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**Bonding and Other Financial Securities
Updates in the Gulf of Mexico**

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Supplemental Bonding: Industry Response to Proposed Reforms



Applicable BOEM regulations concerning surety bonds (30 C.F.R. 556.52, et seq.), designation of operators (30 C.F.R. § 550.143), and lease transfers (30 C.F.R. § § 556.62 and 556.64) include provisions regarding joint and several liability for the performance of non-monetary obligations imposed by the lease and applicable laws and regulations.

In particular, 30 C.F.R. § 556.64(h)(1) and (2) provide that co-lessees, prior lessees, and operating rights owners holding an interest at the time the obligation accrued are jointly and severally liable for all lease and regulatory non-monetary obligations, and that sublessees and operating rights owners are jointly and severally liable for the performance of each non-monetary obligation under the lease to the extent that: (i) the obligation relates to the area embraced by the sublease; (ii) those owners held their respective interests at the time the obligation accrued; and (iii) the rule does not otherwise provide.

30 C.F.R. § 556.62(d) further provides that an assignor shall be liable for all lease obligations accruing prior to approval of the assignment by the BOEM; however, such approval does not relieve the assignor of accrued lease obligations that the assignee, or subsequent assignees, fails to perform, and 30 C.F.R. §556.62(e) states that the assignee and each subsequent assignee shall be liable for all obligations under the Subject Lease subsequent to the date that the BOEM approves the assignment.

Furthermore, the assignor of lease interests remains liable for abandonment obligations associated with wells drilled or used and platforms and facilities installed while the assignor held an OCS leasehold interest. 30 C.F.R. § 250.1700, *et seq.*; see also 30 C.F.R. §§556.62 (f); and 30 C.F.R. §556.64(h).

SUPPLEMENTAL BONDING AND BANKRUPTCY IMPLICATIONS

Industry and regulatory responses to the Chapter 11 petition filed by ATP Oil & Gas Corp. in the face of production delays have been vociferous and have underlined concerns of regulators and oil and gas exploration and production companies as they try to understand the future of supplemental bonding obligations.

As a result of the bankruptcy filing of ATP Oil & Gas Corporation and the magnitude of uncovered decommissioning liabilities being addressed therein, BOEM and BSEE are currently in the process of changing how decommissioning liabilities for Gulf of Mexico owners and operators are assessed and where and at what levels bonding or financial security will be required on a prospective basis.

ATP was exempt from supplemental bonding until July 31, 2012. After the exemption was revoked, ATP did not have the financial resources to provide security and it filed for bankruptcy, leaving its assessed decommissioning liabilities un-bonded.

As a result, BSEE undertook a comprehensive review of all of ATP's decommissioning liabilities and realized, in its view, that the assessments in effect were inadequate.

As a result of this realization, BOEM and BSEE have undertaken a policy review of assessments and bonding and will implement potentially severe changes in the near future.

At a meeting on May 23, 2013, BOEM and BSEE conducted an Industry Forum on Bonding Issues in which it put forth new approaches to ***Decommissioning Cost Assessments and Supplemental Bond Issues Related to Decommissioning Liability.***

To summarize, the following information was gathered:

First, BSEE is in the process of re-assessing leases and increasing, sometimes significantly, the decommissioning assessments for a number of leases.

Although ATP ' s problems are primarily deepwater related, it appears that increased assessments will most likely also affect shelf properties.

Therefore, all companies operating and owning leases in the Gulf of Mexico will most likely be impacted by increased decommissioning assessments for their leases and rights of use and easement.

This will increase the supplemental bond requirements for non-exempt companies, and some exempt companies may lose their exemptions altogether.

Second, BOEM has determined that it will require bonds for rights of way, which traditionally have not been required.

As such, BSEE is most likely in the process of assessing all pipeline rights of way in the Gulf of Mexico and BOEM demands for security to cover same will be forthcoming. It is too early to tell what the magnitude of these new bond/security demands may be, especially for shelf properties.

