1	598512	Acres
Area of Pool _{oil}	25894	183.94	554.36	1	17890	Acres
Duration Inactive _{oil}	9556	8.39	8.33	0	73	Years
Duration Inactive _{gas}	12298	9.58	10.23	0	78	Years
Duration Active _{oil}	14472	10.11	9.11	0	46	Years
Duration Active _{gas}	34047	11.35	11.85	0	46	Years

NOTES: Statistics for wells in the subsample. Data on remaining reserves (Q) are listed for pools, 1993–2007. Extraction (q) is listed for wells, 1993–2007. The pool-specific variables—depth, porosity, density, initial pressure, temperature, water saturation, and discovery year—are time invariant in the data. Data on the age of the wells and duration active and inactive are a snapshot of 2007. Price data are the wellhead price from 1971 to 2007. E³ = 1000.

The results from an estimation using the subsample cannot be generalized to all wells in the full sample, but could be generalized to wells in the full sample that at one time produced.¹⁷ Whether to complete a well for production is a separate decision from whether to produce from an already completed well. And indeed, it is more challenging to determine the future of wells that have, or once had, a potential for production as opposed to those that definitely cannot produce.

The subsample is further reduced by deleting wells that traverse both oil and gas pools. Doing so does not significantly reduce the size of the subsample (from 105,207 to 94,009); however, it does significantly reduce the computational complexity because modeling the choice to produce oil or gas is avoided without losing much insight into the choice of operating state.

The majority of the wells have small reserves, and only a few have large reserves, some being extremely large—for example, the largest gas reserve is 1,500 times larger than the mean gas reserve (Table 1). The pools with large reserves have more than one well—as many as 4,151 wells in a gas pool and 711 in an oil pool.

The production data set contains firm-reported volumes to which the accuracy is difficult to attest. The Alberta Energy Regulator identifies cases when there is *any* difference in the reported production of oil from a production company and a pipeline company. When the difference is 5% to 20% of reported gas volumes, the penalty is only a warning message.

¹⁷ The similarity between age at decommissioning for wells in full sample that produced and all wells in the subsample is shown in the Appendix Figure A3.

TABLE 2
DISTRIBUTION OF OPERATING CHOICE FOR INACTIVE WELLS BY AGE

Age (in Years)	Number of Observations		Proportion Reactivated		Proportion Stay Inactive		Proportion Decommissioned	
	(Oil)	(Gas)	(Oil)	(Gas)	(Oil)	(Gas)	(Oil)	(Gas)
1 ≤ age < 10	18963	21091	0.110	0.194	0.874	0.790	0.016	0.015
10 ≤ age < 20	19892	14965	0.056	0.066	0.922	0.915	0.022	0.019
20 ≤ age < 30	7997	11234	0.057	0.075	0.914	0.897	0.029	0.028
30 ≤ age < 40	2340	4791	0.046	0.054	0.928	0.913	0.026	0.033
40 ≤ age < 50	2176	3135	0.030	0.042	0.945	0.929	0.025	0.030
50 ≤ age < 60	704	1461	0.024	0.027	0.953	0.955	0.023	0.018
60 ≤ age < 70	131	503	0	0.010	1	0.990	0	0
age ≥ 70	50	157	0	0	1	0.987	0	0.013

NOTES: Data from 2000 to 2007 subsample.

Further misreporting results in a fee of \$100 if a well does not report in a given month, and upon persistent noncompliance the firm might be subject to increased audits or inspections or partial or full suspension (Alberta Energy Regulator, 2010a). Nonetheless, to the best of my knowledge there is no other data set of this size or comprehensiveness of any natural resource industry. And, with these data the composition of active, inactive, and decommissioned wells can be replicated to match reality closely.

Table 2 shows the proportion of inactive oil and gas wells that have been reactivated, left inactive, or decommissioned by different age intervals. The table illustrates that the hysteresis of inactivity increases as wells age. The proportion of inactive wells that are reactivated decreases with the age of the well and the proportion of inactive wells that are decommissioned increases then decreases with age.

4. MODEL

In order to capture the value of leaving a well inactive, I construct a real options model that includes the following features: The operating state is dynamic and can be changed now or at some later date; there are unrecoverable sunk costs to changing operating states; and future prices and recovery are uncertain. The producer’s decision to extract, 1, temporarily stop extraction, 2, or permanently decommission and remediate environmental damages, 3, is modeled as an infinite time Markov Decision Process (Rust, 1994). It is assumed that the producer is rational and follows a decision rule, $d_t = \delta_t(s_t, \epsilon_t)_{t=0}^\infty$, that maximizes the expected discounted sum of profits, $V(s, \epsilon) = \max_\delta E_\delta [\sum_{t=0}^\infty \beta^t \pi(s_t, d_t, \epsilon_t) | s_0 = s, \epsilon_0 = \epsilon]$, where V is the value function for the well when choosing the optimal choice, δ , and depends on observed state variables s , and an unobserved random “payoff shock,” ϵ , different for each choice. The instantaneous profit, $\pi(\cdot)$, is discounted by discount factor β , $0 \leq \beta \leq 1$. The observed state variables, s , include the age of the well, A , the wellhead price of the hydrocarbon, P , the per-well remaining reserves, \bar{Q} , and the current operating state, o . The current operating state ($o = 1$, active, 2, inactive, or 3, decommissioned) is endogenous to the decision, and the remaining reserves per well are endogenous (when the operator extracts oil or gas) and exogenous (upon technology change or if another well is in the same pool).

The model assumes that the producer maximizes lifetime profits only through the extensive decision for the operating state, but not through the intensive decision for how much to extract.¹⁸

¹⁸ The implication of not simultaneously modeling the decision of whether to extract and the decision of how much to extract is that there will be a disconnect between the lifetime profit-maximized quantity and the expected quantity I estimate outside of the model, which in turn could bias the predicted duration in a given operating state. However, the assumption rests on the assertion that extraction is mainly driven by reserve size and geologic factors, which producers do not have full control over (further discussed in Subsection 5.1.1).

If the producer decides to extract, the per-period quantity recovered is a random draw from a distribution that depends on the remaining per-well reserves, the age of the well, and parameters, α , estimated in a separate estimation outside the dynamic programming model (i.e., the expected production is $Eq = \int_0^Q q_f(y|\bar{Q}, A, \alpha)dy$). The profit (Equation 1) if the producer decides to produce is equal to the expected quantity recovered, Eq , times the price of the hydrocarbon, P , less the per-unit extracted royalty rate (or severance tax), R , and a per-unit lifting cost to extract, C .¹⁹ The per-unit lifting costs also depend on age, per well-reserves, and parameters, θ , to be estimated, $C = C_g(\bar{Q}, A, \theta)$.²⁰ The royalty rate in Alberta adjusts according to price and quantity produced, $R = R(P, q)$. This profit is then reduced by the corporate income tax, τ , assumed flat for all wells. If the current state of the well is inactive, there is a switching cost to activate, $SC_{(2 \rightarrow 1)}$.

If the producer instead chooses that the well be inactive, the producer pays a annual inactivity cost, M , and if the current state of the well is active, a switching cost $SC_{(1 \rightarrow 2)}$.

To decommission a well is to enter an absorbing state for which the producer pays a one-time switching cost, $SC_{(1,2 \rightarrow 3)}$, assumed to be the same for active and inactive wells.²¹ Leaving the well in its current state entails no switching costs, $SC_{(1 \rightarrow 1)} = 0$, $SC_{(2 \rightarrow 2)} = 0$, and $SC_{(3 \rightarrow 3)} = 0$. The expected profit from a single period is

$$(1) \pi(s, d, \epsilon) = \begin{cases} ((1 - R)P - C)Eq - \tau \max\{((1 - R)P - C)Eq, 0\} - SC_{(o \rightarrow 1)} + \epsilon_1 & \text{if } d=1 \\ -M - SC_{(o \rightarrow 2)} + \epsilon_2 & \text{if } d=2 \\ -SC_{(o \rightarrow 3)} + \epsilon_3 & \text{if } d=3 \end{cases}$$

The expected present discounted value of the well can be expressed as the unique solution to the Bellman equation²²:

$$V(s, \epsilon) = \max_d \left[\pi(s, d, \epsilon) + \beta \int_{s'} \int_{\epsilon'} V(s', \epsilon') h(s', \epsilon' | s, \epsilon, d) d\epsilon' ds' \right].$$

The state transition probability density function, $h(s', \epsilon' | s, \epsilon, d)$, is assumed to be a Markov process. The Conditional Independence assumption, as per Rust (1987, 1988), is adopted, allowing for the factorization, $h(s', \epsilon' | s, \epsilon, d) = f(s' | s, d) \rho(\epsilon' | s')$. Specifically in the case of this model, the state transition probability density function can be written as

$$h(\bar{Q}', P', A', \epsilon' | \bar{Q}, P, A, \epsilon, d) = f_q(\bar{Q} - \bar{Q}' | \bar{Q}, A, d) f_{\bar{Q}}(\bar{Q}' | \bar{Q}, P) f_P(P' | P) f_A(A' | A) \rho(\epsilon' | \bar{Q}', P').$$

Price is assumed to follow the exogenous process $f_P(P' | P, \varsigma)$, characterized by parameters ς . Recoverable reserves decrease from extraction but also increase or decrease from new

¹⁹ Note that I do not include a fixed cost of extraction. When I include a fixed extraction cost, the estimated parameters converge to the lower and upper bounds specified for the parameters. Presumably this is because fixed costs are difficult to identify (as further discussed in Subsection 5.2).

²⁰ Chermak and Patrick (1995) and Foss et al. (2002) show how the lifting cost of natural gas depends on quantity extracted and remaining reserves. Chermak and Patrick (1995) use data from 29 gas wells in Wyoming and Texas from 1988 to 1990, and Foss et al. (2002) use data from 22 gas wells in Alberta for roughly three years. They both find that operating costs increase with quantity extracted and decrease with remaining reserves. It is expected that extraction costs rise as reserves are depleted; however, Livernois and Uhler (1987) explain that the discovery of new reserves can increase the reserves by more than what is extracted, but these new reserves are more costly to extract. This is how Livernois and Uhler (1987) explain a positive relationship between extraction costs and reserves using aggregate data from the Albertan oil industry. However, upon disaggregation, they find the typical results of extraction costs increasing with reserve depletion and quantity extracted.

²¹ It is not necessary to make decommissioning an absorbing state, but in the sample there are only 261 observations of a switch from decommissioned to active, whereas there were 22,308 observed deactivations, 15,369 reactivations of inactive wells, 1,917 active wells decommissioned, and 3,664 inactive wells decommissioned

²² Following Blackwell's theorem (outlined in Rust, 1994, Theorem 2.3).

discoveries, revisions, or technological change and follow $f_{\bar{Q}}(\bar{Q}'|\bar{Q}, P, \phi)$. The quantity extracted, q , is modeled as a random draw from the density, $f_q(q|\bar{Q}, A, \alpha)$. The payoff shocks follow the transition probability $\rho(\epsilon'|s')$, but I assume that $\rho(\epsilon'|s')$ is independent of s , so the payoff shocks are assumed to be independent and identically distributed (i.i.d.) across choices, state variables, and time. They capture unobserved, current period events that make a choice more or less expensive for the operator. For example, the shocks would capture a blowout that forces the operator to shut down an active well or capture an unexpected surplus of available workover rigs that make it cheaper to reactivate or decommission a well. Although it is possible to allow serial dependence in the process $\{\epsilon\}$ (see Norets, 2009), it is computationally burdensome, and as a first approximation, the main dependencies are captured by the serial dependence in the observed state variables.

