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Locke Lord QuickStudy: Riding the Regulatory Wave: BOEM Issues New Rules for Surfing the Provision of Financial Assurance

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The regulatory seascape for financial assurance related to offshore oil and gas production and decommissioning in federal waters has come in waves over the past decade, and like waves, the regulations often build momentum only to scatter against the sand. New guidance on financial assurance issued late in the President Obama administration crashed to shore after President Trump took office. President Trump's Department of the Interior released its own approach just in time to vanish as President Biden took office. While those administrative policy efforts often occurred through agency actions called Notices to Lessee, the Biden administration's latest wave of regulation has occurred through amendments to the Code of Federal Regulations (CFR), suggesting that this latest wave may be the one that energy companies will have to ride for some time.

This QuickStudy will discuss the more significant changes to financial assurance regulation from the new rule released by the Bureau of Ocean Energy Management (BOEM). The new rule, *Risk Management and Financial Assurance for OCS Lease and Grant Obligations* ("Risk Management Rule"), was published on April 24, 2024, and takes effect on June 24, 2024. The Risk Management Rule—motivated by a wave of operator bankruptcies, aging oil and gas infrastructure, and substantial increases in decommissioning costs—dramatically changes the way BOEM evaluates the financial health of companies and offshore assets in setting financial assurance requirements. BOEM estimates the rule will result in \$6.9 billion in supplemental bonding or other financial assurance being required in a market in which surety bonding is increasingly difficult for companies to obtain. This QuickStudy will broadly discuss the Risk Management Rule and implications for the energy industry focusing on the major provisions of the rule including: the criteria used to evaluate financial health of energy companies, the codification of the use of Bureau of Safety and Environmental Enforcement (BSEE) decommissioning estimates to evaluate financial assurance requirements, added flexibility with third-party guarantees and decommissioning accounts, and clarifying financial assurance requirements for right-of-use and easements (RUEs).

1. Evaluation of Energy Company Financial Health

Previously BOEM used a number of criteria to evaluate financial health of its qualified companies including financial capacity, financial strength, reliability in meeting financial obligations, and record of compliance with laws, regulations, and lease terms. See 30 C.F.R. 556.901(d). The Risk Management Rule simplifies this approach to two criteria: (1) credit rating and (2) the ratio of proved reserves to decommissioning liability associated with the

reserves. Companies will be able to avoid additional financial assurance demands with either an investment grade credit rating (as defined below) or a minimum 3-to-1 ratio of the value of proved reserves to decommissioning liability associated with those reserves for a particular lease. Significantly, the criteria can be met by just one current record title owner / co-lessee. In other words, an investment grade credit rated working interest owner (regardless of the percentage working interest or whether the interest is non-operating) could provide the credit rating to avoid additional financial assurance even if other working interest owners and the designated operator are more financially vulnerable.

The credit rating analysis will be determined using a Nationally Recognized Statistical Rating Organization (NRSRO) as identified by the SEC or a proxy credit rating based on a company's audited financial statements using the S&P Global Credit Analytics credit model. This requirement amounts to a BBB- credit rating or above. For the reserve report analysis, BOEM will require submission of reserve reports compliant with SEC regulations on reserve reporting with reserves detailed by lease on which the exemption is requested. In other words, companies cannot use the value of other leases with more reserves to avoid financial assurance requirements for a particular lease with less valuable proved reserves. The value of proved reserves as reported will be evaluated against the BSEE P70 decommissioning estimates discussed below.

This simplified criteria is aimed at addressing the concerns of both financial health of the operator and underlying asset value in the event of a default. A number of recent bankruptcies resulted in sale processes in which no buyer would purchase certain assets. The proposed 3-to-1 value ratio is designed to preserve marketability of those assets in the event of a financial collapse of a lessee. Assets with smaller value to decommissioning costs are less likely to be sold and more likely to become a liability to predecessors or the taxpayer. The co-lessee aspect of the rule recognizes shared benefits from production and the reality of joint and several liability for the ultimate cleanup obligations.