Third, BOEM has determined that it may require bonds for operating rights interests. Traditionally, bonds have been required (or an exemption had to be in place) for record title interests only (which effectively cover all interests in the lease, including operating rights).

At present, it is unclear how BSEE will make an assessment which will be effective only against a specific aliquot/depth associated with carved out operating rights, and it is unclear what BOEM may demand from a financial security standpoint solely from operating rights, but a change in policy associated with supplemental bonding for operating rights is clearly underway.

A hidden issue is the fact that several companies can presently avoid supplemental bonding if a single record title holder is exempt.

With the BSEE re-assessments underway, it is hard to predict which or how many companies may lose their exemptions, which may then require a party on the lease block to provide supplemental bonding or an alternative form of security.

In addition, if operating rights owners need to provide a separate and independent supplemental bond or alternative form of security, significant analysis of each individual block would need to be undertaken to fully analyze the ramifications of this change in policy.

BOEM's RISK: BONDING REVIEW AND ISSUES

BOEM ' s Risk Management, Financial Assurance and Loss Prevention Advance Notice of Proposed Rulemaking (“ANPR”) (RIN 1010-AD83).

BOEM invited comments in response to the ANPR published in the Federal Register on August 19, 2014 (79 Fed. Reg. 49,027).

More than 30 entities, primarily independent oil and gas explorers and producers, filed responses..

Comments are found at
<http://www.regulations.gov>.
Keyword: BOEM-2013-0058

According to the Independent Petroleum Association of America (“IPAA”), independents and the service and supply industries that support them drill approximately 95 percent of American oil and gas wells and produce approximately 54 percent of American oil and more than 85 percent of American natural gas.

Independents also play a unique and important role in the OCS, increasing the range of reserves that can be commercialized.

Several times in years past, independents have drilled more than 50 percent of all wells and more than 50 percent of exploration wells in the deepwater GOM and remain the dominant players in shallow waters.

[IHS Global Insight (USA), Inc., “The Economic Impact of the Gulf of Mexico Offshore Oil and Natural Gas Industry and the Role of the Independents,” (July 21, 2010)].

In 2010, independents were the largest shareholder in 66 percent of 7,521 GOM leases, including a 52 percent share in GOM deepwater leases.

Using these numbers, IHS Global forecasts that independents' contribution to federal, state and local revenues would be an estimated \$147 billion for the period from 2010 to 202. If the \$147 billion would be \$42 billion in federal royalty dollars.

[IHS Global Insight (USA), Inc., "The Economic Impact of the Gulf of Mexico Offshore Oil and Natural Gas Industry and the Role of the Independents," (July 21, 2010)] .

The Advance Notice of Proposed Rulemaking issued after BOEM Regional Director John Rodi ' s 2013 presentation on “Supplemental Bond Issues Related to Decommissioning Liability” elicited a response from the OCS Advisory Board that was echoed in all of the thirty-plus responses filed with the BOEM:

Requiring excessive bond coverage is a “ waste of capital” that would otherwise be productively used in offshore operations, and “unnecessarily uses industry bonding capacity.”

[OCS Advisory Board Response to BOEM/BSEE (Bureau) Bonding Questions” at page 6].

The majority of the responses focused on these general issues:

1. Allocation of Financial Responsibility by Ownership Percentages

When determining whether a company seeks an exemption and the BOEM determines whether the company is financially strong enough not to have to post a supplemental bond for production facility removal, the BOEM should not treat the company as if it owes 100 percent of the cost to clear a site when it owns only a fractional percentage of the lease.

In other words, the BOEM should limit that company's bonding obligation to that company's proportionate share of its ownership in the lease. If there are three companies with ownership interests in a single lease and each must bond 100 percent of the lease, the BOEM is over-securitized and the development of the OCS resource is impaired.