This article abstracts away from modeling the decision to decommission as a function of the strategic interaction between agents competing for the same oil. The common pool resource problem would arise if more than one company competes for a migratory hydrocarbon (Libecap and Wiggins, 1984, 1985). However, each oil and gas pool in the sample is a distinct reservoir that is confined within impermeable rock or water, and so only within pools would we expect to see behavior influenced by the common pool. For the majority of the pools in this article only one firm has access to the pool and the number of wells in a pool is small (Table 1). The average number of wells in a gas pool is 3.5 (and 4.4 for oil pools), but the majority of the time there is only one well per pool (the median and mode are 1 for both oil and gas). This may be driven by the fact that 81% of the mineral rights in Alberta are owned by the Crown and then leased to companies, whereas in the United States, mineral rights are mainly determined by surface landownership, resulting in more fragmentation of mineral rights.²³ Nonetheless, observations of wells that are in pools that have no other wells are modeled and estimated separately from wells that are in pools with other wells. Wells in single-well pools and multiwell pools are modeled differently through their transition probability of recoverable reserves from extraction, f_q . For wells in single-well pools, only when the decision is to extract, $d = 1$, is the transition probability of reserves dependent on the probability of how much can be extracted, $f_q(\bar{Q} - \bar{Q}'|\bar{Q}, A, \alpha, d)$, whereas for wells in multiwell pools, reserves transition according to this probability whether the operator extracts or not, $f_q(\bar{Q} - \bar{Q}'|\bar{Q}, A, \alpha)$. Exogenous to whether the well is active or not, recoverable reserves also follow another process, $f_{\bar{Q}}(\bar{Q}'|\bar{Q}, P, \phi_g)$, that accounts for the probability of change from improved technology, discoveries, reassessment, and additions. The per-well reserves, \bar{Q} , also decrease whenever another well is drilled in the pool. It is assumed that the number of new wells drilled is an exogenously determined random shock.²⁴ The probability of a decrease in per-well reserves by another well being drilled is incorporated into the exogenous change dictated by the transition probability density $f_{\bar{Q}}$. Although there may be strategic interactions between different firms extracting from the same pool, modeling these in the probability of reserve decreases of multiwell pools is beyond the scope of this article. A justification for this simplification is that a large fraction of the multiwell pools are operated by a single firm,²⁵ alleviating much of the concern of strategic extraction driven by the common pool. However, it could still be the case that firms are making joint decisions for all the wells in the same pool, yet the model is treating these as separate decisions. Given that not all wells in the same pool have the same operating state, this is not a very large concern; however, if joint decisions were being made it would be because of increasing returns to scale, in which case, I would be underestimating the per-well costs.

²³ In Alberta, most leases are for one quarter section (160 acres). Only one oil well can be drilled on a quarter section, and only one gas well on one section (a company must obtain the mineral leases for all four quarters of the section).

²⁴ For a model of where to drill for oil and gas, see Levitt (2009).

²⁵ On average there are 1.8 (1.9) firms per oil (gas) pool but 54.1% (49.9%) of the oil (gas) pools only have one firm and pools that have more than one firm are larger (2.6 [4.2] times for oil [gas]).

Assuming that ϵ is drawn from the type I extreme value distribution, the Bellman equation becomes (Rust, 1988)

$$V_\theta(s, \epsilon) = \max_d [v_\theta(s, d) + b\epsilon(d)],$$

where θ are the parameters to be estimated for each well group (including the cost parameters in the profit equation and the parameters in the transition probability density functions) and v_θ is the fixed point of $v_\theta = \Gamma(v_\theta)$, where Γ_θ is a contraction mapping:

$$(2) \quad \Gamma_\theta(v)(s, d) = \pi(s, d, \theta) + \beta \int_{s'} b \log \sum_{d'=1}^3 \left[\exp \left\{ \frac{v_\theta(s', d')}{b} \right\} \right] f(s'|s, d) ds',$$

with location parameter of the extreme value distribution of ϵ normalized to zero and scale parameter, b , to be estimated.²⁶

The assumption of the extreme value distribution²⁷ allows for a closed-form solution of the choice probabilities—that of the multinomial logit:

$$(3) \quad p(d|s, \theta) = \frac{\exp \frac{v_\theta(s, d)}{b}}{\sum_{d'} \exp \frac{v_\theta(s, d')}{b}}.$$

5. ESTIMATION

The estimation consists of three stages. First, I estimate the parameters of the producer's subjective belief for how the state variables progress over time as a standard parametric estimation. Second, the parameter estimates from the first stage are taken as given, and the remaining parameters in the Bellman equation, the costs in the profit function, are estimated via the Nested Fixed Point Algorithm (Rust, 1987). Nested within the algorithm to maximize the likelihood function of the choice probabilities (Equation 3), there is an inner algorithm to compute the fixed point, v_θ , of Equation (2). The outer loop of the algorithm, the maximization of the likelihood, was submitted to the solver KNITRO (Byrd et al., 2006). The inner loop, which solves the fixed point of Equation (2), consists of successive approximations followed by Newton–Kantorovich iterations. The third step is to obtain consistent standard errors from the full likelihood function. The parameter values from the first stage contain a measurement error, but they are treated as the true parameters in the second stage, and so the standard errors for the second stage parameters are inconsistent. To obtain consistent standard errors, the consistent parameter values from the first and second stages are used as starting points for one Gauss–Newton step of the full likelihood function (Rust, 1994).

Well-level heterogeneity is accounted for by estimating the dynamic programming model separately for different well types, g . All wells of the same type are treated as homogeneous, and wells of the same type that also have the same reserve size and the same age are assumed identical. The well types are determined by (i) whether the well is an oil or gas well, (ii) whether the well is in a single-well pool or a multiwell pool, (iii) the royalty regime applicable, (iv) PSAC area, and within these groups, and (v) clusters based on time-invariant characteristics (depth, initial pressure, density, water saturation, and temperature). The group is divided into clusters only if the likelihood ratio test confirms that clustering improves the fit over not clustering. This results in 88 different types of wells. The royalty regime depends on when the pool was

²⁶ A location parameter of zero means that ϵ has a mean zero; a scale parameter of one would mean ϵ has a variance of $\pi^2/6$. As b approaches zero, $V_\theta(s, \epsilon)$ converges to the ordinary Bellman equation.

²⁷ Dagsvik (1995) showed that the generalized extreme value class is dense; choice probabilities from any distribution can be approximated arbitrarily closely by choice probabilities from the generalized extreme value class.

discovered: There is an “old” category for oil from pools discovered before 1974, “new” for oil from pools discovered between 1974 and 1992, and “third tier” for oil from pools discovered after 1992. For gas wells, “old” refers to gas from pools discovered before 1974 and “new” to gas from pools discovered after 1974. Within each type, the royalty depends on price and the quantity extracted. The royalty regime remained the same from 1993 to 2009 (Province of Alberta, 2008), coinciding with the study period.

5.1. First Stage Estimates. The producer’s beliefs about future prices and recoverable reserves are estimated in the first stage. These beliefs are unobservable and subjective, but here I assume that the producer’s beliefs are recoverable from objective probability measures estimated from the data. I estimate the parameters, θ_{1st} , that maximize the first stage partial likelihood function:

$$(4) \quad L_1(\theta_{1st}) = \prod_{i=1}^{N_i} \prod_{t=1}^{T_i} f(s_{t+1}^i | s_t^i, \theta_{1st}).$$

These parameters and their transition probability densities are described in the next three subsections.

5.1.1. Transition in remaining reserves from extraction, f_q . Reserve changes due to extraction are such that when the well is active, the quantity extracted is modeled as a random draw from a distribution that depends on the per-well remaining reserves, \bar{Q} , and age of the well. It implies that the producer only chooses whether to extract and does not have control over the quantity extracted. Although producers do have control over extraction rates, ultimately extraction is also driven by geological constraints that the producer does not have control over. In a regression of the annual quantity extracted on factors that the producer does not have control over, I find that the remaining reserves, porosity, temperature, depth, density, water saturation, and initial pressure are all statistically significant in determining extraction. Furthermore, these exogenous factors explain more of the variation in extraction quantities than the price of oil or gas.²⁸

Therefore, the quantity extracted is modeled as a random draw from a distribution estimated using an equation that describes the production by well w in year t :

$$(5) \quad \log q_{wt} = \alpha_0 + \alpha_1 \log \bar{Q}_{wt} + \sigma \varepsilon_{wt}$$

assuming an i.i.d. $N(0, 1)$ error, ε . The regression is estimated separately for each well type–age group combination.²⁹ Extraction from a well is truncated to fall in the interval $[q^L, q^U]$ where the lower bound, q^L , is 10^{-8} (not zero because of the subsequent logarithm), and the upper bound, q^U , is equal to the well’s per-well remaining reserves, \bar{Q} , multiplied by a factor, κ_m , which depends on whether the well is in a single-well pool, $m = 0$, or a multiwell pool, $m = 1$. In the data set there are a few observations where the amount produced in a year is greater than the per-well remaining reserves even for wells that are on their own pools (6% of the production data would be classified as such). Evidently the reserve size is sometimes an underestimate. Therefore, the factor κ_m is equal to the 99th percentile of the observed fractions

²⁸ The adjusted R^2 of a regression of the quantity extracted on a constant and price is much smaller than the adjusted R^2 of a regression that instead of price includes the remaining reserves (specifically, price results in 0.0068 for oil wells and 0.0002 for gas wells whereas remaining reserves result in 0.1275 for oil and 0.3635 for gas). Per-well remaining reserves also depend on price; however, the adjusted R^2 from a regression that includes the truly exogenous characteristics of porosity, temperature, depth, density, water saturation, and initial pressure is also larger than the adjusted R^2 when only including price (i.e., 0.0836 for oil and 0.2405 for gas).

²⁹ If there are less than 30 observations of production within a given type’s age group, then observations from the age group without clustering were used.

