



BOEM Unveils Significant New Supplemental Financial Assurance Requirements in NTL 2016-No1

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R. Scott Nuzum, Paul Korman, and Jonathan Simon

On July 14, 2016, the Bureau of Ocean Energy Management (“BOEM”) unveiled a new policy governing supplemental financial assurance for oil and gas infrastructure on the Outer Continental Shelf (“OCS”). The new policy, issued as Notice to Lessees 2016-No1 (“NTL 2016-No1”), will fundamentally change the way that BOEM calculates financial strength and reliability of OCS lessees and operators and will require individual lessees and operators to allocate far more capital than previously required to cover future potential decommissioning obligations. NTL 2016-No1 rescinds and supersedes BOEM’s prior supplemental bonding policy—NTL 2008-No7—and becomes effective September 12, 2016.

Once NTL 2016-No1 goes into effect, the new policy has the potential to significantly disrupt the U.S. offshore oil and gas industry. NTL 2016-No1 could fundamentally alter operating conditions for small and independent companies, ultimately forcing them to abandon OCS operations altogether. Additionally, NTL 2016-No1 could send a signal to larger companies that the costs of doing business on the federal OCS are too high to justify future investments in frontier areas such as the Arctic and ultra-deepwater, effectively driving companies to abandon offshore activity in the U.S. in favor of jurisdictions with less burdensome regulatory regimes.

This alert provides a summary of BOEM’s legal authority to require supplemental financial assurance, reviews the impetus for BOEM’s policy changes in this arena, outlines BOEM’s policy reforms to date, examines the major policy changes instituted by NTL 2016-No1, and discusses the potential consequences of BOEM’s new policy on industry.

BOEM’s Legal Authority

The Outer Continental Shelf Lands Act (“OCLSA”) vests with the Secretary of the Interior the authority to require bonds or other forms of financial assurance for oil and gas exploration, development, and production activities on the OCS. The Secretary has delegated authority over financial assurance to BOEM, which has promulgated regulations governing the financial assurance process. BOEM’s regulations require holders of all types of OCS obligations—including leases, rights of use and easement (“RUE”), and rights-of-way (“ROW”)—to post a general lease surety bond in an amount ranging from \$50,000 to \$3,000,000, depending on the lease activity. BOEM’s regulations also require holders of OCS obligations to post supplemental bonds in an amount determined by the Bureau of Safety and Environmental Enforcement (“BSEE”) as appropriate to meet decommissioning liabilities.

Pursuant to its general regulatory authority to provide interpretive guidance, BOEM has issued NTL 2016-No1 to “clarify, supplement, or provide more detail about” its supplemental financial assurance regulations.

Impetus for BOEM’s Policy Reforms

Over the past three years, BOEM has undertaken efforts to amend its financial assurance regulations and policies governing general and supplemental bonding for OCS infrastructure, which BOEM argues are insufficient to cover substantive offshore decommissioning costs. According to BOEM, the agency’s existing bonding regulations are outdated, as they were originally drafted primarily to address risks associated with the non-payment of rents and royalties on OCS leases and with noncompliance with laws and regulations. BOEM contends that changes to its regulations and policies are needed to address “increasingly complex business, functional, organizational and financial issues and vast differences in

costs associated with expanded and varied offshore activities[.]” These concerns were also highlighted in a December 2015 Government Accountability Office report entitled, “Offshore Oil and Gas Resources: Actions Needed to Better Protect Against Billions of Dollars in Federal Exposure to Decommissioning Liabilities.”

BOEM’s desire to amend its financial assurance regulations and policies also is motivated by its experiences related to a slate of bankruptcies among smaller OCS operators. BOEM has feared that these bankruptcies would leave the federal government and taxpayers to cover the costs of decommissioning assets owned by those companies. So far, though, BOEM’s fear has proved to be unrealized, as sufficient capital has existed—either in the form of company assets or from predecessors in interest—to cover decommissioning expenses associated with the bankrupt companies.

Overview of BOEM’s Policy Reforms to Date

BOEM’s issuance of NTL 2016-No1 is only the latest action by the agency aimed at enhancing financial assurance for OCS oil and gas infrastructure. Previously, in May 2013, the agency hosted the first of several industry forums to discuss amendments to its policy. Following that initial public meeting, on August 19, 2014, BOEM published an advanced notice of proposed rulemaking seeking comments on fifty-four questions related to four “major topics”: identification of pertinent risks/liabilities; risk monitoring and risk management; demonstrating financial assurance over project lifecycles; and financial assurance, bonding levels and requirements. BOEM has yet to publish a proposed rule.

