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Strong Public Reaction to Stringent OCS Bonding and Financial Assurance Requirements Proposed by Bureau of Ocean Energy Management

Client Alert | September 14, 2023

On June 29th, 2023, the Department of the Interior ("DOI"), acting through the Bureau of Ocean Energy Management ("BOEM"), published a proposed rule that would modify the criteria it uses to determine financial assurance and bond requirements for the offshore oil and gas industry in the Outer Continental Shelf ("OCS").[1] This proposed rule modifies and does away with a proposed joint rulemaking with the Bureau of Safety and Environmental Enforcement ("BSEE") from October 16, 2020 which also sought to update BOEM's financial assurance criteria, along with other BSEE-administered regulations (further described in Section II below). This latest iteration is intended by BOEM to be more protective of taxpayers by ensuring that OCS lessees have sufficient resources to meet their lease and regulatory obligations.

The publication of the proposed rule triggered a 60-day comment period during which BOEM sought comments from the public and offshore oil and gas industry (further described in Section IV below). The comment period closed on September 7, 2023, and BOEM will now review and analyze all comments that were submitted during the comment period and may choose to modify the proposed rule, issue a final rule to be effective no sooner than 30 days after publication in the Federal Register, withdraw the proposal, or re-open the comment period. This alert will discuss (a) the history and current state of BOEM's financial assurance regulations and the proposed changes thereto, (b) potential industry impacts as a result of the proposed changes, and (c) a general overview of the significant comments received by BOEM during the comment period.

History of Financial Assurance Rules and Proposed Changes

BOEM's current regulations contemplate two forms of financial assurance to ensure that a grant holder or lessee can fulfill its regulatory and contractual obligations, including decommissioning liabilities: (a) base bonds in amounts prescribed by the regulations and (b) supplemental financial assurance, determined on the basis of a five-factor test. The posting of base bonds and any additional financial assurance is intended to cover the costs of clean-up and the decommissioning of offshore wells and infrastructure once they are no longer in use and to ensure that the federal government does not have to perform such activities, with taxpayers footing the bill.[2]

BOEM requires all lessees of an OCS oil and gas or sulfur lease to post base bonds at the time of (a) issuance of a new lease or (b) assignment of an existing lease. Base bonds can range from $50,000 for a lease-specific bond with no approved operational activity up to $3,000,000 for an area-wide bond that includes a development production plan.[3]

BOEM's Regional Director may determine that additional security above the base bond is necessary. This additional security is often referred to as supplemental financial assurance

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and is determined based on the Regional Director's evaluation of a lessee or grant holder's ability to carry out present and future financial obligations demonstrated by a five-factor test. The five factors that the Regional Director will consider are (a) financial capacity, (b) projected financial strength (initial proposals that were done away with would have considered net worth in determining financial strength), (c) business stability, (d) record of compliance with current regulations, laws, and lease terms, and (e) reliability in meeting credit rating obligations. The Regional Director will determine the amount of supplemental financial assurance required to guarantee compliance, considering potential underpayment of royalty and cumulative decommissioning obligations.[4]

In October of 2020, BOEM and BSEE issued a joint-proposed rule with the intention of revising BOEM's financial assurance regulations and BSEE's decommissioning orders. This joint-proposed rule would have modified BOEM's financial assurance requirements such that BOEM would consider a lessee's credit rating from certain recognized rating agencies and proved reserves to determine whether supplemental financial assurance would be required. BOEM proposed an S&P Global Ratings ("S&P") credit rating threshold of BB or a Ba3 from Moody's Investor Service ("Moody's"). Under the proposed framework, BOEM would waive supplemental financial assurance requirements of lessees in the event their predecessors had strong credit ratings. Ultimately, however, in response to comments received by BOEM and BSEE, they decided not to proceed with the joint-proposed rule.[5]

BOEM's 2023 iteration of the proposed rule would update its criteria for determining whether oil, gas, and sulfur lessees, Rights-of-Use Easement grant holders, and Right-of-Way grant holders may be required to provide supplemental financial assurance. The change is intended to better protect taxpayers from bearing the cost of facility decommissioning and financial risks associated with OCS development, such as oil spill cleanup and other environmental remediation by switching to a metric more predictive of financial stress and bankruptcy (as discussed below), thus allowing BOEM to ensure vulnerable lessees and grant holders are providing adequate security for their decommissioning obligations and protecting the federal government, and, in-turn, the taxpayer from having to absorb said obligations in the event of default. In its latest form, the proposed rule does away with the five-factor test and, similar to the 2020 proposal, instead considers an OCS lessee's (a) credit rating and (b) proved oil reserves in determining whether a grant holder or lessee in the OCS is required to obtain supplemental financial assurance.

