



Vinson&Elkins

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BOEM ISSUES NTL IMPOSING MORE STRINGENT FINANCIAL ASSURANCE REQUIREMENTS ON OCS LESSEES FOR DECOMMISSIONING LIABILITIES

Environmental Law Update

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On July 14, 2016, the federal Bureau of Ocean Energy Management (BOEM) issued a Notice to Lessees and Operators (NTL)¹ conducting oil, natural gas, and sulfur activities on the Outer Continental Shelf (OCS) that overhauls the federal government's offshore financial assurance program relating to the performance of decommissioning obligations on the OCS. Greatly anticipated since first being conceptually proposed in September 2015, the new NTL, which is designated as NTL No. 2016-N01, completely revamps the manner in which energy companies operating on the OCS provide financial assurance to satisfy their obligations to decommission wells, platforms and other facilities located on the OCS. Critically, the exclusion process that historically was a key part of the financial assurance program and relied upon by qualifying energy companies to "waive" their provision of financial assurance for all or a portion of their decommissioning obligations has been eliminated by BOEM and replaced by a down-sized "self-insurance" mechanism. Moreover, co-lessees and co-owners will have to work cooperatively to provide financial assurance coverage for their leases and right-of-way (ROW) and right-of-use and easement (RUE) grants, as BOEM will now impose 100 percent liability upon each co-lessee and co-owner to decommission the entirety of each lease, ROW and RUE in which such parties hold an ownership interest or have provided a guarantee. If the responsible parties fail to agree on an allocation system for their financial assurance obligations, then each party will be responsible for 100 percent of the total decommissioning liabilities.

The stringent requirements imposed by NTL No. 2016-N01 will have a significant impact on energy companies conducting business on the OCS, and are expected to disproportionately affect thinly capitalized energy companies whose balance sheets are already substantially impaired by the prolonged period of low commodity prices for crude oil and natural gas. The new NTL replaces the former NTL on supplemental bonding (NTL No. 2008-N07) and becomes effective on September 12, 2016.

BOEM's Rationale for Implementing a Revamped Financial Assurance Program has been influenced by Energy Company Bankruptcies.

Development of a more stringent offshore financial assurance program has been under consideration by BOEM for several years but the impetus to move forward may have arrived in 2012, following the much publicized bankruptcy of ATP Oil & Gas Corporation, an energy company operating on the OCS in the Gulf of Mexico.

¹ The full title of the NTL is "Notice to Lessees and Operators of Federal Oil and Gas, and Sulfur Leases, and Holders of Pipeline Right-of-Way and Right-of-Use and Easement Grants in the Outer Continental Shelf." As the title implies, the additional security requirements imposed under the NTL apply not only to lessees but also to holders of pipeline right-of-way and right-of-use and easement grants.

Consequently, BOEM embarked on a mission to ensure that U.S. taxpayers never have to pay for a lessee's decommissioning of offshore wells, platforms and other facilities located on the OCS, by seeking to overhaul the financial assurance program.

As we have previously [reported](#), the process of reforming OCS financial assurance requirements was launched in August 2014, with BOEM's publication of an Advanced Notice of Proposed Rulemaking posing more than 50 questions to the offshore energy industry regarding its financial assurance program. A year later, in September 2015, BOEM issued [draft guidance](#) on proposed revisions to the agency's procedures and criteria for providing financial assurance. We have previously provided certain [recommended measures](#) that offshore energy companies might take to mitigate adverse effects of the anticipated bolstered financial assurance program. However, with issuance of the final "Additional Security" NTL, offshore energy companies must now satisfy bolstered financial assurance requirements for decommissioning obligations on the OCS. An overview of the new requirements is set forth below.

BOEM's Authority to Impose More Stringent Offshore Financial Assurance Requirements.