More recently, in August 2015, BOEM published NTL 2015-No4, “General Financial Assurance.” With that NTL, BOEM made several key policy changes related to its general bonding regulations. First, BOEM expanded the range of entities to which the general bonding policy applies. Whereas historically bonding obligations fell only on OCS lessees and operators, NTL 2015-No4 explicitly states that bonding obligations also attach to ROW holders, RUE holders, and geological and geophysical (G&G) permit holders. Second, while an earlier version of BOEM’s general bonding policy allowed an operator to post the bond after lease/plan approval so long as it did so prior to beginning the relevant operational activity, BOEM appeared to mandate that a lessee or operator furnish a general bond prior to approval of the lease/plan.

These three actions, while noteworthy, pale in significance when compared to BOEM’s effort to amend its supplemental bonding policy. One reason for this is that supplemental financial assurance is an area where BOEM’s regulations provide the agency with greater flexibility to change requirements through interpretive guidance. Whereas BOEM’s financial assurance regulations established fixed requirements for general bonds and set general bond amounts at relatively low levels, the supplemental bonding regulations allow the agency more leeway to exercise discretion as to bond terms and amounts. Thus, BOEM can undertake significant policy shifts via NTL. Indeed, NTL 2016-No1 represents such a shift.

Summary of NTL 2016-N01 Requirements

NTL 2016-No1 represents a fundamental shift in the way BOEM manages risk on the OCS. Once effective, NTL 2016-No1 will require that a company be able to make an annual showing that it has the “financial ability to carry out obligations” on all leases, pipeline ROWs, and/or RUEs. BOEM also will be able to undertake an assessment of a company’s financial ability any time the agency wishes, including when the agency learns of a “material or adverse change [in a company’s] financial strength or OCS obligations” and when the company violates “Department of the Interior or other applicable regulations.”

In assessing whether a company has this ability, BOEM will treat every company as if it has a sole interest in each OCS obligation in which it has an interest; in other words, BOEM will assign 100% percent of decommissioning and other liability to a company for any lease, ROW, and RUE in which that company has an ownership interest or for which that company acts as a guarantor. This is a significant departure from BOEM’s previous policy outlined in NTL 2008-No7, in which BOEM allowed risk pooling among multiple companies with shared interest in an OCS lease, ROW, or RUE.

With issuance of NTL 2016-No1, the method that BOEM uses to calculate financial strength and reliability also changes. No longer will BOEM presume financial strength where a company can demonstrate a net worth equal to or greater than \$65 million, cumulative decommissioning liability less than or equal to 50 percent of net worth, and a certain level of production or debt to equity ratio. Instead, BOEM will now undertake a far more scrupulous look into a company's fundamentals, looking at the following five criteria:

1. *Financial capacity* – BOEM will require that a company be able to demonstrate both short-term financial capacity and long-term financial capacity “substantially in excess” of current and future lease obligations. To prove this capacity, a company must be able to demonstrate that it exceeds minimum thresholds for a number of financial criteria, including: Cash Flow from Operations/Total Debt; Earnings Before Interest and Taxes (EBIT)/Interest Expense; Return on Equity; Total Debt/Capital; and Total Debt/Equity. BOEM has established benchmarks for each ratio, which are available at <http://www.boem.gov/Benchmark-for-Each-Ratio/>.
2. *Projected financial strength* – Under this criterion, a company must be able to demonstrate that the estimated value of its existing OCS production and proven reserves substantially exceeds current and future lease obligations.
3. *Business stability* – Where a company can show that it has maintained continuous OCS or onshore operations and production for a period of five years or more, BOEM will find that the company satisfies the business stability requirement of NTL 2016-No1.
4. *Reliability* – BOEM will base reliability upon a company's credit rating from Moody's or Standard and Poor's, or upon the company's trade references.
5. *Record of compliance* – BOEM will review a company's record of compliance to see whether BOEM or BSEE has assessed civil penalties to the company or any of the company's affiliates or subsidiaries. BOEM also will: (i) undertake a review to ensure that the company is in compliance with BOEM and BSEE lease, plan, and permit terms and conditions; (ii) check to see whether the company has been cited for non-compliance with other federal requirements for operations on the OCS; and (iii) ensure that the company has no outstanding debts to the government from the non-payment of rents, royalties, inspection fees, etc.