Based on its credit rating and the valuation of its proved oil reserves, an OCS lessee would not be required by BOEM to provide supplemental financial assurance in any of the following cases: (a) if the lessee has an investment grade credit rating (greater than or equal to either BBB- from S&P or Baa3 from Moody's),[6] (b) if there are multiple co-lessees on a lease, if any one lessee meets the credit rating threshold, or (c) for leases where all lessees are below investment grade, if the value of the lease's proved oil and gas reserves is three times the decommissioning cost estimate for such lease. The shift from relying primarily on the net worth of a lessee to its credit rating to determine whether supplemental financial assurance is needed is based on studies that suggest a strong correlation between credit rating and the probability of default due to credit ratings being based on cash flow, debt-to-earnings ratios, debt-to-funds ratios, and past performance, amongst other financial metrics.[7] The ability of an entity's credit rating to predict financial distress and, in turn, an inability to absorb future decommissioning liabilities better than its net worth will allow BOEM to ensure those lessees and grant holders that are most vulnerable to defaulting will have provided sufficient security to cover their liabilities in the form of supplemental financial assurance.

Further, under the proposed rules, BOEM will no longer set a lower supplemental financial assurance requirement for lessees with financially strong predecessor lessees, as was proposed by BOEM and BSEE in their 2020 joint-proposed rule. While BOEM will retain the authority to pursue predecessor lessees for the performance of decommissioning, the proposed rule would not allow BOEM to rely upon the financial strength of predecessor

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lessees when determining whether, or how much, supplemental financial assurance should be provided by current OCS leaseholders, thus ensuring that current lessees have the financial capability to fulfill decommissioning obligations and discouraging lessees from ignoring end-of-life decommissioning costs, further reducing the likelihood that such obligations would fall upon the federal government and taxpayers in the event of default.

In order to value the proved oil and gas reserves, the proposed rules require lessees to submit a reserve report that complies with the SEC's accounting and reporting standards valuing the oil and gas reserves located on a given lease. Leases for which the value of the reserves exceeds three times the cost of the associated decommissioning estimate (using BSEE's P70 decommissioning level, which provides a 70% likelihood of covering the full cost of decommissioning) would not be required to obtain supplemental financial assurance. Under the proposal, the P70 value would be used to set the amount of any required supplemental financial assurance.

In order to ease the significant financial burden on impacted lessees and grant holders, BOEM proposes to phase in its new bonding requirements over a three-year period, whereby a lessee receiving a supplemental financial assurance demand will be required to post 33% of the total financial assurance amount by the deadline listed in the demand and a second 33% of the total financial assurance amount by the end of the second year after receipt of the demand letter, with the final 33% of the total assurance amount due within 36 months after receipt of the demand letter. If a lessee's credit rating improves to investment grade during the three-year period, BOEM will no longer collect the remaining financial assurance and will return any supplemental financial assurance previously provided.

Industry Impacts

BOEM's proposed rule changes will be at the front of OCS lessees' minds for the next few years. Investment grade companies will have new opportunities because they will be more attractive as lease partners. Meanwhile, sub-investment grade companies, particularly "small businesses" (which have less than 1,250 to 1,500 employees),[8] will have to figure out how to navigate the costs and challenges of complying with these new changes.