BOEM is authorized pursuant to Section 5(a) of the Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C. § 1331, *et seq.*, to oversee the management of financial risks to the United States government arising from development of energy and mineral resources on the OCS. Accordingly, BOEM and its predecessors have sought to discharge this obligation by establishing a risk management program in the form of bonding regulations under 30 C.F.R. parts 550, 556 (subpart I), 581 (subpart C), 582 (subpart D), 585 (subpart E) and in § 551.7.²

Oil and natural gas exploration and production companies holding leases of federal lands on the OCS have the obligation pursuant to OCSLA regulations to permanently plug all wells, remove all platforms and other facilities, decommission all pipelines, and clear the seafloor of all obstructions created by lease operations. Collectively referred to as "decommissioning obligations," these plugging, removal and decommissioning activities are regulated by the federal Bureau of Safety and Environmental Enforcement (BSEE). In its regulations, BSEE imposes joint and several liabilities on lessees, consisting of owners of record title and owners of operating rights, for decommissioning obligations for facilities on their leases. Similarly, all holders of ROW and RUE grants (sometimes referred to herein as "grant holders") are jointly and severally liable for meeting decommissioning obligations for facilities on their ROW and RUE, respectively.

BOEM is tasked with the responsibility of assuring that appropriate levels of financial assurance are provided by lessees and grant holders to guarantee performance of their decommissioning obligations and, to that end, has developed and implemented regulations under 30 C.F.R. part 556, subpart I relating to financial assurance requirements. BOEM and its predecessors have issued a series of NTLs over the years that expand upon the agency's regulations by clarifying, supplementing or providing more detail regarding its financial assurance requirements. BOEM's July 14, 2016 issuance of NTL No. 2016-N01 is the latest, and certainly the most transforming, iteration of the additional security notices issued to lessees and holders on the OCS.

Six Things to Know About BOEM's July 14, 2016 NTL.

As a practical matter, BOEM's basic scheme of requiring security by operators on the OCS remains unchanged: to conduct oil, natural gas, and sulfur exploration and production activities on the OCS, the lessee or grant holder must provide bonds or other financial guarantees in amounts deemed acceptable by BOEM to assure that end of lease and grant obligations – namely, decommissioning obligations – will be performed at no cost to the

² Specifically, lease bonding regulations are found at 30 C.F.R. part 556, subpart I, security regulations applicable to ROWs are found at 30 C.F.R. § 550.1011(a)(2). Security regulations applicable to RUEs are found at 30 C.F.R. § 550.166(b). Other financial assurance regulations relating to minerals other than oil, natural gas or sulfur or to geological and geophysical or renewable energy activities are found in parts 551, 581, 582 and 585.

federal government. What has changed, pursuant to the new NTL, is how, and in what amount, the required security will be determined by BOEM and provided by the lessee or holder. In the past, certain energy companies of relatively high net worth (as confirmed by BOEM) had the option to exclude or “waive” some or all of their responsibility to provide financial assurance for decommissioning obligations on the BOEM-held belief that such companies had the financial wherewithal to satisfy those obligations without posting additional security.³ BOEM eliminates the waiver process in the new NTL. In its place, BOEM has introduced a “self-insurance” mechanism that continues to allow qualified energy companies to exclude posting of security for certain of their decommissioning obligations, but, as explained below, the amount of security allowed to be excluded from posting with BOEM is significantly less than was allowed under the waiver process. In addition, lessees and grant holders are now responsible for posting security for 100 percent of their decommissioning liabilities for a particular property unless all of the co-lessees or co-owners of such property have agreed upon a plan for the sharing of the security burden, typically based on their respective legal interest in the property.

A. Every Lessee and Grant Holder is Now Responsible for 100% of Its Decommissioning Liability on Every Lease, ROW and RUE.

Under past practice, for a particular lease, ROW or RUE, BOEM would assess all of the co-lessees or co-owners to determine whether any one party had the financial ability to cover the decommissioning liability of that property. Typically, the party identified as having the necessary financial ability (e.g., “Big Energy Company”) was large enough that BOEM would waive that party’s posting of some or all of the required financial security. And because Big Energy Company had sufficient financial ability to cover those decommissioning liabilities, BOEM would excuse the other co-lessees or co-owners of the property from posting any financial security for the decommissioning obligations. Consequently, scenarios would emerge where little or no financial security had been posted for a lease, ROW or RUE with multiple co-lessees or co-owners, resulting in potential risk for satisfying decommissioning liabilities in the event that Big Energy Company was unable to fulfill the decommissioning obligation.

