SFAA THE SURETY & FIDELITY ASSOCIATION OF AMERICA

August 21, 2023

Ms. Kelley Spence
Office of Regulations
Department of the Interior, Bureau of Ocean Energy Management
45600 Woodland Road, Mailstop VAM–BOEM DIR
Sterling, VA 20166

Re: Bureau of Ocean Energy Management Docket No. 2023-0027 Risk Management and Financial Assurance for OCS Lease and Grant Obligations, RIN 1010-AE14

Dear Ms. Spence:

The Surety & Fidelity Association of America ("SFAA")[1] appreciates the opportunity to provide written comments, in addition to our virtual meeting two weeks ago, regarding the proposed Regulations entitled Risk Management and Financial Assurance for OCS Lease and Grant Obligations (the "Proposed Regulations").

1. <u>The entire value of decommissioning obligations should be subject to financial assurance requirements for all lessees.</u>

BOEM and the US taxpayers would benefit from requiring all lessees to provide financial assurance covering the entire value of decommissioning obligations without exception. Such should be the case regardless of credit rating or the point-in-time value of the reserves associated with a given lease. Furthermore, bonds should be required whenever a lease transfers in both the ordinary course of business and as part of a bankruptcy matter. This would be a much more equitable, sustainable system.

As currently proposed, the financial assurance requirements continue to be a form of adverse selection against the financial assurance provider, including sureties. Granting exceptions to the posting of financial assurance for certain "creditworthy" lessees based on assessing which assets will likely be purchased and assessing the lessee's financial ability to perform its ultimate decommissioning requirements is a form of adverse selection against financial assurance providers. Further, these criteria, standing alone, are not reliable metrics for measuring the totality of the risk to BOEM – and, ultimately, the U.S. taxpayers – of whether the lessee will be able to meet its decommissioning obligations.

[1] SFAA is a non-profit, national trade association of more than 400 companies that write 98 percent of surety and fidelity bonds in the United States. SFAA is licensed as a rating or advisory organization in all states and is designated by state insurance departments as a statistical agent for the reporting of surety and fidelity experience. SFAA members provide the vast majority of bonds that secure regulatory obligations.

The problem is further exacerbated by the fact that, as noted in BOEM's commentary regarding the Proposed Rules, the financial position of lessees and commodity prices can change rapidly. It is not clear what the measurement date of the calculation of the value of reserves versus decommissioning costs will be, nor is it clear how frequently this measurement will be monitored. Though this is unclear from the Proposed Regulations, BOEM advised during our meeting it plans to review these two metrics annually at a minimum.

Further, it is unclear whether or how a lessee operating under a current permit that does not at some point meet the financial or proven reserve valuation requirements would be impacted. Would such a lessee be prohibited from continuing to operate until financial assurance is posted?

SFAA generally agrees that BOEM should eliminate Director discretion in determining which lessees in the Gulf of Mexico need to post supplemental financial assurance. As a result of the Director's discretion, BOEM's inconsistent enforcement of its existing regulations is improper and causes uncertainty for all stakeholders. For these reasons, SFAA recommends that BOEM require supplemental financial assurances of all lease operators.

2. SFAA also suggests that the blanket bond should be increased.

Based on the amount of time that has passed and inflation experienced since the last revisions, which required $3 million bonds, SFAA recommends an increase to the blanket bond amount. This will serve to provide blanket protection across all wells and can act as a partial backstop should decommissioning costs exceed supplemental bond amounts.

3. Surety appetite has already been restricted due to recent changes in the marketplace. BOEM's Proposed Regulations will result in an even more limited appetite amongst the industry and potentially more stringent terms where a surety appetite remains.

Given BOEM's current and proposed positions and the fact that BOEM has continued to allow some current lessees to operate without providing financial assurance, there will be even less of an appetite within the surety industry to provide financial assurances that lease operators will perform their decommissioning obligations. Moreover, it is unlikely that whatever appetite would exist will be in the aggregate amounts contemplated in the proposed rule, making commercial implementation of the Proposed Regulations unlikely through surety bonds alone.

Each surety member underwrites accounts independently and determines its terms and conditions for providing such financial assurance on an instrument that is non-cancellable unless replaced by acceptable alternative security or paid in full. Further, given BOEM's position that wells or fields that are subject to lease will only require financial assurance when the proven reserves are less than three times BOEM's estimated costs of decommissioning, SFAA would expect that lessees that are required to post bonds would be required to post collateral with the sureties to fund the newly required obligations as a result of BOEM's proposed rule and for both the existing BOEM bonds and private obligation bonds that have been written on behalf of a lessee to a named record chain title holder ("Private Bonds"); the percentage of collateral required would be subject to each individual surety's underwriting appetite for such obligations.