Where BOEM determines—based on its assessment of the five criteria above and in the absence of other “relevant information” furnished by a company—that a company does not have the financial ability to meet obligations, the agency will send the company a written order requiring the company to post additional security necessary to put the company in a position to meet its obligations. BOEM's order will include a list of properties that the agency determines to be “sole liability properties,” which the agency defines as “leases, ROWs, or RUEs for which the company is the only liable party, i.e., there are no co-lessee and/or other grant holders, and no prior interest holders who would be liable to BOEM to meet the obligations arising from such properties.” For these properties, BOEM will require that additional security—a surety bond, a pledge of U.S. Treasury Securities, or a “tailored financial plan”—be posted within 60 days of the date the company received BOEM's order. The tailored financial plan concept allows a company to pursue alternative forms of financial assurance, including abandonment accounts, third party guarantees, or another form of financial security approved by BOEM.

BOEM's order will also list all other properties requiring additional security, i.e., properties that are not sole liability properties. For these properties BOEM will allow a company to “phase-in” compliance over a longer period of time. Here, BOEM will allow companies to propose a timetable for compliance. NTL 2016-No1 sets for a schedule, whereby one third of the additional security would be due within 120 days from the date of approval of a company's timetable; two-thirds would be due within 240 days of approval; and the full amount would be due within 360 days of approval. NTL 2016-No1 contemplates companies employing alternative timetables with approval from the Regional Director.

NTL 2016-No1 also does away with the agency's past practice of waiving supplemental bonding obligations where a company could display a certain level of financial strength. Instead, BOEM will allow companies to "self-insure," but only up to 10% of a company's "tangible net worth," which is defined as the difference between a company's total assets and the value of all liabilities and intangible assets. BOEM notes that if a company's credit rating is not satisfactory, the agency will not permit a company to self-insure sole assets.

Potential Impacts of NTL 2016-N01 on Industry

While BOEM has expressed a willingness to work with industry to ensure that the policy pronouncements of NTL 2016-No1 do not force any company off the OCS, the reality is that the reforms contemplated in BOEM's new policy are very likely to change the profile of the U.S. offshore oil and gas industry.

First, BOEM's reforms to its supplemental financial assurance policy ultimately could force some smaller operators to sell their assets to a larger company better positioned to meet the significant costs of supplemental bonding. This ultimately would lead to a consolidation of assets in the exploration and production ("E&P") and pipeline sectors into the hands of a small number of large companies, signaling the end of the robust competitive market in the offshore oil and gas industry. Alternatively, in situations where a company is both unable to find a willing buyer of its assets and unable to satisfy the requirements of a BOEM supplemental bonding order, BOEM could issue civil penalties or request that BSEE order the company to immediately decommission its assets.

Where the cost of meeting decommissioning obligations exceeds a company's net worth, BOEM's orders also could drive certain companies to declare bankruptcy. If this were to happen, the bankrupt company would forfeit its general bond and any existing supplemental bond likely would not be sufficient to meet decommissioning obligations. Accordingly, BSEE's joint and several liability regulations would trigger to allow BSEE to seek compliance with decommissioning obligations from another party in the lease, RUE, or ROW chain of title, assuming the property was not a sole liability. BSEE's ability to mandate decommissioning by others in the chain of title poses issues for larger companies as well. Where it is unable to secure decommissioning from smaller companies, the government can be expected to pursue any prior owner with "deeper pockets."

The issue of supplemental financial assurance is further complicated by the fact that securing a surety bond has proven to be an expensive and difficult task for smaller companies. The surety bond market is, for all intents and purposes, non-existent. Multiple sources report that there is a lack of surety capacity in the market. A company seeking a bond must pay a premium on the bond *and* post collateral equal to 100 percent of the bond amount.

BOEM financial assurance policy also could influence investment decision by larger E&P companies, ultimately leading those companies to conclude that the U.S. regulatory environment is far too burdensome to justify the billions of dollars in capital expenditure required to develop and produce resources in frontier areas such as the Arctic and ultra-deepwater Gulf of Mexico.

For more information

Van Ness Feldman's Upstream Oil & Gas practice regularly monitors and assists clients in navigating BOEM's financial assurance requirements and other issues related to offshore oil & gas development. If you have any questions about NTL 2016-No1 or any of BOEM's regulatory activities, please contact [R. Scott Nuzum](#), [Paul Korman](#), or [Jonathan Simon](#) or at 202-298-1800.

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