Under the new approach, when BOEM calculates the decommissioning liability for a particular lease, ROW or RUE, BOEM will determine 100 percent of the decommissioning (and other)⁴ liabilities for every co-lessee or co-owner that holds an ownership interest in that lease, ROW or RUE, or has provided a guarantee, even if Big Energy Company is also a co-lessee or co-owner. As noted above, because liability is joint and several, BOEM establishes a financial assurance level equal to 100 percent of the estimated cost to decommission the entirety of each lease, ROW and RUE in which covered parties hold an ownership interest or have provided a guarantee, not just a covered party’s proportionate share. BOEM will also require the same with regard to Big Energy Company. While, at first glance, this appears to result in duplicative coverage, BOEM expects that Big Energy Company and the other co-lessees and co-owners will work cooperatively and agree to an allocation of the decommissioning liabilities which they share in common with respect to the lease, ROW or RUE, and will each present this sharing arrangement to the designated operator of its lessees when it is time for the operator to provide evidence of financial assurance to BOEM.

In other words, the burden is on the co-lessees or co-owners of a particular lease, ROW or RUE to decide amongst themselves how the decommissioning liabilities will be apportioned so that there is 100 percent coverage of those liabilities, otherwise, the responsibility for the full amount of the decommissioning liability rests with each of the co-lessees or co-owners.

³ For more information on the past waiver practice, please review our previous [article](#) discussing BOEM’s issuance of draft guidance in September 2015.

⁴ There are other lease or grant obligations beyond decommissioning, such as the obligation to pay rent. The driver for significant liabilities is decommissioning liabilities.

B. BOEM Has Developed New Criteria to Determine Whether a Lessee or Grant Holder Needs to Provide Additional Security.

BOEM has concluded that the methodology by which it previously determined financial strength and reliability has become outdated. Consequently, the newly issued NTL sets forth new criteria that will be used to determine an energy company's financial ability to carry out its end of lease, ROW or RUE obligations. Critically, the new process includes the possibility of developing an individually tailored plan that will enable the energy company to use one or more forms of additional security or to "phase-in" compliance over time.⁵

BOEM's evaluation of an energy company's financial ability to carry out its lease, ROW or RUE obligations, including decommissioning obligations, is based on consideration of the same set of factors as previously considered: financial capacity, financial strength, stability, reliability and record of compliance. However, how BOEM analyzes each of these factors may have changed.

1. *Financial capacity.* As before, an energy company's ability to demonstrate financial capacity in excess of existing and anticipated end of lease obligations is based on its most recent (not more than 12 months old) audited financial statements. BOEM's focus, however, will now include consideration of specific financial criteria of the energy company for which the agency has established minimum thresholds (as well as the number of such thresholds that BOEM requires the energy company to exceed):
 - Cash Flow from Operations/Total Debt
 - Current Ratio
 - Earnings before Interest and Taxes (EBIT)/Interest Expense
 - Quick Ratio
 - Return on Assets
 - Return on Equity
 - Total Debt/Capital
 - Total Debt/Earnings Before Interest, Texas, Depreciation and Amortization (EBITDA)
 - Total Debt/Equity

BOEM's stated minimum thresholds and required number of criteria exceedances are set forth on the agency's website at <http://www.boem.gov/Risk-Management/>. BOEM may periodically update this information based on prevailing market conditions or other factors.

2. *Projected financial strength.* This measure is based on the energy company's estimated value of its existing OCS lease production and proven reserves of future production.
3. *Business stability.* This is a period of at least five years' continuous operation and production on the OCS or onshore.
4. *Reliability.* This factor is based on the energy company's credit rating from Moody's or Standard and Poor's, or the energy company's trade references.

⁵ As will be noted below, energy companies that are the lessee or grant holder of "sole liability properties," meaning that there are no co-lessees, co-owners or assignors that BOEM could turn to for coverage of decommissioning liabilities, do not have the option of pursuing a tailored plan for coverage of those liabilities.

5. *Record of Compliance.* BOEM has set forth specific criteria in assessing this factor, including whether any of the energy company's affiliates or subsidiaries have been: (i) assessed civil penalties by BOEM or BSEE; (ii) found by BOEM or BSEE to be non-compliant with any lease, plan or permit term or condition; (iii) cited by any other agency with jurisdiction on the OCS for non-compliance with any regulation; and (iv) cited for non-payment or under-payment of rentals, royalties, interest bills, civil penalties, or inspection fees and such non-payment or over-payment has been referred to the U.S. Treasury for collection within the past five years.⁶

In addition, in evaluating a lessee's or grant holder's financial ability, BOEM may consider other information relevant to those criteria, including transfers of working interests, production payments, and other interests; off balance sheet transactions; contractual defaults; suspensions; debarments and violations of U.S. laws.