The most obvious impact will be the new premiums for the supplemental financial assurance that lessees will have to acquire in order to comply with the rule, which is expected to cost sub-investment grade companies an additional $319 million per year (assuming 7% discounting).[9] The costs of these new premiums will fall disproportionately on the 76% of OCS lessees that are small businesses which, without the support from an investment grade co-lessee, may have difficulty satisfying either prong of the revised financial assurance rule. The average investment grade company has a net worth of approximately $115 billion,[10] which is a hurdle that most small businesses are unlikely to meet. Small businesses also tend to focus on late-stage wind down of assets to extract value from marginal wells and will have a harder time meeting the 3x ratio of reserve value to decommissioning liability than larger entities that are drilling new reserves.[11] Relying on the ratio of reserve value to decommissioning liability likely may not be a long-term solution because (a) the lessee would be actively producing the asset (and lowering the ratio) and (b) in the event of a downturn in oil prices, the reserve value could get marked down and the lessee would be forced to secure a bond in a time of relative economic distress.

For some small businesses, these rules may change the calculus on whether to seek an investment grade partner for any current or future offshore projects. The current method of determining whether a lessee needed to provide additional financial security relied on a mix of objective and non-objective measures (see the five-factor test described in Section II above) that afforded small businesses the opportunity to avoid the need to post additional bonds by showing a history of sound operatorship and regulatory compliance without looking exclusively to hard financial metrics or a rating from a credit agency. The

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proposed rule may eliminate this opportunity. Seeking an investment grade partner may be a more attractive alternative than paying for additional bonding, securing an adequate credit rating, or relying on the ratio of reserves to decommissioning liabilities.

BOEM assesses that, based on P70 levels, there is approximately $42.8 billion of offshore decommissioning liability, $20.2 billion of which is held by sub-investment grade companies.[12] The revised bonding requirements would result in a $9.2 billion increase in the amount of bonds to cover that liability (on top of the approximately $3.0 billion that is currently in place).[13] BOEM cited the need to protect taxpayers from potential decommissioning liability as a justification for revising the rule and pointed to the more than 30 lessee bankruptcies since 2009, which resulted in $7.5 billion of un-bonded decommissioning liabilities. The ultimate risk to the taxpayer was not near that figure (BSEE requested a mere $30 million in its FY2023 budget to address unbonded liabilities).[14] In the vast majority of cases, the decommissioning costs were covered by either co-lessees or predecessors or acquired by entities who purchased the related assets out of bankruptcy. Ultimately, the biggest winner of these changes may be predecessors to the leases who sought a “clean exit” and may now have greater barriers between outstanding decommissioning liabilities and their balance sheets.

Significant Comments/Overview of Comments

During the comment period, BOEM sought comments on, amongst other things, (a) the wisdom in setting the supplemental financial assurance requirements based on each of the P50, P70, and P90 decommissioning liability levels, (b) the appropriateness of relying on S&P’s Credit Analytics credit model, or other similar, widely accepted credit rating models to generate proxy credit ratings and the appropriateness of relying on lessee and grant holder credit ratings, including whether BOEM has proposed an appropriate credit rating threshold of BBB-, and if not, what threshold would best protect taxpayer interests while balancing burdens on the industry, (c) whether financial assurance should be required of all companies, regardless of credit rating, and the impacts such a requirement might have on OCS investment and on potential taxpayer liabilities, (d) whether the elimination of the current five-factor test would create a disincentive to comply with regulations, (e) whether the use of a minimum number of years of production remaining is an appropriate criteria to qualify for an exemption from supplemental financial assurance as an alternative to the 3:1 ratio of value of reserves to decommissioning costs, and (f) the costs and benefits of considering the financial capacity of predecessor lessees or grantees in determining the level of supplemental financial assurance required.

BOEM received close to 1,200 comments during the public comment period which closed on September 7 after the initial August 28 deadline was extended. The comments received were generally opposed to the proposed rule, questioning the validity of BOEM’s claims and highlighting the lack of supporting evidence provided by BOEM. The submitted public comments generally claimed that BOEM (a) did not adequately account for adverse economic consequences, (b) conducted an inadequate cost-benefit analysis, and (c) overstated the current impact to taxpayers, and the claimed benefits to the taxpayer, of the proposed rule. The public comments further claimed that the proposed rule will disproportionately burden smaller businesses, and will “create more emissions harm than benefit by making it more expensive to explore in the Gulf of Mexico, resulting in more demand for higher carbon intensity oil from global sources.”[15]

