Summary of Major Provisions in Final Rule - Risk Management and Financial Assurance for OCS Lease and Grant Obligations (Smith, April 21, 2024)

Purpose of the Rules

- This rule finalizes amendments to the existing provisions to better protect the taxpayer from bearing the cost of facility decommissioning and other financial risks associated with OCS development, such as environmental remediation.
- The final rule also provides regulatory clarity to OCS lessees regarding their financial obligations by codifying requirements in the Code of Federal Regulations (CFR)
- Since 2009, more than 30 corporate bankruptcies have occurred involving offshore oil and gas lessees that did not have sufficient financial assurance to cover their decommissioning liabilities.
- This final rule pertains only to the financial assurance requirements for oil and gas or sulfur leases under part 556, RUE grants and ROW grants under part 550, and appeals of supplemental financial assurance demands under part 590.

Summary of Major Provisions

1. Streamlines the criteria used for evaluating the financial health of lessees and grantees.
2. Codifies the use of the BSEE probabilistic estimates of decommissioning cost for determining the amount of supplemental financial assurance required.
3. Removes restrictive provisions for third-party guarantees and decommissioning accounts.
4. Adds new criteria under which a bond or third-party guarantee that was provided as financial assurance may be canceled.
5. Clarifies financial assurance requirements for RUEs serving Federal leases.

Supplemental Financial Insurance Criteria

- Lessees will not be required to provide supplemental financial assurance if they meet one of these two criteria:
    1. an investment grade credit rating threshold (BBB-) or a proxy credit rating equivalent determined by BOEM.
    2. a minimum 3-to-1 ratio of the value of proved reserves to decommissioning liability associated with those reserves.
- These proposed criteria better align BOEM's evaluation process with accepted financial risk evaluation methods used by the banking and finance industry.
- Having to meet only one of the two criteria will likely result in very few lessees having to provide supplemental financial insurance. This includes Sable who has purchased the SYU Unit and onshore facilities from XOM.

- The rating of BBB- from Standard & Poor's and Baa3 from Moody's represents the lowest possible ratings for a security considered investment grade. These securities are one downgrade away from being below investment grade.
- Since BOEM began proposing updates to its financial assurance regulations in 2009, 37 offshore oil and gas operators have filed for bankruptcy, some of which had sole liability or unbonded decommissioning liabilities (source GAO January 2024 Report - Interior Needs to Improve Decommissioning Enforcement and Mitigate Related Risks). This calls into question why a higher credit rating (BBB or BBB+) was not required.
- Using reserves as a criterion presents problems due to the volatility of oil and gas prices and does not take into consideration environmental and political constraints; this has been clearly shown offshore California where large reserves are located on leases that cannot be developed.
- Using reserves as a criterion also provides opportunities for companies (e.g., Signal) to hire unscrupulous consultants to develop bogus reserve estimates determined by BOEM resulting in protracted negotiations, followed by multiple appeals which history has shown can take 5 or more years to wind its way through the IBLA.

Credit Rating Threshold

- BOEM will not require supplemental financial assurance for properties where at least one co-lessee meets the credit rating threshold BBB-.
- BOEM believes that 1-year default rates are an appropriate measure of risk, given BOEM's policy of reviewing the financial status of lessees, ROW holders, and RUE holders at least on an annual basis.
- The average S&P 1-year default rate for BBB- rated companies from 1981 to 2020 was 0.24 percent. Is this the default rate for oil and gas companies or all companies?
- Raising the threshold criteria would only reduce the rate to 0.12 percent for a credit rating.
- Comparatively, the average 1-year default rate for BB- rated companies was 1.21 percent, for B- rated companies, 8.73 percent, and for C rated companies, 24.92. percent.
- The final rule applies a similar credit rating requirement to potential guarantors, although guarantors would not be able to leverage the value of associated leases "because that value is a characteristic of the lease belonging to the guaranteed lessee and not an asset belonging to the guarantor."

Proxy Credit Ratings

- If an entity does not have an issuer credit rating, the new rules allow companies to request the Regional Director to determine a proxy credit rating based on audited financial information for the most recent fiscal year, including an income statement, a balance sheet, a statement of cash flows, and the auditor's certificate.
- The vast majority of companies operating on the OCS are private companies that do not have an issuer credit rating; therefore, without an option for a proxy credit rating, these

companies would be required to provide supplemental financial assurance unless they met the reserves criterion.