C. Whether Self-Insurance is Available Depends on BOEM's Evaluation of the Financial Ability Factors but the Amount of Self-Insurance is Very Limited.

BOEM uses the five factors described in Section B, above, to assess whether the lessee or grant holder is eligible to self-insure some or all of any additional security obligations for a lease, ROW or RUE. However, a lessee's self-insurance may no longer be sufficient for all decommissioning obligations. Unlike waivers, which allowed upwards of 50 percent of an eligible company's net worth to be attributable to decommissioning obligations, under the newly issued NTL, companies may only self-insure *up to* 10 percent of their *tangible* net worth.⁷ This difference between 10 and 50 percent in exemption from security coverage is a gap that all energy companies that previously held waivers may have to fill with additional security if their decommissioning liabilities exceed 10% of their tangible net worth.

With one caveat, assuming that a lessee or grant holder is eligible for a self-insurance amount, then the lessee or grant holder must notify BOEM how it will apportion the self-insurance amount: spread over all its leases, all to one lease, or a mixture of specific leases, ROWs and RUEs. The caveat is that, depending on a lessee's or grant holder's credit rating (as determined when considering the Reliability factor), BOEM may prohibit the lessee or grant holder from using the self-insurance amount on properties where the lessee or grant holder is the only party that could be held liable for decommissioning cost (*i.e.*, there are no co-lessees, co-owners, or assignors). These properties are referred to in the newly issued NTL as "sole liability properties." BOEM has established a minimum credit rating, below which a lender or grant holder will not be able to allocate any of its self-insurance amounts to sole liability properties.⁸

Finally, in the event that the lessee or grant holder believes it was wrongly denied self-insurance, or self-insurance is available but the amount granted is believed to be too low, then the lessee or grant holder has the right to provide "other evidence" that it believes is of "equal relevance" to the factors listed above.⁹

⁶ BOEM may excuse one or more non-payments or under-payments on a case-by-case basis upon submittal of sufficient and reasonable justification of circumstances that prevented timely payment.

⁷ Self-insurance is limited to the lessee's or grant holder's tangible net worth, which means the company's net worth minus any intangible assets such as copyrights, patents and intellectual property. Concerns regarding liquidity, or the ability to turn a lessee's or grant holder's assets into cash for purposes of addressing decommissioning obligations led BOEM to shift to tangible net worth. The amount is not an "all or nothing" zero or 10 percent; rather, it can be anywhere between zero and 10 percent.

⁸ This minimum credit rating will be made available on BOEM's website, together with the financial ability information. See <http://www.boem.gov/Risk-Management/>.

⁹ There is no elaboration on what this "other evidence" might include or how one demonstrates that it has "equal relevance"; the expectation is that it will be unlikely for BOEM to change its determination.

D. What Happens After the Amount of Additional Security Required has been Calculated and BOEM has Determined Whether Self-Insurance is Available?—Notification, Dispute, and Submittal of Additional Security.

Once BOEM has determined 100 percent of the decommissioning liability for each lease, ROW and RUE in which a lessee or grant holder holds an ownership interest, and has further determined whether, and in what amount, self-insurance is available, BOEM must notify lessees and grant holders of the agency's decision. Lessees and grant holders will then have the opportunity to dispute the findings before they must submit the required additional security:

1. *Notice.* BOEM must notify lessees and grant holders in writing of its determination with regard to any additional security required and the availability of self-insurance. With regard to leases, BOEM will notify the designated operator of the lease in writing, and the designated operator is required to coordinate with any co-lessees to provide the amount of additional security required for each lease. With regard to ROWs and RUEs, BOEM will notify the respective holders-of-record in writing. In turn, these respective holders-of-record are required to provide the amount of additional security required for each ROW and RUE, respectively.