TABLE 3
WEIGHTED AVERAGE PARAMETER ESTIMATES FROM THE FULL LIKELIHOOD

Parameters	Oil		Gas	
	Estimate	Std. Err.	Estimate	Std. Err.
Reserves Transition				
$\alpha_{0,1}$	0.312	(0.596)	3.333	(2.324)
$\alpha_{0,5}$	0.3	(0.581)	2.522	(1.797)
$\alpha_{0,15}$	0.07	(0.430)	2.454	(1.036)
$\alpha_{0,30}$	-0.103	(0.411)	2.288	(1.369)
$\alpha_{1,1}$	0.43	(0.163)	0.438	(0.263)
$\alpha_{1,5}$	0.274	(0.147)	0.47	(0.194)
$\alpha_{1,15}$	0.317	(0.128)	0.492	(0.115)
$\alpha_{1,30}$	0.404	(0.161)	0.51	(0.179)
σ_1	1.288	(0.178)	1.501	(0.100)
σ_5	1.267	(0.078)	1.52	(0.132)
σ_{15}	1.273	(0.077)	1.504	(0.231)
σ_{30}	1.171	(0.242)	1.344	(0.302)
$\phi_{0,U}$	0.373	(0.026)	0.268	(0.071)
$\phi_{1,U}$	2.00E-07	(3.81E-01)	571.55	(371.032)
$\phi_{0,D}$	0.69	(0.082)	0.432	(0.040)
$\phi_{1,D}$	1.00E-08	(3.13E-03)	6.56E-05	(7.56E-06)
Price Transition				
ϑ_L	0.427	(0.972)	0.707	(0.747)
ς_L	0.155	(0.477)	0.17	(0.357)
ϑ_H	0.603	(0.498)	0.594	(0.660)
ς_H	0.145	(0.206)	0.213	(0.378)
Lifting Cost (C)				
θ_1	0.032	(0.066)	1.64E-04	(7.76E-05)
θ_2	0.046	(0.202)	0.147	(0.286)
θ_3	1.588	(1.229)	3.775	(1.066)
Inactivity Cost (M)				
θ_4	0.26	(0.259)	0.386	(0.415)
Cost to Reactivate ($SC_{(2 \rightarrow 1)}$)				
θ_5	4.86	(1.131)	5.957	(2.629)
θ_6	0.087	(0.095)	0.024	(0.019)
Cost to Temporarily Deactivate ($SC_{(1 \rightarrow 2)}$)				
θ_7	1.774	(2.267)	2.594	(1.311)
Cost to Decommission ($SC_{(1,2 \rightarrow 3)}$)				
θ_8	7.923	(3.673)	9.703	(1.333)
Scale Parameter				
b	1.134	(0.376)	1.346	(0.300)
Not Estimated in Likelihood				
p_{HL}	0.272		0.062	
p_{LH}	0.160		0.100	
\bar{P}	0.031		1.143e-4	
μ_H	-3.203		-8.784	
μ_L	-3.772		-9.726	
β	.90		.90	

NOTES: These are the weighted averages of the estimates across 88 well groups. Using specification $C = \theta_1 + \theta_2/\bar{Q}^{\theta_3}$; $M = \theta_4$; $SC_{2 \rightarrow 1} = \theta_5(1 + \theta_6)^A$; $SC_{1 \rightarrow 2} = \theta_7$; $SC_{1,2 \rightarrow 3} = \theta_8$. The standard errors are derived from the White (1982) misspecification consistent information matrix.

q_w/\bar{Q}_w (different for single-well pools and multiwell pools).³⁰ The weighted average (across well types) of the coefficients in Equation (5) are displayed in Table 3. As expected, the older the well, the less production is expected from the well, for both oil and gas wells.

³⁰ The 99th percentile is used because there are a few outliers where q_w dramatically exceeds \bar{Q}_w . (That is, the 99th percentile of q_w/\bar{Q}_w for gas wells in single-well pools, k_0 , is 2.9 compared to a maximum of 66 and for gas wells in multiwell pools, k_1 , is 25.2 compared to a maximum of 807.)

5.1.2. *Exogenous transition in reserves, $f_{\bar{Q}}$.* Apart from production, there are exogenous changes in reserves from, for example, more wells being drilled, reassessments, improved technology, or new discoveries. Changes in reserves from production are already accounted for by including f_q , so to estimate exogenous changes, $f_{\bar{Q}}$, the estimates of IER are used. A pool's IER is an estimate of the initial oil or gas in place multiplied by the recovery factor and does not include what has been extracted.

The current price of oil or gas might have different effects on the transition probability of remaining reserves. For example, under high prices, one would expect there to be more research and development into extraction technology, which would in turn increase the recoverable reserves. Once developed these technologies would remain available, even under low gas prices, and therefore, one would not expect there to be symmetrical decreases in reserves under low prices, but rather only smaller increases. On the other hand, higher prices would also result in the drilling of more wells, which would in turn reduce the per-well remaining reserves. I therefore estimate the distribution of the size of reserve increases separately from the distribution of the size of reserve decreases. As well as the likelihood of the size of a change, the transition probability, $f_{\bar{Q}}$, also includes the probability to increase, decrease, or remain the same. Depending on the type of pool (i.e., PSAC area, single- or multiwell, year discovered), 63% to 84% of the pool-year observations have no change in per-well IER.

The distribution of the natural logarithm of changes that did occur is depicted in Figure A5 in the Appendix and can be approximated by two exponential distributions spliced together. When there is an increase in reserves, the size of the increase, $\ln(\bar{Q}_{t+1}^{IER}/\bar{Q}_t^{IER})$, can be approximated by an exponential distribution, as when there is a decrease in reserves, and the size of the decrease, $-\ln(\bar{Q}_{t+1}^{IER}/\bar{Q}_t^{IER})$, can be approximated by a different exponential distribution. That is, when there is an increase (or decrease), $\Delta = \left| \ln(\bar{Q}_{t+1}^{IER}/\bar{Q}_t^{IER}) \right|$ follows a distribution with density function

$$f_{\bar{Q}}(\Delta|\lambda) = \lambda \exp(-\lambda\Delta).$$

The current price is incorporated into the probability via λ , where

$$\lambda = \begin{cases} (\phi_{0U} + \phi_{1U}P)^{-1} & \text{when increase,} \\ (\phi_{0D} + \phi_{1D}/P)^{-1} & \text{when decrease.} \end{cases}$$

Therefore, using any observations of a reserve increase ($\bar{Q}_{it}^{IER} > \bar{Q}_{it-1}^{IER}$), I maximize the likelihood of the size of a increase as

$$L(\phi_U) = \prod_i \prod_t \frac{1}{(\phi_{U0} + \phi_{U1}P_{t-1})} \exp\left(-\frac{\left| \ln(\bar{Q}_{it}^{IER}/\bar{Q}_{it-1}^{IER}) \right|}{(\phi_{U0} + \phi_{U1}P_{t-1})}\right).$$

And similarly, using any observations of a reserve decreases ($\bar{Q}_{it}^{IER} < \bar{Q}_{it-1}^{IER}$), I maximize the likelihood of the size of a decrease as

$$L(\phi_D) = \prod_i \prod_t \frac{1}{(\phi_{D0} + \phi_{D1}/P_{t-1})} \exp\left(-\frac{\left| \ln(\bar{Q}_{it}^{IER}/\bar{Q}_{it-1}^{IER}) \right|}{(\phi_{D0} + \phi_{D1}/P_{t-1})}\right).$$

5.1.3. *Transition in price.* Analysis of the price of oil is a well-researched area, although there is little consensus for the best-fitting model. Models differ by allowing for mean reversion, nonstationary unit roots, underlying market fundamentals, unexpected jumps, or time-varying volatility, for example. To limit the number of states included in the model, I assume price

follows an exogenous first-order Markov process, which is an assumption for the formation of expectations for future prices: The producer bases its expectation on current prices. At the same time, producers have experienced periods of both low and high prices in the past. Therefore, I include a switching process between a high-price regime and a low-price regime in the Markov process. The regimes are determined depending on whether the price is above or below the average price observed from 1971 to 2007. Because we know which regime we are in simply by knowing whether the price is above or below the average price, there is no need to include “price regime” as a state variable in the model. That is, the final matrix of transition probability weights for price depends only on the current price. The transition probability of switching from regime H to L is simply the number of times that regime H was followed by regime L divided by the number of times the process was in regime H :

$$\hat{p}_{HL} = \frac{\sum_{t=1}^T I\{r_t = L, r_{t-1} = H\}}{\sum_{t=1}^T I\{r_{t-1} = H\}},$$

whereas, the opposite holds true for switching from L to H . For each regime, the parameters from a regression with deviations from the mean logarithm of price, $\wp_{t,r} = \log P_t - \mu_r$, are estimated:

$$(6) \quad \wp_{t,r} = \vartheta_r \wp_{t-1,r} + \varsigma_r \varepsilon_t,$$

where ε is i.i.d. $N(0, 1)$. The process is truncated so that price does not fall below $\underline{P} = 1\text{E} - 6$ (and not zero because of the subsequent logarithm). The transition probability of price in regime r is

$$F_P(P_t|P_{t-1}, r) = \frac{\Phi((\wp_{t,r} - \vartheta_r \wp_{t-1,r}) / \varsigma_r) - \Phi((\underline{\wp}_r - \vartheta_r \wp_{t-1,r}) / \varsigma_r)}{1 - \Phi((\underline{\wp}_r - \vartheta_r \wp_{t-1,r}) / \varsigma_r)},$$

where Φ is the standard normal cumulative distribution function and $\underline{\wp}_r = \ln(\underline{P}) - \mu_r$.

The transition probability matrix is derived from a mixture of the distributions under high- and low-price regimes, including the transition probabilities between the two regimes:

$$F_P(P_t|P) = \begin{cases} p_{HH}F_P(P_t|P_{t-1}, r = H) + p_{HL}F_P(P_t|P_{t-1}, r = L) & \text{if } P > \bar{P}, \\ p_{LH}F_P(P_t|P_{t-1}, r = H) + p_{LL}F_P(P_t|P_{t-1}, r = L) & \text{if } P \leq \bar{P}. \end{cases}$$

5.1.4. Transition in age. To save computing time the age variable is discretized into the intervals $A = 1, 5, 15, 30$ for $1 \leq \text{age} < 5$, $5 \leq \text{age} < 15$, $15 \leq \text{age} < 30$, $\text{age} \geq 30$, under the assumption that wells within these age intervals are similar. Oil and gas production over the life of a well typically follows an exponential decline, with the steepest decline within the first several years. Therefore, I make smaller intervals for younger wells, when the difference in age matters more.³¹ These intervals also divide the sample into roughly four even groups (of 19%, 31%, 29%, and 18% of the observations in each age group, respectively). The transition probability of entering the next interval is $1/n_{\text{years}}$, where n_{years} is the number of years in the current interval.

³¹ Also, when estimating production, q , from a well, the shorter intervals for younger wells helps capture this nonlinearity in production over the life of the well.

5.2. Second Stage Estimation. For each different well type, g , a different set of structural parameters, $\theta_{2nd} = (C, M, SC_{(2 \rightarrow 1)}, SC_{(1,2 \rightarrow 3)})$, is estimated. The likelihood of observing the decisions d that were made for each well ($w = 1 \dots W_g$) in the well group is maximized:

$$L(\theta_{2nd}) = \prod_{t=1}^T \prod_{w=1}^{W_g} p(d_t^w | P_t, Q_t^w, A_t^w, \theta_{2nd}, \hat{\theta}_{1st}),$$

where p is the multinomial logit probability, given in Equation (3), that the choice for well w at time t is decision d . For each iteration of the likelihood there is a nested subroutine to find the fixed point to the Bellman equation (2). The model is in discrete time, and the producer chooses the operating mode on a yearly basis. In reality, this decision is in continuous time; however, a well is classified as an inactive well by the Alberta Energy Regulator if it has not reported any volumetric activity (production, injection, or disposal) within the last 12 months. Therefore, the data are assigned as follows: For a well in 2000, the current operating state, o , is the operating state in 1999, where the decision, d , is the operating state in 2000, given the average wellhead price of oil (or gas for gas wells) in 2000, the reserve size in 2000, and the age of the well in 2000.

The royalty rate is calculated using formulas specified by the Alberta Department of Energy (Alberta Energy, 2006). The rates range from 5% to 35% depending on the price of oil (or gas), when the reserve was discovered, and the volume of oil (or gas) produced. As this model is based on the expected production, and not the actual production, the royalty rate is the expected royalty rate.³² The Alberta corporate income tax rate is 10% of taxable income whereas the federal corporate income tax rate is 22.12%. The combined federal and provincial tax rate on corporate income, τ , is set at 32.12% (Alberta Department of Energy, 2007).