One comment of note cited a study which independently calculated OCS plugging and abandonment liability, assessed the risk it presents to the U.S. taxpayer, and performed a cost-benefit analysis of the proposed rule’s economic impact on the offshore oil and gas industry, the Gulf Coast, and the United States. According to the study, additional bonding requirements will spur bankruptcies as surety markets have threatened to exit the offshore sector, reducing available bonding capacity and driving up costs, which will in turn guarantee that small independent lessees will not be able to obtain the required supplemental bonding. Further, the study claims that additional bonding will reduce offshore drilling and related production to the tune of approximately 55 million barrels of oil

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equivalent over a 10-year period, reducing associated U.S. royalty revenues by approximately $573 million over the 10-year period. Moreover, according to the study, additional bonding requirements will cause reduced revenues and operations for companies serving the OCS, resulting in a loss of jobs and tax revenues along the Gulf Coast, with the study estimating the impact of the additional bonding requirements on the U.S. Gross Domestic Product to be a reduction of approximately $9.9 billion over a 10-year period.[16]

Conclusion

BOEM's proposed rule is intended to safeguard U.S. taxpayers by strengthening bonding and financial assurance requirements for the offshore oil and gas industry in the OCS; however, as seen in the volume and content of public comments BOEM has received, those in the industry are skeptical and fear that it may do more harm than good. How BOEM proceeds from here bears close scrutiny.

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[1] Risk Management and Financial Assurance for OCS Lease and Grant Obligations, 88 Fed. Reg. 42136-42176 (June 29, 2023).

[2] *Id*.

[3] 30 CFR 556.900.

[4] 30 CFR 556.901.

[5] BSEE instead issued a stand-alone final rule (88 Fed. Reg. 23569) effective as of May 18, 2023, which (a) included Rights-of-Use and Easements ("RUEs") and RUE grant holders in the agency's decommissioning regulations for the first time, and (b) formalized BSEE's procedures for enforcement of decommissioning orders issued to predecessors when a subsequent assignee defaults on its obligations. RUE grants are authorizations from BOEM to use a portion of the seabed not encompassed by the holder's lease to construct, modify, or maintain platforms, artificial islands, facilities, installations, and other devices that support exploration, development, or production from another lease. Pursuant to the BSEE rule, RUE holders and prior lessees or owners of operating rights are jointly and severally liable for meeting accrued decommissioning obligations for infrastructure installed subject to a lease and maintained after lease expiration under a RUE. Further, when BSEE issues a decommissioning order to predecessors, it requires them to monitor, maintain, and decommission all wells, pipelines, and facilities by (a) initiating maintenance and monitoring within 30 days of receipt, (b) designating an operator or agent for decommissioning activities within 90 days, and (c) submitting a decommissioning plan to BSEE within 150 days. BSEE did not promulgate previous proposals (x) requiring parties appealing decommissioning orders to file an appeal bond or (y) requiring the proceeding up the chain of title in "reverse chronological order" against predecessor lessees, grant holders, and owners of operating rights when subsequent assignees fail to perform.

[6] For entities not rated by a major credit rating agency, BOEM proposes using an "equivalent proxy credit rating." Such entities would be required to submit audited financial statements, which BOEM would use to determine its equivalent proxy credit rating using a commercially available credit model. (88 Fed. Reg. 42143).

[7] 88 Fed. Reg. 42136-42176 (June 29, 2023).

[8] See *Id*. (BOEM is required to analyze the impact of its regulations on "small" entities pursuant to the Regulatory Flexibility Act, 5 U.S.C. 601–12. The Small Business Administration (SBA) defines a small entity as one that is "independently owned and operated and which is not dominant in its field of operation." What constitutes a "small business" varies by industry, but in the context of offshore hydrocarbon development, the

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SBA defines a small business as one with fewer than (i) 1,250 employees for upstream companies and (ii) 1,500 employees for midstream companies.)

[9] *Id*.

[10] *Id*.

[11] See *Id*.

[12] *Id*.

[13] *Id*.; BOEM Collateral List Report.

[14] *Id*.

[15] For comments, please see: https://www.regulations.gov/document/BOEM-2023-0027-0001/comment.

[16] https://opportune.com/insights/news/a-cost-benefit-analysis-of-increased-ocs-bonding-july-2023.

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