- BOEM proposes to use S&P Global's Credit Analytics credit model to calculate proxy credit ratings, or a different model if it determines that a different model more accurately reflects those factors relevant to the financial evaluation of companies operating on the OCS.
- The rules require a company requesting a proxy credit rating to provide information on its ownership of other OCS facilities and leases (contingent liabilities).
- This new provision authorizes BOEM to take the contingent liabilities associated with the company's coownership of these assets into consideration in determining the appropriate proxy credit rating.

Oil and Gas Reserve Estimates

- Under the new rules the lessee is required to submit a reserve report for the proved oil and gas reserves (as defined by the SEC regulations at 17 CFR 210.4–10(a)(22)) located on a given lease.
- The reserve report provided to BOEM would contain the projected future production quantities of proved oil and gas reserves on a per lease basis, the production cost for those reserves also on a per lease basis, and the discounted future cash flows from production.
- The reserve report would also provide the value of the proved oil and gas reserves per lease, determined under the accounting and reporting standards set forth in SEC Regulation.
- BOEM would use this proved oil and gas reserves per-lease value when determining whether the value of the reserves on any given lease exceeds three times the cost of the P70 decommissioning estimate associated with the production of those reserves.
- BOEM believes that a property with a sufficient ‘‘reserves-to-decommissioning cost’’ ratio would likely be purchased by another company if a current lessee defaults on its obligations, thereby reducing the risk that decommissioning costs would be borne by the government, and consequently reducing the need for supplemental financial assurance.
- A reserves-to-decommissioning cost ratio of one-to-one would mean that the estimated value of remaining oil and gas reserves on a lease is equal to the cost of decommissioning.
- A reserves-to-decommissioning cost ratio below three-to-one might be considered adequate to encourage a new lessee to take on the cost of purchasing the lease and assuming liability for all the existing decommissioning obligations.
- Bankruptcy data show that the most valuable properties of the bankrupt company (with at least a 3-to-1 ratio of the value of reserves to decommissioning costs) are acquired by another entity.

Determination of Decommissioning Costs Using Probabilistic Estimates

- BSEE probabilistic estimates of decommissioning costs will be used to determine the amount of supplemental financial assurance required.
- The estimates will be based on industry decommissioning costs that have been reported to BSEE in accordance with requirements specified in an NTL issued by BSEE.
- BSEE will determine costs based on a P70 probabilistic estimate (70 percent likelihood of covering the full cost of decommissioning a facility).
- If probabilistic estimates are not available, BOEM will use the available deterministic values.
- BOEM noted the use of the P70 value does not reflect the total cost of corrective action that may be required to bring a lease or grant into compliance.
- The rule provides no information on what corrective actions involve or the cost of corrective actions.
- BOEM considered bonding at P90, but determined P90 would result in an approximately 40 percent chance of being over bonded.
- BOEM's analysis concluded that the increased cost to lessees resulting from adopting P90 rather than P70 in a high interest rate environment would be too high when compared to the additional risk reduction.
- To date, BSEE has collected about 2,050 data points for wells, 1,235 for facilities (including removal and site clearance and verification), and 1,020 for pipelines.
- This actual expenditure data collected shows a wide range of costs for similarly situated infrastructure, making a probabilistic approach preferred over a single deterministic estimate.
- For lessees or grant-holders that can demonstrate decommissioning costs below BSEE's estimates, the Department has included in the final rule a provision in 30 CFR 556.901(g) allowing for the submission of decommissioning cost data for consideration by the Regional Director in potentially reducing the supplemental financial assurance demand.
- This presents opportunities for companies like Signal to hire a consultant to develop bogus costs resulting in protracted negotiations followed by multiple appeals which history has shown can take 5 or more years to wind its way through the IBLA.
- Such information could include, for example, an existing contract for decommissioning activities.

Phase in of Requirements and Companies Affected

- BOEM will phase in the new financial assurance requirements over a 3-year period for existing leaseholders.
- BOEM estimates the rules will affect approximately 391 companies with ownership interests in OCS leases and grants.
- Approximately 271 (69 percent) of the businesses operating on the OCS subject to this rule are considered small (defined as having fewer than 1,250 employees).