Estimating the discount factor, β , along with the cost parameters is difficult. For example, both a high reactivation cost and a low discount factor will prolong reactivation. Therefore, for each well group, I estimate the cost parameters under seven candidate discount factors, ranging from 0.7 to 0.99. By examining the sum of the log-likelihoods across well groups for each candidate discount factor, a discount factor of 0.90 results in the highest total log-likelihood (illustrated in Appendix A.4).

The estimation requires specifying the functional form of the profit equation. I estimated the model under many different specifications that seemed reasonable and were flexible to incorporate features such as costs increasing as age increases and remaining reserves decrease. A parsimonious specification that led to timely convergence and high likelihood values is a specification where the lifting cost depends on the reserve size and age, $C = \theta_1 + \theta_2/\bar{Q}^{\theta_3}$; the fixed inactivity cost is a constant, $M = \theta_4$; the reactivation cost depends on age, $SC_{2 \rightarrow 1} = \theta_5(1 + \theta_6)^A$; and deactivation and decommissioning costs are constant, $SC_{1 \rightarrow 2} = \theta_7$ and $SC_{1,2 \rightarrow 3} = \theta_8$. By construction of the multinomial logit (Equation (3)), identifying all fixed costs of the model is not possible. To identify the absolute costs, external information on actual well sale prices would be needed. The cost parameters are interpreted in million dollars, but also in relation to a normalized reactivation cost of zero for active wells (i.e., $SC_{(1 \rightarrow 1)} = 0$). Furthermore, the scale of the profit equation is already normalized because the coefficient on price is normalized (to one), which also means that I can estimate the scale parameter of the type I extreme value error term, ϵ .

5.3. Third Stage Estimation: Maximizing the Full Likelihood. The parameter estimates from the partial likelihood estimation are used as starting values in the maximization of the full likelihood function. I allow for one iteration of the maximization routine of the full likelihood function to determine a consistent estimate of the asymptotic covariance matrix for the estimates, which is used to determine consistent standard errors. The average estimates and standard errors of the 88 different well types, weighted by the number of observations, are displayed in Table 3.

³² Formulas can be found in Alberta Energy (2006).

The coefficients were derived using price data scaled by one million dollars. The coefficient on price in the probability distribution for an exogenous increase in reserves, $\phi_{1,U}$, appears to be very different for oil and gas wells; however, because the prices are in millions of dollars, inverted, and taken to the negative power of Euler's number, the difference in the probability of an increase is not as large as these coefficients suggest. Nonetheless, gas reserve growth is more responsive to price changes than oil reserve growth, which is most likely because gas reserves are more difficult to estimate than oil reserves (Vanorsdale, 1987).³³

It is important to note that the estimates in Table 3 do not represent the costs for switches that were actually made, but are the costs for a hypothetical well to switch to an arbitrary operating state (Kennan and Walker, 2011). Operators only choose to switch when the costs net of the payoff shocks are favorable, which would be less than the estimates in Table 3.

I find that on average the costs to decommission a well are higher than the costs to reactivate a well, and so one might expect that wells are more likely to be reactivated than decommissioned. However, the lifting costs increase as the remaining reserves decrease, and therefore, reactivating the well for a lower range of \bar{Q} would result in paying more to extract than the price of gas or oil.

Firms could be postponing decommissioning because they intend to declare bankruptcy in the future; however, the number of orphan wells is relatively small in Alberta, implying that bankruptcy is not a very important option.³⁴ In other empirical contexts in which bankruptcy is an important option, the model would have to take the full portfolio of wells that a firm owns into consideration (e.g., a firm would not declare bankruptcy if it had many producing wells). In this case, to the extent that bankruptcy is an option, I am omitting an option that is available to active and inactive wells (i.e., the option to declare bankruptcy, at some cost, and avoid decommissioning costs), and by omitting this option, the estimated costs of an inactive or active well are biased downward and the decommissioning costs biased upward as compared to a model that incorporates this option. However, more important than interpreting the cost estimates is correctly simulating counterfactual scenarios, in which case the biased cost parameters to some extent account for the omitted bankruptcy option.

5.4. Goodness-of-Fit Tests. To test the dynamic programming model's ability to fit the data, the choice probabilities from the estimated dynamic programming model $p(d|s, \hat{\theta})$ are compared to the observed (nonparametric) estimates of the conditional choice probability function $\hat{p}(d|s)$. The nonparametric estimate \hat{p} is the sample histogram of choices made in the subsample of wells with state s . Following Rust and Phelan (1997) and Rothwell and Rust (1997), by sample enumeration, if S is a collection of s cells, the nonparametric estimate of the choice probability is computed as

$$\begin{aligned}\hat{p}(d|S) &= \int_{s \in S} \hat{p}(d|s) \hat{F}(ds|S) \\ &= \frac{1}{N_S} \sum_{i=1}^N I\{d_i = d, s_i \in S\},\end{aligned}$$

³³ Gas reserves are not only made up of "free" gas, but also the more difficult to measure "adsorbed" gas attached to the rock surface. There are other less probable reasons for differences in reserve-growth elasticities. For example, by construction of the model, newly drilled wells reduce per-well recoverable reserves, which combined with four times stricter well-spacing limits for gas wells (see Footnote 23) would reduce the probability of a reserve decrease for gas compared to oil. However, gas pools are on average four times larger than oil pools, so this is not likely to be the case. It is also not likely that the difference in reserve-growth elasticities is driven by a difference in the age of pools. Gas pools are slightly younger (84% of the gas pools were discovered after 1974 compared to 82% for oil), however not significantly.

³⁴ For example, in 2012, a year noted for having a "large increase in the number of new orphan wells," 50 new wells were added to the inventory of 14 orphan wells (Orphan Well Association, 2013).

TABLE 4
ACTUAL VERSUS PREDICTED CHOICE PROBABILITIES

Current State	Oil		Gas	
	Observed	Expected	Observed	Expected
<i>Active or Inactive</i>				
Pr(Active)	0.6207	0.6205	0.6878	0.6822
Pr(Inactivate)	0.3683	0.3684	0.3026	0.3042
Pr(Decommission)	0.0110	0.0111	0.0096	0.0136
No. Obs.		150078		186274
χ^2		0.15		227.37
Marg. Sig.		0.93		0
<i>Active</i>				
Pr(Active)	0.9253	0.9256	0.9421	0.9330
Pr(Inactivate)	0.0691	0.0690	0.0534	0.0572
Pr(Decommission)	0.0056	0.0054	0.0046	0.0097
No. Obs.		96880		129322
χ^2		0.90		402.53
Marg. Sig.		0.64		0
<i>Inactive</i>				
Pr(Activate)	0.0660	0.0652	0.1105	0.1128
Pr(Inactive)	0.9132	0.9133	0.8685	0.8650
Pr(Decommission)	0.0209	0.0216	0.0210	0.0222
No. Obs.		53198		56952
χ^2		1.67		7.25
Marg. Sig.		0.44		0.03

NOTES: The chi-square test statistic was calculated as $\chi^2 = N \sum_{d=1}^3 \{(\text{Obs}_{Pr(d)} - \text{Exp}_{Pr(d)})^2 / \text{Exp}_{Pr(d)}\}$, where N is the number of observations.

where $\hat{F}(ds|S)$ is the nonparametric estimate of the conditional probability distribution of s given S , equal to the number of observations in cell ds divided by the total number of observations in all cells that comprise S . This is compared to the estimates of the choice probability from the dynamic programming model:

$$\begin{aligned} p(d|S, \hat{\theta}) &= \int_{s \in S} p(d|s, \hat{\theta}) \hat{F}(ds|S) \\ &= \frac{1}{G} \sum_{g=1}^G \frac{1}{N_g} \sum_{i=1}^{N_g} p(d|s, \hat{\theta}_g) I\{s_{ig} \in S\}, \end{aligned}$$

where $p(d|s, \hat{\theta}_g)$ is the probability given by Equation (3) and $\hat{\theta}_g$ are the estimates of the structural parameters for group g .

Table 4 shows the observed choice probabilities alongside the expected choice probabilities from the dynamic programming model for oil and gas wells. The three panels in Table 4 show the cases that S is a collection of all possible s cells, that S is a collection of wells that are active, and that S is a collection of wells that are inactive. The dynamic programming model does a very good job at predicting the overall observed choice probabilities. In predicting the operating state all wells, the chi-squared test cannot reject the dynamic programming model at the 93% significance level for oil wells and at the 70% significance level for gas wells. In the case of gas, as well as when the sample is separated by current operating state, the chi-squared test rejects the dynamic programming model; however, the observed and expected probabilities do not differ by more than 0.01.

5.5 Comparing Actual and Simulated Data Over Time. The estimated model performs extremely well in replicating the period-by-period decisions. However it is also important to show

that the model can predict decisions over time and not just predict a onetime snapshot. Simulating the composition of wells over time is a more difficult task because any deviations from the real data will accumulate after each period, particularly when there is hysteresis. Using the state of the industry in 2000 as a starting point, I simulate the progression of wells, quantity extracted, and remaining reserves over seven years (Figure 1). Each well's path is simulated individually by a series of pseudo-random draws from its type-specific probability density of the state transitions and its subsequent type-specific probability density of operating-state choice.³⁵

The dynamic programming model is able to match the data closely for the first year of the simulation for both oil and gas wells, but over time slightly overpredicts the number of inactive oil wells and underpredicts the number of inactive gas wells. The greatest discrepancy between the observed and predicted data, although still modest, is found in the underprediction of total oil production and overprediction of total remaining gas reserves (Figures 1 c and f). The difference in total oil production can be partially explained by the accumulated underprediction of the number of active oil wells. However, it is more likely driven by the fact that the sample used to estimate the parameters is different from the sample used in this simulation. In order to make a comparison between simulated and real data over time, I must restrict the sample used to estimate the parameters to a smaller subsample. First, because I am not modeling the decision to drill new wells, I restrict the sample to wells that were already drilled as of the year 2000, and therefore the simulation sample is composed of older wells on average. Second, because some of the pools in the estimation sample are missing reserve estimates in some years, I restrict the sample to only wells that have reserve estimates available for every year from 2000 to 2007.³⁶ The well-average of the ratio of log oil production to log oil reserves is 5.6% larger in the simulation sample than in the estimation sample, which would explain why the simulated production is underpredicted (i.e., the parameters governing production are set to be too small for this subsample). The difference between the estimation sample and the simulation sample also appears to be driving the discrepancy in the remaining gas reserves. The well-average change in the remaining gas reserves from year to year is 5% larger in the estimation sample than in the simulation sample, which would explain why at the end of the simulation the simulated reserves are higher. This exercise illustrates that the model is more reliable in predicting the extensive margin over the intensive margin.