BOEM's notification will either (i) propose an amount of additional security required, and give the opportunity to meet with the agency within a specified period of time to discuss this amount; or (ii) order that the required additional security be provided within a specified period of time or, alternatively, that a tailored plan for providing the additional security may be presented to BOEM. However, because sole liability properties present a heightened degree of risk (because decommissioning liabilities are not backstopped by any co-lessees, co-owners or assignors), they are a priority under BOEM's bolstered financial assurance program. Consequently, the tailored plans option is not available to lessees and grant holders of sole liability properties and the additional security for sole liability properties must be provided within the specified period of time as set forth in the notice issued by BOEM. Any order issued by BOEM under the second option described above is supposed to include a separate listing of sole liability properties so that the lessees and grant holders will immediately know which of its leases, ROWs and RUEs do not constitute sole liability properties (as determined by BOEM) and therefore are eligible for additional security coverage under a tailored plan.

2. *Dispute of BOEM's Determination of Proposed Additional Security Required.* A lessee or grant holder has up to 30 days from the date of receipt of BOEM's notification proposing increased security requirements for specified leases, ROWs and RUEs to notify BOEM in writing, that it disputes some or all of the agency's determination. In making such dispute notice, the lessee or grant holder may request a meeting with BOEM to further discuss the dispute. If no dispute notice is submitted to BOEM within the 30-day period, then BOEM will presume that the proposed additional security is acceptable to the lessee or grant holder and issue an order to either provide a specified amount of additional security, or to present BOEM with a tailored plan that meets the additional security requirements (provided the property is not a sole liability property).

As a practical matter, because a lessee or grant holder has only 30 days to challenge BOEM's determination, it is imperative that lessees and grant holders maintain contact with designated operators and ROW and RUE holders-of-record to assure that the lessee or grant holder has ample time to review and assess BOEM's initial notification.

Notwithstanding the 30-day period for protesting a BOEM notification of proposed additional security, a lessee or grant holder may at any time request a reduction of the additional security requirement; however, the lessee or grant holder will be responsible for submitting appropriate evidence and supporting materials to BOEM for the agency's consideration.

3. *Submittal of Additional Security without Use of a Tailored Plan.* After BOEM issues an order to a lessee or grant holder to provide additional security (regardless of whether an initial notification letter and/or meeting with BOEM is held), a lessee or grant holder must meet the following timelines in providing the directed additional security:

- Additional security for sole liability properties: within 60 days of receipt of the order.
- Additional security for leases, ROWs and RUEs other than sole liability properties: within 120 days of receipt of the order (unless other time is specified in order).
- Notice of intent to submit a tailored plan: within 10 days of receipt of the order.
- Submittal of a tailored plan: within the 120-day timeline for leases, ROWs and RUEs other than sole liability properties (unless other time is specified in the order).

Moreover, for purposes of submitting the additional security, the same methods as previously allowed by BOEM continue to be available: surety bonds, pledge of U.S. Treasury Securities, abandonment accounts, third-party guarantees, other forms of security approved by BOEM, or any combination thereof.

E. BOEM has Developed a Phased-In Approach for Providing Additional Security.¹⁰

As set forth under the newly issued NTL, any lessee or grant holder subject to additional security obligations (other than for sole liability properties) has the opportunity to request the ability to phase-in the provision of additional security through the development and implementation of a tailored plan. The financial mechanisms to be used in the tailored plan may be any one or a combination of surety bonds, U.S. Treasury Securities or other financial mechanisms referenced above, or they can be any other type of financial assurance approved by BOEM.

The phase-in timelines remain unchanged from BOEM's September 2015 draft guidance. The lessee or grant holder may phase-in compliance with the additional security requirement in accordance with the following schedule:

- Within 120 calendar days from the date of BOEM approval, provide at least one-third of the remaining required additional security.
- Within 240 calendar days from the date of BOEM approval, provide at least two-thirds of the remaining required additional security.
- Within 360 calendar days from the date of BOEM approval, provide the full amount of the remaining required additional security.

A lessee or grant holder may request variances to the above phasing-in schedule.

If BOEM cannot approve a lessee's or grant holder's tailored plan within 180 days of its submission, BOEM may require the lessee or grant holder to provide the full amount of the required additional security within 30 days of the date on which the 180-day period ends. This 180-day time limit, and BOEM's authority to require additional security within 30 days after such period ends, may have the effect (intended or otherwise) of serving as a "hammer" to force lessees or grant holders to make certain concessions to BOEM that they might not otherwise make, if only to avoid triggering submittal of additional security 30 days after the 180-day period ends.