Lessee Decommissioning Obligations

- Under existing OCS regulations at 30 CFR 556.604(d) and 556.605(e) lessees are jointly and severally liable for the lease decommissioning obligations that accrue during their ownership, as well as those that accrued prior to their ownership.
- In addition, a lessee that transfers its interest to another party continues to be liable for any unperformed decommissioning obligations that accrued prior to, or during, the time that lessee owned an interest in the lease.

Right-of-Use and Easement Grants

- The new rules clarify the financial assurance requirement for RUEs serving Federal leases, which is not explicitly addressed in the existing regulations.
- Under the new rule, a grant holder must provide base financial assurance in a specific amount ($500,000), regardless of whether the RUE serves a State lease or a Federal OCS lease; the previous rule specified a $500,000 base financial assurance requirement for a State RUE.
- BOEM acknowledged that the initial base bond amount $500,000 was determined many years ago (1993) and acknowledges that this value should be reevaluated.
- BOEM plans to evaluate the specific values of the base supplemental financial assurance for RUEs, ROWs, and leases in a future rulemaking.
- How could this have been overlooked?
- Factoring in inflation, $500,000 in 1993 dollars would equate to $1.1 million in 2024 dollars.

Area-Wide Financial Insurance

- The new rule allows any lessee that has already posted area-wide lease financial assurance to modify that lease surety bond to also cover any RUE(s) in the area owned by the same lessee.
- For example, under the proposal, a lessee with a $3 million area-wide lease surety bond could establish or acquire any number of Federal or State RUEs in the area without having to post any additional financial assurance (other than, potentially, supplemental financial assurance), provided the lessee agrees to modify the terms of its area-wide lease surety bond to also cover any State or Federal RUEs that it owns or acquires.
- Another measure to reduce costs for lessees, increasing the risk to taxpayers.

Pipeline Right-of-Way Grants

- Under the new rules BOEM will evaluate pipeline ROW grant-holders using the criterion proposed for lessees (i.e., investment grade credit rating or proxy credit rating of grant holders or co-holders).
- The value of proved oil and gas reserves will not be considered in this evaluation.

- Existing bonding requirements for pipeline ROW grants, contained in 30 CFR 550.1011, prescribe a $300,000 area-wide base surety bond that guarantees compliance with all the terms and conditions of the pipeline ROW grants held by a company in an OCS area.
- Under existing regulations at 30 CFR 550.1011(a)(2) BOEM may require a pipeline ROW grant holder to provide supplemental financial assurance if the Regional Director determines that financial assurance exceeding $300,000 is required.
- The $300,000 bond amount was set assuming pipelines can be decommissioned in place and will cover only a fraction of pipeline decommissioning costs if pipelines are required to be fully removed.
- Factoring in inflation, $300,000 in 1993 dollars would equate to $648,000 in 2024 dollars.
- The recent ROD for the PEIS prepared for decommissioning Pacific Region OCS oil and gas facilities selected full removal of pipelines as the preferred decommissioning option.

Supplemental Financial Assurance for RUE and ROW Grants

- Under the new rule RUE grant holders "must meet bonding requirements" with the specific criteria governing financial assurance requirements (the credit rating or proxy credit rating of RUE co-grant holders).
- The value of proved oil and gas reserves is not applicable in this case.
- Under the prior regulations, ROW grant holders were required to post a $300,000 area-wide base surety bond guaranteeing compliance with all the terms and conditions of the pipeline ROW grants, but, unlike with leases, the regulation provides no factors for the Regional Director's consideration when making this determination.
- The new rules for ROW's clarified that the new rules for RUEs also apply to ROWs.

Third-Party Guarantees

- To add flexibility and encourage the use of third-party guarantees, the final rule allows third-party guarantors to guarantee only a limited set of entities or a limited amount of liability, rather than requiring every third-party guarantor "to ensure compliance with the obligations of all lessees, operating rights owners, and operators on the lease.
- BOEM believes that allowing third-party guarantors to limit their guaranteed obligations will ease the burden for entities required to provide additional supplemental financial assurance, while continuing to reduce the risk to taxpayers.
- The final rule also allows a third-party guarantee to be used as supplemental financial assurance for a RUE or ROW grant as well as a lease.
- The new rule would allow a third party to limit its cumulative obligations to a fixed dollar amount or to cover the costs of performing one or more specific lease obligations (with no fixed dollar amount).
- In both scenarios, the value or the obligations to be covered must be agreed to by BOEM at the time the third-party guarantee is provided.