5.6 Policy Application of the Model. If the option to mothball a well did not exist, then there would be a state of nature, L , of low enough prices, remaining reserves, and expectations for their increase that the value of operating the well, $V_L(1)$, would be less than the value of decommissioning, $V_L(3)$, and the well would be decommissioned. When the option to mothball exists, then such a well (with $V_L(1) < V_L(3)$) would not necessarily be decommissioned because leaving it inactive could be more valuable (less costly) than decommissioning, $V_L(1) < V_L(3) < V_L(2)$. However, the values of course depend on the current state of nature, and it could be the case that when prices or recovery rates become high enough, H , and these same wells would be reactivated in a high state, $V_H(3) < V_H(2) < V_H(1)$. However, there is a problem when there are wells for which even in a high state it is preferable to decommission them, but even more preferable to leave them inactive, $V_{L,H}(1) < V_{L,H}(3) < V_{L,H}(2)$.

It could be the case that if the externalities associated with mothballing are internalized, then the option to decommission would become preferred and wells that would not be reactivated would be decommissioned, $V_{L,H}(1) < V_{L,H}(2 \text{ \& internalized costs}) < V_{L,H}(3)$. There are various policies that a regulator could try that would persuade the inactive wells, $V_H(1) < V_H(3) < V_H(2)$, to be decommissioned, $V_H(1) < V_H(2) < V_H(3)$, such as by increasing inactivity costs or subsidizing decommissioning costs. But without knowing the social cost of an inactive well, policies might be too bold and result in too many wells being prematurely decommissioned. Specifically, the worry of regulators is that these policies might encourage

³⁵ Each well path is simulated 30 times to obtain a 90% confidence interval around the average simulation.

³⁶ Otherwise, there would be artificial drops in total reserves in years when data on reserves are missing.

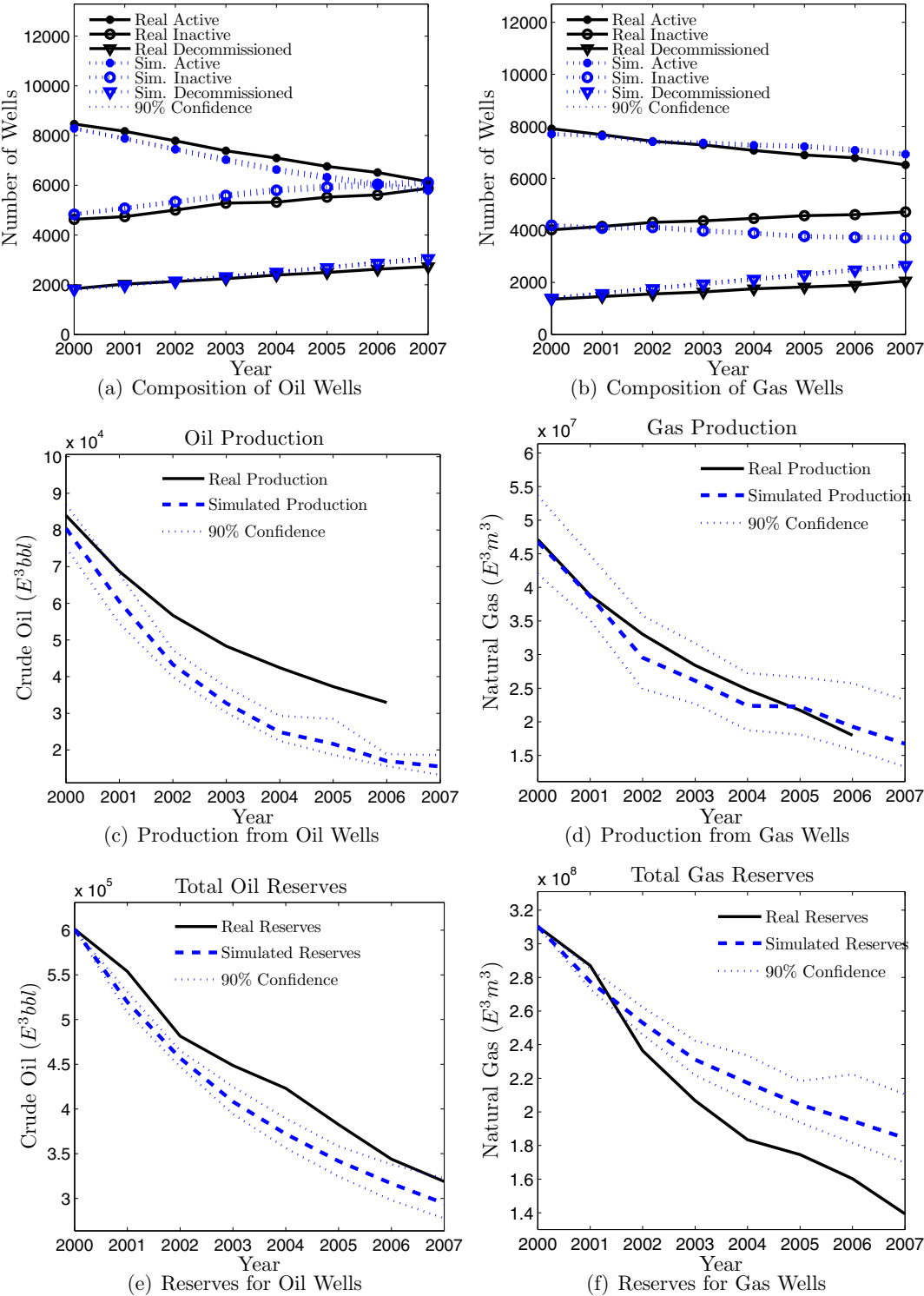


FIGURE 1

COMPARISON OF ACTUAL DATA AND SIMULATED DATA

wells that would otherwise be producing, $V_H(3) < V_H(2) < V_H(1)$, to be decommissioned, $V_H(2) < V_H(1) < V_H(3)$. This might occur because the value of an active well depends on the option to mothball, so when the option to mothball becomes more expensive, the value of an active well also decreases. Moreover, wells that would have otherwise been temporarily deactivated in a low state might be decommissioned and then not able to reactivate in a high state. Premature decommissioning is an undesirable outcome especially when the regulator places a large value on domestic production.

To evaluate a policy based on its ability to encourage decommissioning without jeopardizing future production really depends on the well in question. Importantly, the value of a well in each of its operating states depends on the current state of nature as well as the payoff shock, ϵ . Because there is a wide distribution in the age of wells and the remaining reserves, one policy will affect each value differently. Therefore to evaluate a policy, it is important to look at the current distribution of wells in question and to look at how the policy affects the sum total of all wells. To do so, I simulate the choices for wells under different counterfactuals to determine the total effect on wells in the sample. If a significant proportion of the wells in the sample fall into the category of $V_{L,H}(1) < V_{L,H}(3) < V_{L,H}(2)$, then under a high state of nature, we would not see many reactivations. We can also see how changes to parameters in the model affect the operating choices, current production, and cumulative production overall. An important caveat is that these simulations are made under the assumption that the estimated transition probabilities reflect the actual transition probabilities of the operator. It could be the case, however, that an operator is more optimistic about reserves or prices and puts higher weight on future high states relative to those estimated in this article. Therefore the hypothesis that operator behavior can be explained by their waiting for better conditions is tested under the assumption that operators forecast the future using the same transition probabilities that are estimated in the article. The hypothesis that operator behavior can be explained by optimism about the future is not tested.

5.6.1 Twelve-year forecasts of ideal scenarios. The model is used to simulate the industry under different scenarios that operators claim to be waiting for: high prices, improved recovery rates, and reduced reactivation costs. These ideal scenarios are compared to a baseline scenario where prices, recovery factors, and the state of the industry are simulated to progress using only the estimated parameters.

In the first scenario, each well-type faces the costs estimated for the type, but they now receive a constant “high price” of \$197.72/bbl for oil and \$462.44/e³m³ for gas produced.³⁷ At the end of the 12-year forecast, averaged over 50 simulations, the high price for oil is 3.2 times the average forecasted price of the baseline. As illustrated in Figure 2 and listed in the first two rows of Table 5, the high price case results in 19% more oil wells that are active than the baseline prediction. The high price for gas wells is on average 2.0 times the average forecasted price of the baseline after 12 years, but only leads to 6% more wells that are active. The annual oil production by the 12th year is 21% higher, and there is 21% more cumulative oil production over the prior 12 years. In the case of oil, the growth in reserves does not compensate for the increased production, so that after 12 years there are 24% fewer oil reserves than in the baseline case. For gas reserves, the high price results in more reserve growth showing that the expected returns from investments in exploration or enhanced recovery are greater for gas than oil. At the end of the 12 years, there are 120% more gas reserves and 78% more production than in the baseline case. It is fascinating that in spite of the active wells being more productive, the increased reserves and higher prices are not sufficient to induce many inactive gas wells to be reactivated. This is particularly striking in the case of gas wells where, with 78% more productive wells and 120% increased remaining reserves, there are only 6% fewer inactive wells than in the baseline case.

³⁷ This is equal to the U.S. Energy Information Administration’s Annual Energy Outlook of 2009 “high price” case in 2030 for oil and 1.5 times the “high price” for gas.

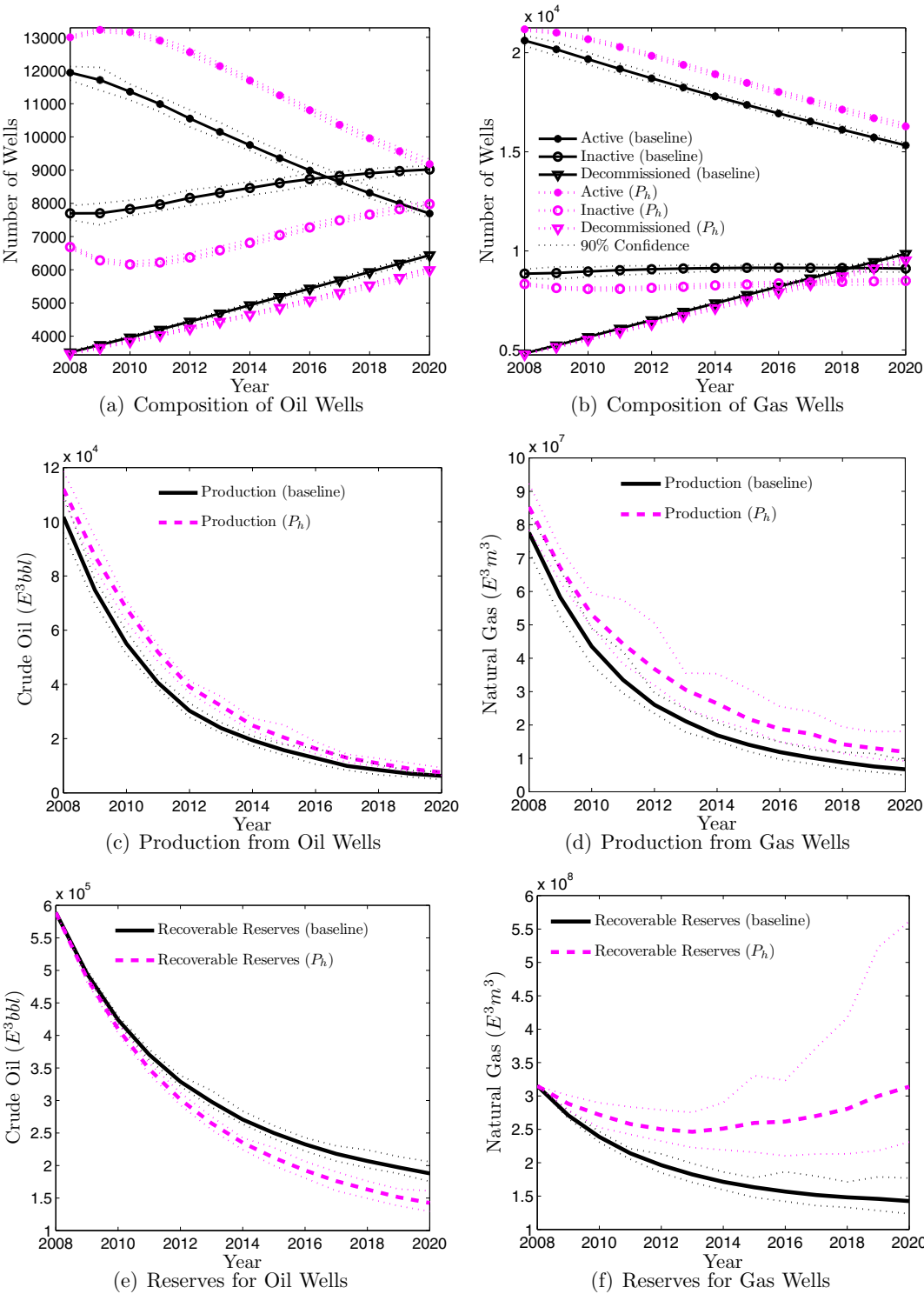


FIGURE 2

FORECAST UNDER BASELINE AND HIGH-PRICE SCENARIOS

TABLE 5
TWELVE-YEAR FORECAST OF COUNTERFACTUAL SCENARIOS (% Δ FROM BASELINE)