2. Give Credit for Existing Escrows Held by Lenders and Regulatory Agencies

When the BOEM does its determination of whether a company is exempt or in determining the amount needed for a supplemental bond, the BOEM should credit funds already held in escrow for decommissioning of OCS properties. Federally-held or privately managed escrows should be afforded equal weight.

All of the commentators agree that requiring a \$20 million bond to cover a \$20 million removal operation is duplicative and wasteful when an insured escrow account already holds \$20 million for that same removal operation.

3. Credit for Costs Attributed to Asset Retirement Obligations (“ARO’s”)

When determining a company's "net worth," general accounting principles already reduce a company's net worth by subtracting the cost of abandoning wells and removing production facilities. Generally Accepted Accounting Principles require companies to record decommissioning liabilities as AROs on their balance sheets. ARO amounts expected to be expended in the current year are shown as current liabilities and amounts expected to be expended in later years are discounted to present value and carried as long term liability obligations. Assets are offset by liabilities to arrive at the company's net worth. Thus, the BOEM's calculation of "Shareholders' Equity" already accounts for the ARO balances.

The "asset retirement obligations" ("AROs") are ignored by the BOEM, and the BOEM effectively charges the company twice for the costs of removal by subtracting its own estimates of removal liability from a net worth already reduced by AROs.

4. Revise Criteria used to Determine Financial Strength to Reflect Conservative Lending Principles

When determining whether a company is exempt from bonding, the BOEM should use modified criteria of financial strength, namely, criteria used by financial institutions in lending, to assure it does not have to deal with another bankruptcy similar to the ATP bankruptcy.

IPAA proposed the following formula for calculating decommissioning liability in its response to the BOEM, stating that “using this methodology ATP would not have qualified as exempt and would have been subject to a supplemental bond ” and attaching its work papers demonstrating this principle. *IPAA Comments dated November 17, 2014, p. 20-24 and Attachment A thereto.*

Recommendation: Modify the metric for cumulative decommissioning liability currently set forth in Section III, paragraph 2 of NTL No. 2008-N07 to include the following alternative calculation:

- i) Cumulative Decommissioning Liability \leq 100% of Adjusted Net Worth (defined as GAAP based Shareholders' Equity + Current and Long-term ARO Liability); and
- ii) Adjusted Debt* to EBITDA(X)** ratio $<$ 4.0x; and
- iii) EBITDA(X) to Cash Interest Expense*** ratio $>$ 3.0x. OR
- iv) Current Assets**** to Current Liabilities***** ratio $>$ 1.5x; and
- v) Current Assets — Current Liabilities $>$ Cumulative decommissioning liability

* Adjusted Debt = Bank revolver debt, other long-term debt, current maturities of long-term debt, other long-term liabilities in which the company is contractually obligated to pay a third party.

** EBITDA(X) = Net income, adjusted to add back interest expense, income tax, depreciation, depletion and amortization, accretion, and impairment. For successful efforts companies, also add back exploration expense.

*** Cash Interest Expense = Interest expense before the effects of capitalized interest, adjusted to add back any noncash interest expense if any.

-24-

**** Current Assets = A balance sheet account that represents the value of all assets that are reasonably expected to be converted into cash within one year in the normal course of business. Current assets include cash, accounts receivable, inventory, marketable securities, prepaid expenses and other liquid assets that can be readily converted to cash. Current Liabilities = A company's debts or obligations that are due within one year. Current liabilities appear on the company's balance sheet and include short term debt, accounts payable, accrued liabilities and other debts.

5. Bond Only Incremental Value for Exempt Status

Current BOEM practice would exempt from bonding a company if such company has a net worth of \$100 million. However, if the company's net worth is only \$95 million, the BOEM demands that the company provide supplemental bonding to cover production facility removal liabilities.