2. Use of BSEE Decommissioning Estimates

Anyone familiar with offshore oil and gas leases has followed the evolution of BSEE's decommissioning costs estimates. In recent years, BSEE developed a set of probabilistic estimates based on industry-reported cost data to replace the previous algorithm-based deterministic estimates. These estimates are broken down into P50, P70, and P90 estimates. In other words, the P50 estimate represents a 50 percent chance that the estimated costs are adequate to cover decommissioning costs. The P70 estimate represents a 70 percent chance that the estimated costs will cover the decommissioning liabilities. Where probabilistic estimates are not available, BSEE continues to provide a deterministic value.

The Risk Management Rule codifies use of the P70 estimated value in determining decommissioning costs for financial assurance determinations. By providing that specific value for decommissioning costs, companies should be quickly able to evaluate whether proved reserves meet the 3-to-1 ratio requirement to avoid financial assurance. Companies will also be able to evaluate likely bonding or other financial assurance costs from any supplemental bonding demand should they fail the credit rating and reserves ratio criteria. While certain commenters requested BOEM use the P90 estimates for bonding requirements, BOEM ultimately decided the P70 estimate would better balance the likely actual costs of decommissioning with the costs associated with obtaining bonding or other financial assurance.

3. Third-Party Guarantees and Decommissioning Accounts

Consistent with the new criteria for evaluating lessees, BOEM will evaluate third-party guarantors providing financial assurance based on credit rating. **BOEM will also allow third party guarantors—upon agreement with BOEM—to provide limited guarantees to specific amounts or specific leases instead of the blanket guarantees that have been used in the past.** These rule changes should provide broader flexibility for companies who have creditworthy affiliates.

The Risk Management Rule also adds flexibility for Decommissioning Accounts. BOEM has removed the requirement to pledge Treasury securities when the account exceeds the amount insured by the FDIC. This change should allow companies with significant cash positions to create decommissioning escrow accounts as financial assurance (even if it is likely, under the new rules, that companies with strong cash positions will not need additional financial assurance).

4. Financial Assurance for RUEs

While there is a body of regulations related to RUEs, RUEs have largely been left out of prior financial assurance requirement regulation. The Risk Management Rule changes this by requiring a base financial assurance requirement of \$500,000 for federal RUEs to match the requirement for state RUEs. The Risk Management Rule also provides the option of a \$500,000 area-wide base financial assurance for RUE grant holders as an alternative to the base financial assurance requirements. RUEs can involve significant decommissioning expense, and this requirement provides some protection similar to the current area-wide requirements for rights of way or leases. RUE grant holders will also be subject to the investment grade credit rating analysis (but not the reserves analysis) discussed above and potentially subject to additional financial assurance requirements.

5. Implications

BOEM recognizes the Risk Management Rule will have significant impact on companies. To assist, BOEM added a **3-year compliance period** for current leaseholders. In other words, companies receiving an additional financial assurance demand can provide one third of the financial assurance each year over a three-year period. Even with the phase-in for compliance with financial assurance demands, the Risk Management Rule will have a substantial impact on companies with poor credit ratings, end-of-life assets with lower remaining proved reserve amounts, and no creditworthy affiliate who can serve as a guarantor. These companies can expect substantial financial assurance demands to cover ever-increasing decommissioning costs. These financial assurance demands come at a time in which surety bonding is more difficult to obtain, as bonding companies often require significant collateralization before issuing bonds, particularly in the wake of the Fieldwood and Cox Operating bankruptcies. Moreover, under the Risk Management Rule, companies that seek to challenge financial assurance requirements will need to post appeal bonds to stay appeals of the financial assurance demands. These changes could put substantial financial pressure on smaller producers who have acquired older oil and gas leases. The co-lessee aspect of the financial analysis also presents challenges to working interest owners who co-own leases with financially weak partners. Those working interest owners will remain exposed as the weaker partner can piggyback on the financial strength of the stronger partners.

On the other hand, predecessors in title will likely benefit from the new regulatory regime once it is fully

implemented. Recent oil and gas bankruptcies such as those filed by Fieldwood Energy and Cox Operating left behind scores of abandoned platforms, wells, and pipelines. Predecessors have been left to surf through the aftermath and clean up often at significant expense. The Risk Management Rule should help build additional financial security layers over time leaving creditworthy predecessors less exposed in future insolvencies.

The practitioners at Locke Lord have significant prior experience in addressing financial assurance matters including site-specific trusts, long term plans, and supplemental bonding as well as a thorough understanding of reserve reporting and other financial metrics.

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