Counterfactual Scenario	Well Type	No. Active	No. Inactive	No. Decomm.	Remaining Reserves	Annual Prod.	Cumulative Production
High prices (2.1–3.3 \times baseline P)	Oil	19%	–12%	–7%	–24%	21%	21%
	Gas	6%	–7%	–3%	120%	78%	31%
High recovery factors (100% recovery)	Oil	17%	–10%	–7%	514%	411%	164%
	Gas	7%	–6%	–6%	418%	387%	275%
Low reactivation (.75 \times SC _{(2\rightarrow1)g})	Oil	19%	–7%	–12%	–13%	20%	9%
	Gas	9%	–4%	–10%	–11%	14%	7%
Low decommissioning (.75 \times SC _{(1,2\rightarrow3)g})	Oil	–17%	–20%	48%	14%	–17%	–5%
	Gas	–18%	–20%	46%	10%	6%	–2%
Low annual inactivity (1.25 \times M)	Oil	6%	–9%	5%	–4%	–5%	2%
	Gas	5%	–13%	3%	3%	11%	2%

NOTES: Values represent the percent difference between the counterfactual scenarios in the first column and the baseline scenario. Values are averages over 50 simulations. The columns of values represent the difference in the number of active wells in year 12, inactive wells, decommissioned wells, remaining reserves in year 12, annual production in year 12, and cumulative production over 12 years.

In a second scenario (Table 5, rows 3 and 4) a hypothetical technology change allows for all of the oil or gas-in-place to be recovered. To date, according to the data, recovery rates range from 15% to 95% with an average of 67% for gas and from 0.01% to 90% with an average of 12% for oil. In the hypothetical scenario, recovery rates are simulated to be 100% of the oil and gas that is in place. In the case of gas, increasing the recovery rate to 100% increases the remaining recoverable reserves by 418% and increases the annual production from producing wells by 387% (275% cumulative). But this significant increase does not induce the reactivation of many inactive gas wells (there are only 7% more active wells at the end of the period than in the baseline case). In the case of oil, the increased recovery rate increases remaining reserves by 514% and increases annual production by 411% (164% cumulative), but the number of active wells only increases by 17%. A higher recovery rate alone has less of an effect on increasing the number of producing wells than a higher price of oil or gas.

However, technology might not only improve recovery factors, but might also decrease the cost to reactivate a well. Therefore, I simulate the industry when the reactivation costs for all well groups are reduced by 25% (Table 5, rows 5 and 6). In the case of gas, after 12 years of lower reactivation costs, there are 9% more active wells, 4% fewer inactive wells, and 10% fewer decommissioned wells. Interestingly, the additional production from these wells is only marginal: there is only 14% more production in the last year of the simulation (7% more cumulative production). The reactivated oil wells are slightly more productive than gas wells: After 12 years there are 19% more active wells, and 20% more production (only 9% more cumulative production than in the baseline case). Corresponding with the increased cumulative production, there are less remaining reserves at the end of the 12-year period (a 11% to 13% reduction). And in the case of gas wells, the production by the end of the 12 years is less than in the baseline case. However, due to lack of data on reactivation costs, it is more difficult to assess the probability of a reduction in reactivation costs than to assess the probability of an increase in prices or recovery rates.³⁸

It is also interesting to see how responsive the model is to changes in the cost of decommissioning the well. I simulate the 12-year forecast with decommissioning costs being 25% cheaper than in the baseline case. I find that the number of decommissioned wells is very elastic to decommissioning costs, as a 25% reduction in cost results in 46% to 48% more decommissioned wells. Decreasing decommissioning costs might be unappealing to a regulator because not only

³⁸ Cost data are very hard to come by. For example, PSAC publishes average drilling and completion costs for 46 “typical” wells for \$750 per year; however, these data would not shed light on the reactivation costs, which could vary widely depending on the well.

does the number of inactive wells decrease but also the number of active wells. This scenario results in 20% fewer active wells, and 2% to 5% less production.

Instead, increasing the costs of leaving a well inactive could increase the number of decommissioned wells without decreasing the number of active wells. To examine how responsive the operating choice is to the cost of leaving a well inactive, I simulate a 12-year forecast under a scenario where inactivity is 25% more expensive per year. As long as the externalities associated with leaving a well inactive are accounted for, *ad infinitum*, then leaving a well inactive could be socially optimal. This simulation can be likened to a tax on inactive wells. Such a policy would be more appealing to a regulator in favor of maximizing production because, under this scenario, the number of decommissioned wells increases (by 3% to 5%) as does the number of active wells (by 5% to 6%). As expected with the reactivation of wells, this scenario results in an increase in the cumulative oil and gas produced over the 12-year period. However, the increase in cumulative production is less than the increase in reactivated wells (cumulative production only increases by 2%), indicating that the average reactivated well is considerably less productive.

6 CONCLUSION

The decision that oil and gas producers make for the operating state of their wells can be categorized as a classic example of an irreversible investment under uncertainty. Restarting production or finally decommissioning a well is an expensive endeavor and is made with uncertainty in future recovery technology and prices. I show that this decision can be modeled by a real options formulation, and the structural parameters of the model can be estimated using data on operating decisions from oil and gas wells in Alberta. Indeed, the operating decisions made for 84,000 wells in Alberta can be replicated by modeling well operators as dynamic optimizers. Within-sample goodness-of-fit tests show that the model is able to closely predict actual operating choices.

The example of whether to activate, temporarily deactivate, or permanently decommission is used to demonstrate real options in textbooks and classrooms; however, the case of firms using temporary deactivation as a way to avoid paying for permanent decommissioning has been ignored. The motivation of this article was to determine the rational for leaving oil and gas wells inactive; either they could be a blessing, if they eventually are reactivated and contribute to our energy supply, or they could be a curse, if they are never reactivated, cause environmental degradation, and must undergo costly decommissioning. With the estimated structural parameters, I can predict how the operating choices might change under different conditions. I find that increased oil and gas prices and recovery rates might increase per-well annual production, but will not substantially increase the number of active wells. For example, doubling the gas price results in a 120% increase in recoverable reserves, but only a 6% increase in the number of inactive wells. On the other hand if it became cheaper for wells to be reactivated, we would have more active wells, but these wells would likely not be very productive, and total production would not increase as much. The cost of decommissioning plays an important part in determining the number of decommissioned wells; however, a policy to decrease the cost of decommissioning a well would result in not only fewer inactive wells, but also fewer active wells, making such a policy less appealing to a regulator in favor of production. Conversely, a policy of increasing the cost of mothballing a well would increase the number of active wells as well as decrease the number of inactive wells.

If optimistic conditions are not enough to induce well reactivation, this implies that wells are left inactive not because of the option to reactivate, but rather the sunk cost of decommissioning is too high to warrant undertaking. Should there be externalities from idling the wells (such as continued contamination of groundwater) that are not accounted for in the decision, then this behavior may not be socially optimal. This article demonstrates that for the majority of inactive wells, temporary closure is, in effect, permanent closure. Advances in hydraulic fracturing and horizontal drilling have prompted a new surge in drilling for oil and gas, which has resulted in much debate and controversy, particularly in regards to the immediate environmental impacts.

Less attention has been given to concerns for the final cleanup and reclamation of these wells—unwarrantedly so given that in many of the areas where wells are being drilled, the financial bonds meant to ensure cleanup were set over half a century ago. The occurrence of firms not internalizing their decommissioning costs is likely generalizable to other industries that have high cleanup costs and are also allowed extended temporary closures.

APPENDIX

A.1. *PSAC Areas.* See Table A1 and Figure A1.

TABLE A1
CHARACTERISTICS OF PSAC AREAS

PSAC Area	Surface	Hydrocarbon	Characteristics
1	Rocky Mountains	Deep gas	Strict environmental regulations
2	Ranching, farming and forest	Oil and gas	Easily accessed
3	Agricultural prairie grassland	Gas and medium/heavy oil	Easily accessed
4	Prairie and woodland	Gas and heavy oil	Easily accessed
5	Agricultural	Oil and gas	Most densely populated area
6	Prairie and woodland	Shallow gas	Only winter drilling
7	Agricultural and logging	Oil and gas	Often no road access and winter drilling



FIGURE A1
PSAC AREAS

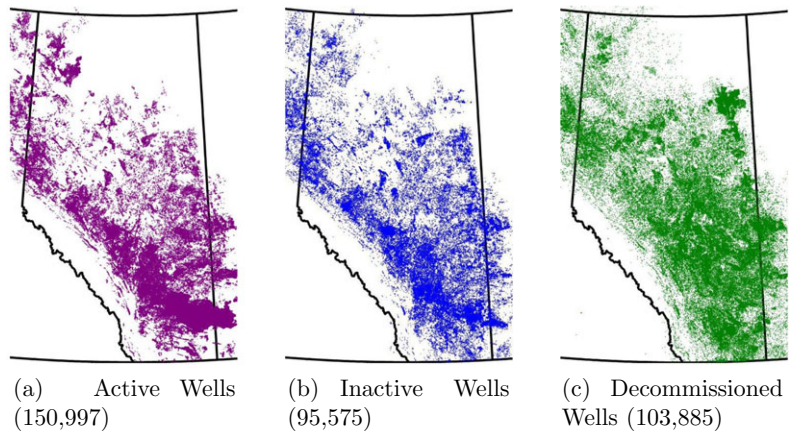


FIGURE A2

A.2. *Subsample as Compared to Full Sample.* See Figure A3.