- The new rule removes the requirement for a third-party guarantee to ensure compliance with the obligations of all lessees, operating rights owners, and operators on the lease, and, as agreed to by BOEM, would allow a guarantee limited to a specific amount or limited one or more specific lease obligations.
- By allowing a third-party guarantor to guarantee only the obligations it wishes to cover, BOEM provides industry with the flexibility to use the guarantee to satisfy supplemental financial assurance requirements without forcing the guarantor to cover the risks associated with all parties on the lease or grant or operations in which the party they wish to guarantee has no interest and over which the guarantor may have limited influence.
- BOEM's asserted its capacity to accept a third-party guarantee that is limited to the obligations of a specific party does not reduce BOEM's protection because if a limited guarantee is approved, the guaranteed party will be required to provide other supplemental financial assurance with respect to any of its liabilities left uncovered by the limited guarantee.
- The new rule allows BOEM to cancel a third-party guarantee under the same terms and conditions that apply to cancellation of other types of financial assurance, as provided in proposed section 556.906(d)(2).
- In my opinion, this is the most detrimental part of the new rule. It is basically a "*get out of jail card free"* for major oil and gas companies who had guaranteed they would fulfill all decommissioning obligations on leases that they desired to sell to smaller companies to obtain BOEM approval of the assignment of the lease. By allowing a company to guarantee only the obligations it wishes to cover or allowing the guarantor to limit its cumulative obligations to a fixed dollar amount, the risks are transferred to taxpayers. Given that the level of decommissioning activity is projected to increase significantly over the next 10 years both domestically and internationally, the cost of decommissioning is also likely to significantly increase as the demand for heavy lift vessels and other decommissioning service grows. In addition, experience has shown that the actual cost to decommission offshore oil and gas facilities is commonly 30-50 higher than projected costs due to unanticipated problems that are encountered during well plugging and abandonment and structure removal process. Allowing a guarantor to limit its decommissioning obligations to a fixed dollar amount at today's market prices is therefore very unlikely to be sufficient to cover decommissioning expenses in the future with the result being the taxpayer will be required to cover those expenses if lessees declare bankruptcy and default in covering their decommissioning obligations.

Transfer of Leases

- Many of the facilities currently on the OCS have decommissioning obligations where the cost of performance greatly exceeds the amount of financial assurance currently available to DOI.

- The final rule clarifies that BOEM will not approve the transfer of a lease interest, whether a record title interest or an operating rights interest, until the transferee complies with all applicable regulations and orders, including the financial assurance requirements.

Appeals

- Under the final rule any company seeking to stay a supplemental financial assurance demand pending appeal must, as a condition of obtaining a stay of the order, post an appeals bond in the amount of supplemental financial assurance required.
- The recipient of a financial assurance demand has 60 days within which to file a notice of appeal with the IBLA, during which time it is free to meet with BOEM and attempt to resolve any issues with respect to the demand. See 30 CFR 590.3
- The IBLA must grant or deny a stay based on the factors set forth at 43 CFR 4.21(b)(1), and not on whether an appeal bond has been, or must be, posted.
- Under the new provision, the IBLA may still grant a stay of a decision, and until a stay is granted, the decision remains in effect, but for the stay to take effect, the appellant must post the required appeal bond.
- Of the 1,449 appeals the IBLA received during the last 5 fiscal years, only 5 were from BOEM decisions concerning financial assurance.
- BOEM's retention of the appeal bond provision means that, in the event of a stay of a financial assurance order, there will be an appeal bond, ensuring that, even if the appellant becomes insolvent during the appeal, there will be sufficient funds to perform decommissioning when it is ordered by BSEE.
- This provision is an improvement over the previous rules that did require bonds to posted for appeals, but if a lessee declares bankruptcy and defaults on meeting its decommissioning obligations, and the bonding level is not sufficient to cover decommissioning obligations, the federal government and taxpayers will be required to cover unbonded decommissioning costs**.**