In other words, if the decommissioning/removal liability of a company is \$25 million, it posts no bonds if its net worth is \$100 million. If the company's net worth is \$95 million, it must post \$25 million in bonds. Industry uniformly urges the BOEM to revisit the bonding rationale and limit the supplemental bond to the \$5 million difference between the two net worth calculations. IPAA goes a step further and advocated that if exemption requirement minimums are not met in one period but are subsequently attained in a later period, the BOEM should consider the release of those bonds once the company attains exempt status again. *IPAA Response at p. 24.*

6. Access to Bonds and Timely Release of Bonds

According to the IPAA, the BOEM has only once allowed companies access to bonds, calling for forfeiture of a bond after negotiations with parties to the ATP bankruptcy.

The responses to the ANPR emphasized that if the purpose of bonding is to ensure proper abandonment, such funds should be accessible to the party who ultimately performs the decommissioning work. Under the present system, current and former lessees who are joint and severally liable (but who are not in breach of the obligation) have no rights to the bond and have no ability to call for forfeiture of a bond.

Thus, if a current lease operator does not plug wells and remove production facilities on a lease, BOEM and BSEE can order co-lessees and prior lessees to shoulder the financial responsibility. Ironically, the BOEM and BSEE do not make the bonds available to cover the costs of the plugging and removing of wells and equipment. Many respondents concur that the BOEM should permit those willing to decommission have access to the funds of those who fail to fulfill their obligations.

Similarly, the BOEM should revise its policies to require the prompt release of bonds that are no longer needed. Lengthy delays in releasing bonds occur when replacement bonds are submitted and when a lessee fulfils the obligations for which the bond was required.

7. Bond Timelines Should Reflect the Events Requiring the Need for Security

The entities filing responses to the ANPR agree that BOEM requires supplemental bonds prematurely.

Under current regulations, a lessee may file an exploration plan to drill up to seven wells. Upon approval, but long before all of the wells might be drilled, BOEM requires bonds to cover the cost of abandoning all seven wells. The present procedure gives no consideration of the possibility that the first well may be unsuccessful and operator may abandon the rest of the plan.

Nevertheless, BOEM has been historically slow to release the bond and company capital languishes.

Industry suggests that BOEM should instead require a bond to be posted only when the lessee is ready to drill a particular well and limit the bond amount to the cost of plugging that particular well. Similarly, the BOEM should release the bond within a statutory timeframe when the lessee shows the well has been properly plugged.

8. Bonding Amounts Should Reflect Accounting Standards and Not be Arbitrarily Set

BOEM's method of determining bond amounts do not take into account accepted accounting standards of the Financial Accounting Standards Board. BOEM 's calculation of the full cost of removal 15 years in the future does not reflect discounting that cost to present value.

This arbitrary approach ties up company dollars that could be spent more productively in producing additional oil and gas or in conducting currently-due decommissioning operations.

Industry suggests that the BOEM should bond only present value of the future cost, and adjust bond amounts for all the lessee's removal liabilities annually. This methodology would eliminate the cost of those obligations already performed and permit the increase of amounts as future removals get closer in time.

COMMENTS FROM THE SURETY INDUSTRY

The Comments submitted by RLI Insurance Company provide another perspective for evaluation of the ANPR.

In response to whether BOEM should continue to allow self-insurance for companies with requisite financial strength, RLI contends that doing away with the self-insurance option penalizes all for the problems of a few.

If there is no self-insurance, “there is not even close to enough surety capacity in all of the existing surety markets to provide bonding.”

“As only a limited amount of surety companies are willing to provide this type of bonding (long term non-cancellable obligations), the need for bonding, if there is no self-insurance option, greatly exceeds the capacity of the surety industry.”

In other words, if there is not enough surety capacity, every company operating on the OCS will have to set aside more capital to cover liabilities that are normally covered in the normal course of business. This means less drilling and less revenue for the federal government.

Moreover, without self-insurance, many viable companies may not be able to raise the amount of cash or obtain bonds quickly, and defaults and bankruptcies may follow. This would make worse the very situation BOEM seeks to rectify.

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