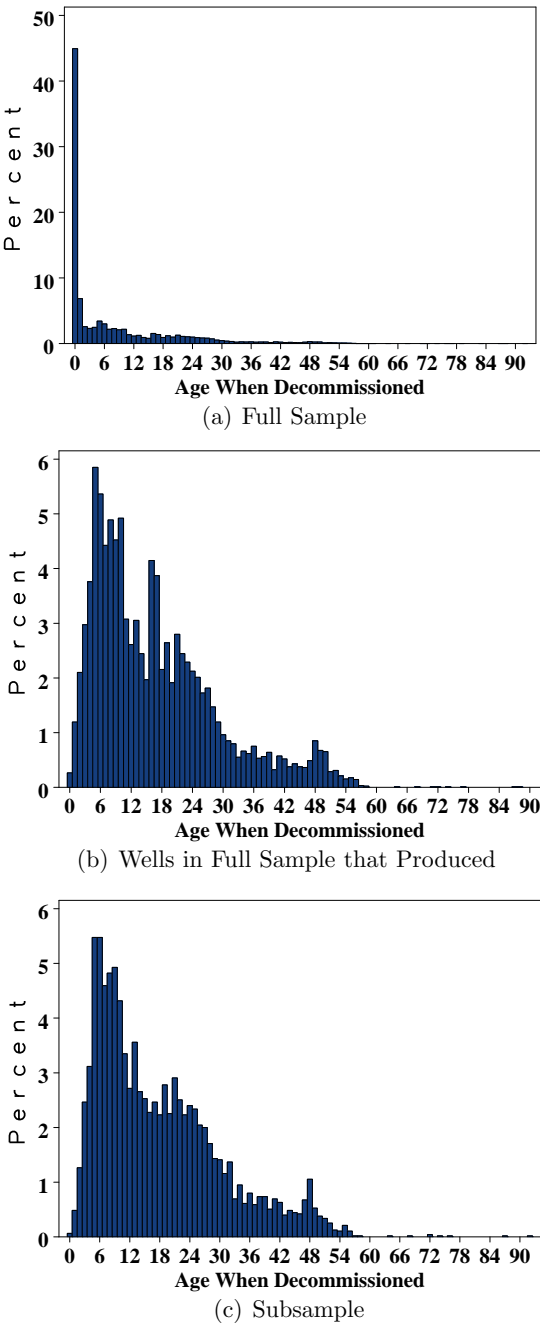


FIGURE A3

HISTOGRAM OF AGE WHEN DECOMMISSIONED

A.3. *Choice of Discount Factor.* The optimal discount factor varies by the different well groups, and no one discount factor would result in the highest likelihood for all groups separately. However, by summing the log likelihoods across the well groups by different fixed discount factors, a discount factor between 0.90 and 0.95 has the highest log likelihood.

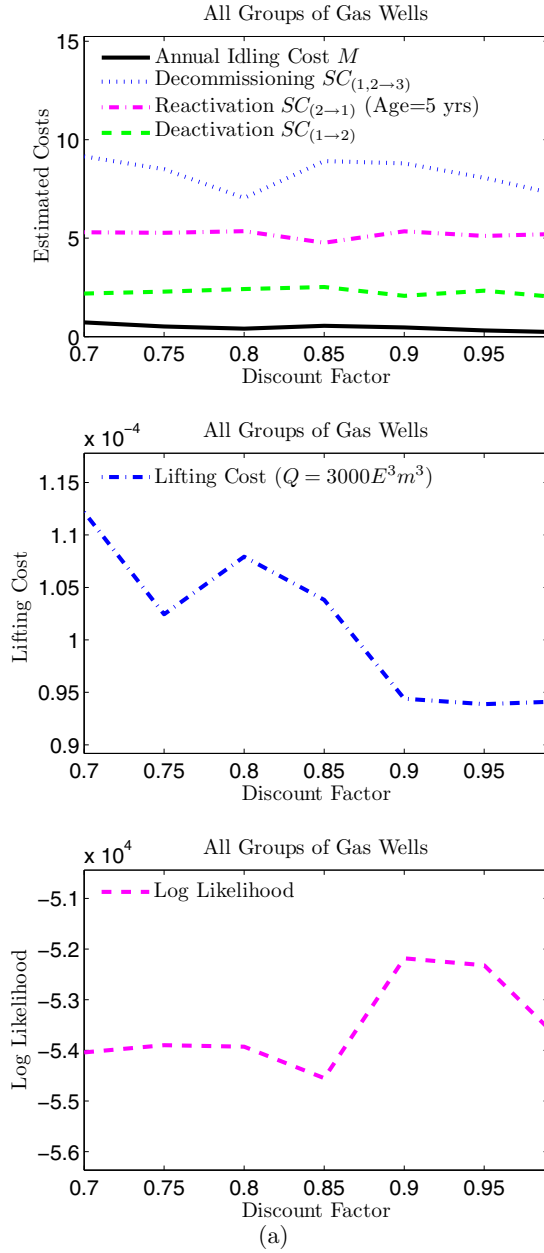
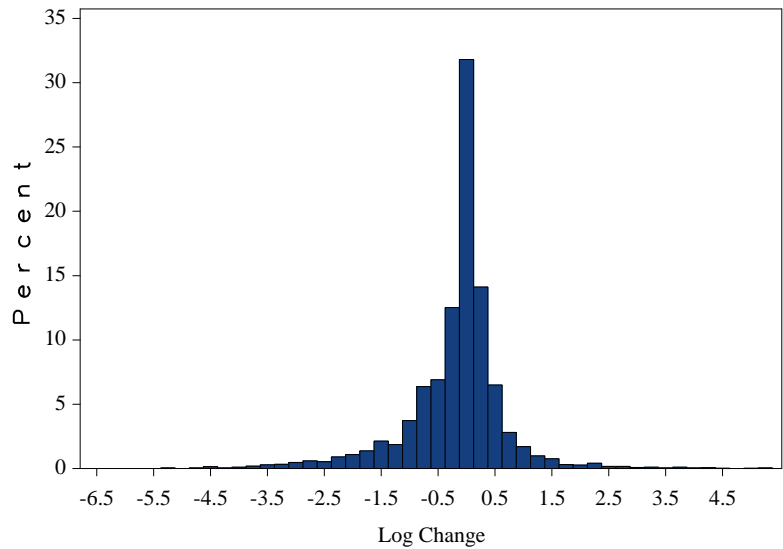


FIGURE A4

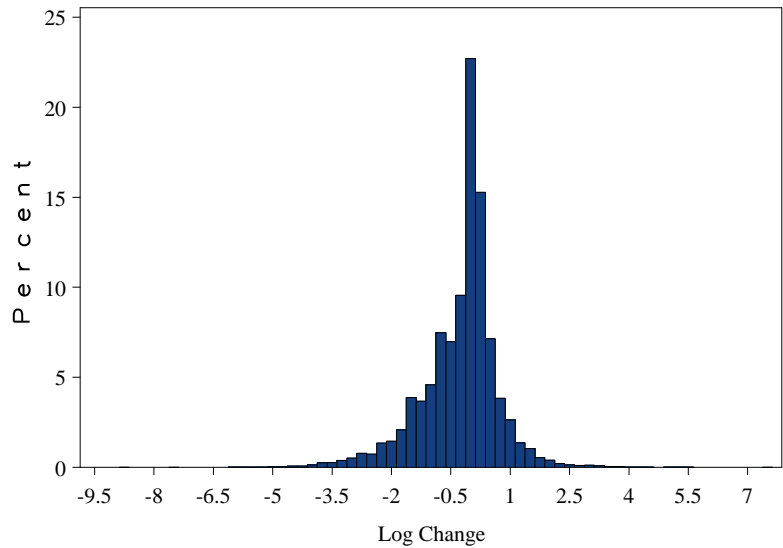
EFFECT OF USING DIFFERENT DISCOUNT FACTORS ON RESULTS FROM ALL GAS WELLS

Therefore, the estimation presented in this article uses a constant discount factor of 0.90 across all of the different well types. The summed log likelihoods by discount factor for all gas well groups are displayed in Figure A4. Also depicted are the average estimated costs across the well groups by discount factor. The reactivation costs are for inactive wells, five years of age, and the lifting costs are for wells with per-well reserves of 3 million m^3 .

A.4 *Modeling the Probability of Transition of Recoverable Reserves.* See Figure A5.



(a) $\log \left(\frac{\overline{Q}^{IER'}}{\overline{Q}^{IER}} \right)$ for Oil Pools



(b) $\log \left(\frac{\overline{Q}^{IER'}}{\overline{Q}^{IER}} \right)$ for Gas Pools

FIGURE A5

HISTOGRAMS OF THE NATURAL LOGARITHM OF ANNUAL CHANGE IN INITIAL ESTABLISHED RESERVES (NOT INCLUDING OCCURRENCES OF NO CHANGE)

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April 12, 2023

Natasha Ballif
Legislative and Policy Coordinator
Utah Division of Oil, Gas, and Mining
Via email to: natashaballif@utah.gov

Dear Ms. Ballif:

EDF appreciates the Division of Oil, Gas & Mining's continued stakeholder engagement with respect to proposed revisions to its Bonding rule, R649-3-1. We understand the Division is updating its Bonding rule, at least in part, in response to a Utah Auditor General Report that found the current bond amounts and structures to be inadequate and a financial risk to the state. *See* Report to the Utah Legislature, No. 2019-11, A Performance Audit of Utah's Oil and Gas Program, Chapter VII ("Audit"). The Auditor General recommended that the Division update its bond amounts and structures to reflect current industry and bond practices and better address financial risks. *Audit*, pp. 47, 49, 51.

We concur that the Division's current bonding amounts and structure are inadequate, particularly with respect to blanket bonding and financial assurance for idle or marginally producing wells. The Division's proposed revisions in drafts from August and December 2022 begin to address these issues, but do not solve them. To protect Utah taxpayers from the responsibility of cleaning up after under-bonded operators in the coming decades, the Division must ensure its blanket bond amounts and qualifications match the orphan well risks presented by long-idled wells and under-capitalized operators. With significant state and national attention on the problem of orphan wells, and with federal orphan well closure resources available for states that reduce future orphan well burden, now is the time for the Division to make significant progress toward the goal of all oil and gas wells being plugged in a timely fashion at the end of their useful lives, with only private resources.

We focus our comments on two distinct but related regulatory measures, each of which has been adopted in various forms in other oil and gas producing states, and we opine on the sufficiency of proposed blanket bond amounts.

First, blanket financial assurance should not be allowed, or should be highly restricted, for wells that have been shut-in or temporarily abandoned for longer than several months. Temporary abandonment is far too frequently a way station on the journey to becoming an orphan well that will be cleaned up with public funds. While there are legitimate reasons to shut-in or temporarily abandon a well for a short time, in the significant majority of cases idle wells are never put back on production. Instead, many molder for decades, threatening groundwater, surface water, public health, and the climate, until the operator either disappears or goes bankrupt, leaving the public on the hook for the improperly abandoned infrastructure. Because idle wells are at significantly increased risk of orphaning, it is appropriate to significantly limit their coverage by blanket bonds.

Second, to be eligible for blanket financial assurance an operator must be required to demonstrate that it has the long-term economic strength and stability to plug, abandon, and reclaim all its wells and well sites. Absent such a showing, blanket financial assurance resembles a high-risk, unsecured, interest-free loan that taxpayers will have to pay for if the operator defaults. We acknowledge and appreciate that proposed Rule 649-3-1.9.3.6 would require operators to qualify for blanket bonding based on the economic criteria in subpart 9.3.7. Our comments seek to ensure the Division's proposed qualifying criteria will effectively identify high-risk operators, and to stress that all *existing* blanket bond operators should be required to qualify under the new criteria or provide individual well bonds as quickly as practicable.