¹⁰ As previously referenced, lessees and grant holders of sole liability properties do not have the option of pursuing a tailored plan for coverage of additional liabilities.

After a tailored plan is approved, a lessee or grant holder may request that BOEM review and approve a modification of that plan. Pending the decision on such a request, the lessee or grant holder must adhere to its approved plan and timetable for compliance.

F. Failure to comply may result in penalties as well as lease cancellations and suspensions.

Under the OCSLA, BOEM's issuance and continuance of leases to explore for, develop and produce oil, natural gas and sulfur are conditioned on compliance with regulations implemented pursuant to the act. A failure to comply with supplemental bonding obligations is a violation of OCSLA's implementing regulations. The statute and regulations provide the following potential consequences for such non-compliance:

1. *Suspension/temporary prohibition* – OCSLA allows for suspension or temporary prohibition of operations if there were a threat of serious, irreparable, or immediate harm or damage to life, property, mineral deposits, or the marine/coastal/human environment. It is likely the government would take the position that supplemental bonding to provide for future decommissioning obligations is meant to address such a threat to safety and the environment, and therefore the government could seek suspension under this provision for failure to provide the required bonding. By regulation, BSEE may direct a suspension of operations or a suspension of production, either in response to a threat of harm, or in response to a failure to comply with any law, regulation, order, or lease provision.
2. *Disqualification as operator* – BOEM may revoke an energy company's designation as operator for a single facility or multiple facilities for unacceptable operating performance. Among the factors BOEM uses to determine unacceptable performance is "failure to adhere to OCS lease obligations" and "any other relevant factors." Prior to disqualification, an operator must be provided with notice and an opportunity for review by BOEM officials.
3. *Lease cancellation (for probable serious harm or damage)* – OCSLA authorizes lease cancellation if, after a hearing, the government determines that (i) continued activity would probably cause serious harm or damage to life, property, minerals, national security, or the marine/coastal/human environment; (ii) the threat will not dissipate to acceptable levels within a reasonable period of time; (iii) the advantages of cancellation outweigh the advantages of a continued lease; and (iv) the lease has been suspended or temporarily prohibited for at least 5 years. As a practical matter, the 5-year suspension requirement likely renders this mechanism unlikely.
4. *Lease cancellation (for any non-compliance)* – BOEM may seek to cancel a producing lease for any non-compliance with OCSLA, its regulations, or the lease by pursuing an action in federal district court.
5. *Civil penalties* – Non-compliance with OCSLA, its regulations, and lease terms can result in civil penalties, after notice, of up to \$20,000 per day (subject to inflationary adjustments). For some violations, penalties do not begin to accrue until the expiration of a corrective action period.

BOEM's bonding website contains a table of proposed civil penalties for non-compliance with bonding requirements. This table provides that failure to submit a required bond or to make an incremental payment required by BOEM may result in a \$1,000 penalty for the first week, an additional \$2,500 per week for the second and third weeks, and \$1,000 per day after three weeks. Penalties are doubled each time there is an additional violation within the previous two calendar years, up to a maximum of \$30,000 per day.

6. *Other remedies* – OCSLA provides for temporary restraining orders, injunctions, or other appropriate remedies to enforce any OCSLA provision, regulation, or lease. It also provides criminal penalties for knowing and willful violations.

Conclusion.

BOEM has developed a much more rigorous process for calculating and assessing additional security for assuring satisfaction of an energy company's offshore decommissioning liabilities. This may result in gaps in a company's existing financial assurance coverage, resulting in the imposition of additional financial assurance requirements. Energy companies, save and except those operating on sole liability properties, will have the opportunity to provide their additional financial assurance over a 360-day period through the development and implementation of a BOEM-approved tailored plan. Failure by lessees and grant holders to comply with these newly imposed requirements for additional security may well result in the imposition of penalties or suspension and ultimately cancellation of the leases, ROWs and RUEs in which the parties hold a legal interest.

For further information on this topic, or if there is a need to discuss additional security issues, please contact Vinson & Elkins lawyers Larry Nettles, Larry Pechacek, George Wilkinson or Brandon Tuck.