We encourage the Division to adopt a blanket financial assurance structure and amounts that account for an operator's orphan well risks. Our detailed comments below include examples from other states that have restricted blanket bonding for idle wells, based on an operator's economic strength, or both.

1. The Division should require full-cost, single well financial assurance for all wells that have not been produced for more than several months.

Properly bonding idle wells based on risk plays a key role in limiting the transfer of orphan well liability from operators to the public. According to one analysis of 84,000 conventional oil and gas wells, less than 4% of inactive wells are ever plugged, abandoned, and reclaimed. *See A Dynamic Model of Cleanup: Estimating Sunk Costs in Oil and Gas Production*, Muehlenbachs, Int'l Econ. Rev. Vol. 56, No. 1, p. 162, Table 2,

February 2015 (attached to these comments as appendix #1). The Muehlenbachs' analysis provides compelling evidence that temporary closure largely implies permanent closure. It is rarely economical to return inactive wells to production. The modelled results in Table 5 of the Muehlenbachs' report show that even under ideal operating conditions, such as higher prices and higher recovery rates, the fraction of inactive oil and gas wells that return to production is at most 12% higher compared to the baseline analysis. The main benefits from ideal operating conditions are higher production rates from currently active wells, and not a return of idle wells to service. Muehlenbachs, pp 162, 177. The proportion of inactive wells that remain inactive is greater than 80% for inactive wells less than 10 years old. *Id.* at p. 162. For all wells more than 10 years old, this fraction is over 90%. *Id.*

Because non-producing wells are obviously not generating revenue that can be used to finance plugging operations, by their very nature, idle wells are less likely to have associated revenue to cover closure costs. Since it cannot be assumed that these wells will be returned to service, it is incumbent on the regulator to apply increased bonding requirements on such wells to compensate for increased risk of orphaning.

The Division's proposed Rule 649-3-1.6 states that a well that has had operations suspended (OPS), shut-in (SI), or temporarily abandoned (TA) for greater than one year *from the date the new regulation goes into effect* "does not qualify to be on a statewide blanket bond and will require an individual bond." (Emphasis added. We refer to OPS, SI, and TA wells collectively as "idle wells.") Additionally, proposed Rule 649-3-1.9.3.2 states, "wells that have been shut-in over a year shall be bonded individually per Subsection 6." We applaud the Division's intent to exclude long-term idled wells from blanket bonding, which we believe is essential to reducing financial risks to Utah taxpayers. However, we are concerned that, as currently written, wells that already have been idled for years could be added to or remain on an existing blanket bond. Moreover, under proposed Subpart 6.1 an idle well could be placed on a blanket bond by producing *any amount* of oil or gas for three consecutive months. This threshold is far too low, and invites gaming of the system where operators produce a de minimis amount of hydrocarbons in order to avoid plugging obligation or enhanced risk-based bonding. The Division should require a minimum monthly volume of oil or gas production for at least three consecutive months. For example, Texas requires a well to produce not less than 5 barrels of oil or 50 mcf of gas per month consecutively for three months (or one barrel of oil or one mcf of gas per month for 12 months) to be considered in active operation (16 Tex. Admin. Code § 3.15(a)(1)).

These potential gaps in the individual bonding requirement for idle wells threaten to impede the Division's aspiration to reduce the State's future orphan well liability. We recommend the following changes to shore-up Subparts 6, 6.1, and 9.3:

6. A well that has had operations suspended (OPS), shut-in (SI) or temporarily abandoned (TA) for greater than one year ~~from on or after~~ [the date the regulation goes into effect], including an inactive well approved by the Division pursuant to Rule 649-3-36, does not qualify to be on a statewide blanket bond and will require an individual bond.

6.1. A well that is OPS, SI or TA must produce not less than 5 barrels of oil or 50 mcf of gas per month consecutively for three months, or not less than one barrel or oil or one mcf of gas per month consecutively for twelve months, before the well can be placed back onto a blanket bond.

9.3 The operator may bond wells on lands with state or privately owned minerals with an accepted blanket bond approved by the division and shall include:

9.3.2. wells that have been shut-in, had operations suspended, or temporarily abandoned for less than one year;

9.3.2.1 Wells that have been shut-in, had operations suspended, or temporarily abandoned over a year, including wells approved by the Division pursuant to Rule 649-3-36, shall be bonded individually per Subsection 6.

We interpret Subparts 649-3-1.6 and 9.3.2.1 to apply to a well approved by the Division to remain shut-in or temporarily abandoned for more than 12 months under Rule 649-3-36 and recommend that the rules state this expressly. If the Division intends otherwise, we urge the Division to impose annual fees that increase incrementally for as long as such wells remain idle. California uses this strategy on each well that has *been idle at any time* in the prior calendar year. The annual fees increase from \$150 to \$1,500 depending on how long the well has been idle.¹ Ohio also imposes an idle well fee that increases from \$100 in year 1, to \$250 in year 2, and \$500 / year thereafter. Ohio Rev. Code § 1509.062. Louisiana imposes a \$250 / year fee on idle wells, and is proposing to increase that to \$500 / year in some cases. LA Admin. Code 43:XIX § 137 and Louisiana Register, Vol. 49, No. 2, p. 428, February 20, 2023. As the Muehlenbachs' study demonstrates, it is quite rare for operators to either decommission such wells or return

¹ Available here: https://www.conservation.ca.gov/calgem/idle_well/Pages/idle-well-operators.aspx

them to production. Such a fee would both incentivize operators to plug their end-of-life wells and would provide funding to Utah to cover orphan wells that slip through the cracks.

We support the Division's intention to require individual bonds for idle wells, subject to the foregoing proposed revisions. In doing so, Utah will join several other states that prohibit or restrict blanket bonding for idle wells. Examples include:

In North Dakota, no more than six wells, in total, that are temporarily abandoned for more than seven years, not properly plugged, or not properly reclaimed can be covered by blanket financial assurance. N.D. Admin. Code 43-02-03-15.2.

Arkansas requires that wells receiving temporary abandonment status provide single well bonds in the amounts of \$35,000 for dry natural gas production wells or \$15,000 for liquid hydrocarbon production wells, and requires such bonds remain valid until the well is put back into sustained production, plugged or transferred. *See* AOGC Rule B-7(h)(3)(a). (Under the Division's Rule 649-3-1. 9.1, an individual well bond could be depth bonding or full cost bonding. We note that the 2017 Audit states the total cost to plug eight abandoned wells was \$505,000, or \$63,125 per well on average. Audit, p. 49. Thus, Utah's full cost individual well bonds likely would be higher than what Arkansas requires).

Colorado limits blanket bonds to operators whose average daily production per well, including idle wells, exceeds 15 barrels of oil equivalent or 22 MCF of natural gas equivalent over the preceding 12 months; all other operators must provide single well financial assurance for all wells. *See* 2 CCR 404-1 Rules 702.d.(1)-(4). For the operators that can use blanket bonds, the number of inactive wells that can be covered is still limited to 5% or 10% of the operator's total well count. *See id.*, Rules 702.d.(1)B.ii, 702.d.(2)B.ii.

As the Audit points out, New Mexico and Wyoming also impose substantially higher bond amounts for inactive wells, due to the increased risk of abandonment. Audit, pp. 50-51. In New Mexico, the blanket bond amount for more than 25 inactive wells is \$1,000,000 compared to a cap of \$100,000 for active wells. NMAC 19.15.8.9(C)-(D). In Wyoming, an inactive well may be subject to an increased bond amount of up to \$10 per foot, and the bond amounts are adjusted every three years based on the consumer price index or actual plugging costs. 055-3 Wyo. Code R. § 3-4.

The examples above demonstrate that the Division's proposal to require individual well bonds for inactive wells is akin to existing requirements in several other oil and gas producing states. The Division should bolster its proposed rules as we have suggested

to minimize the likelihood that Utah taxpayers will need to pick up the tab for future orphaned wells because an under-bonded operator abdicated its decommissioning obligations.

2. Blanket financial assurance should only be available to financially robust operators.

We understand that proposed Rules 649-3-1.9.3.6 and 9.3.9 would limit new blanket bonding to operators who meet the financial criteria set forth in Subpart 9.3.7. and who are approved by the Division. We strongly endorse the Division's intent to restrict blanket bonding to operators who have a minimum threshold of financial strength and stability. While we endorse the Division's use of the three financial ratios (9.3.7.1, 9.3.7.2, and 9.3.7.3) and agree that these metrics are a reasonable measure of both current and long-term financial health, we recommend adjusting the debt-to-equity ratio (9.3.7.2) to less than 2.5. The suggested ratio of 2.5 indicates a company's liabilities can be up to 250% of what their stockholders have put in equity which is significantly higher than our analysis of what financially healthy publicly traded companies operating in Utah have reported in recent years. For example, Conoco Philips and its peer companies report D/E in the range of 40-50% from 2015-2019 (see Appendix 2). We highly recommend the Division lower the debt-to-equity ratio to at the very least less than 2 and preferably in the range of 0.4 – 0.8 to be more in line with the financially healthy companies operating in the region. To improve our understanding of how Rule 9.3.7 might work in practice, we evaluated a subset of Utah operators based on the pertinent economic criteria (Appendix #3). An immediate observation of the companies we explored is the high percentage of private companies. We assume that the Division requires private companies to disclose their audited financial ratios. If this is not already explicitly included in the Division's regulations, we strongly recommend it be added. Of the small subset of 5 publicly traded companies in our analysis, two companies reported ratios that meet the Division's ratio limits and also report debt-to-equity ratios of less than 50%. In summary we endorse the use of the three ratios, with the caveat of lowering the debt-to-equity ratio to be in the range of 0.4- 0.8 and ensuring the Division has access to private companies audited financial ratios. We also suggest the Division consider using a credit rating as part of the approval process to provide a more holistic assessment of the companies' status and associated risk.

We applaud the Division's intent to limit blanket bonding to operators with strong economic fundamentals and a low risk of shirking their legal obligation to timely plug, decommission, and reclaim their wells and well sites at the end of their useful lives. As noted above, Colorado limits use of blanket bonds to operators based on the average

daily production of their well portfolio, which the Commission determined was a fair proxy for an operator's economic strength. *See* 2 CCR 404-1, 700 Series Rules. Like Utah, Colorado is seeking to ensure that operators with a higher risk of orphaning wells provide individual well bonds rather than blanket financial assurance to reduce the risks taxpayers will foot industry's cleanup bill.

3. Are the Division's proposed blanket bond amounts sufficient?

We believe the Division's highest priorities should be those we have discussed above: to effectively preclude under-capitalized operators from using blanket financial assurance entirely; and to require individual well bonds for wells that have been shut-in or temporarily abandoned for more than several months, without exception. If those regulatory controls are in place and implemented efficiently and enforced diligently, the wells with the highest likelihood of being orphaned will all be covered by individual bonds rather than blanket bonds. It will also be important for the Division to rigorously update existing blanket bonds pursuant to Subparts 3.1 and 9.6.1. Similarly, the Division must keep a watchful eye on the financial stability of the operators that have blanket financial assurance to ensure they remain compliant with Subpart 9.3.7. These measures should reduce the financial risks that alarmed the Auditor General and would lead us to support the blanket bond amounts as they currently are proposed.

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Thanks again for the opportunity to comment on this important rulemaking, and we look forward to working with the Division to solve the problem of orphan wells going forward.

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