It is unknown whether the oil and gas operators will retain sufficient ability to provide such collateral to the sureties in support of the new and existing obligations. Given that "less" (relatively speaking) creditworthy lessees will necessarily have restricted access to capital and would be the ones subject to the proposed financial assurance requirements, having their capital tied up in collateral obligations will present a substantial burden on these operators and likely lead to more financial failures. Such financial failures will have cascading negative impacts that undermine BOEM's stated purpose of increasing access to these bonds and alleviating the burden on the taxpayer. For a sense of magnitude, the surety industry supports $2.93 billion of financial assurance with BOEM as beneficiary. This does not include Private Bonds, which are estimated to be at least as much, if not more, in amounts outstanding than those bonds written with BOEM as beneficiary.

a. **Surety industry cannot use pricing to improve the economics of this marketplace, particularly due to the nature of the Proposed Regulations being steeped in adverse selection.**

The Proposed Regulations estimate surety bond pricing to range from 2% to 12% based on BOEM's new framework contemplated therein, but sureties do not price based on expected loss levels. Unlike insurance, where risk is pooled and premium calculated to cover the anticipated losses from the risk profile of the policyholders in the pool, surety companies underwrite risks based on an expectation of zero losses. This is the reason the Proposed Regulations are considered to be adverse selection against the surety, where only the riskiest accounts and leases are required to post security for decommissioning obligations. SFAA respectfully recommends all lessees be required to post security at any time the lease is transferred to that party, whether in the ordinary course of business or as part of a bankruptcy matter, as suggested earlier in these comments.

4. **Respectfully, BOEM evaluating a lessee's ability to meet their decommissioning obligations using the proposed methodology would be flawed and outside the scope of BOEM's purpose as a regulatory body. Financial assurance providers are better suited than BOEM to evaluate a lessee's risk of default on its decommissioning obligations.**

SFAA takes exception to certain aspects of the methodology described in the solicitation for comments of the Proposed Regulations, and there is one reference to Moody's ratings in the proposal, which is inconsistent. Specifically:

a. Regarding the proposed use of an Issuer Credit Rating (Page 42146 VI. A.), we agree that credit statistics support a lower probability of default with investment grade companies (sureties typically include third-party-provided credit ratings as part of the underwriting process). However, the inherent volatility in the oil & gas industry can, and has, resulted in circumstances where exploration and production companies received multiple notch downgrades at once and/or quickly moved into bankruptcy. This occurred in 2015 when we witnessed a dramatic increase in multi-notch (as many as five notches) downgrades, distressed bond exchanges, and bankruptcies. As both BOEM and the surety industry have experienced, bankruptcies can lead to defaults on existing and future decommissioning obligations that ultimately result in bond claims and/or

losses borne by the taxpayers. Further, some companies, including those emerging from bankruptcy proceedings, will have an investment grade rating that nevertheless may be insufficient to demonstrate the financial wherewithal of the lessee to fulfill its decommissioning responsibilities. These aspects of credit ratings support the conclusion that any system where certain lessees are exempted from financial assurance requirements will result in extensive losses by US taxpayers and financial assurance providers.

Further, BOEM's use of NRSRO credit ratings and private company equivalent ratings as one of two criteria for determining exemption status is over-reliant upon NRSRO credit rating agencies. This overreliance, especially upon the private company equivalent ratings, may create strong incentives for market participants to game the model, as they did with rating agency models in the lead-up to the 2007-2009 financial crisis (see John Soroushian's 2016 brief, "Credit Ratings in Financial Regulation: What's Changed Since the Dodd-Frank Act?"[2]; and see Gretchen Morgenson and Louise Story's 2010 New York Times article, "Rating Agency Data Aided Wall Street in Deals").[3]

To be clear, sureties utilize NRSRO credit ratings to augment their analyses. However, BOEM's significant reliance upon credit ratings as one of only two evaluation tools is improper and is a primary reason why SFAA maintains exemptions are inappropriate.

b. On page 42146 (part of Section VI.A) and elsewhere in the proposal, there is reference to utilizing a third-party credit model to generate proxy ratings for companies that lack an external credit rating. This proposal is another example of an effort to construct an adverse selection system that will result in expenditures by the US Taxpayer. The surety industry has and continues to use internally created and externally provided credit models for non-rated companies well. The general surety industry experience has been that implied credit ratings change frequently and dramatically. One factor contributing to the differences between external credit ratings and ratings provided through a credit model is the size of the company as measured in equity. If BOEM implements this proposal, we suggest that rules be modified such that a minimum net worth of some multiple of total decommissioning obligations be required, in addition to the credit rating.

c. In Section VI. and elsewhere in the proposed rulemaking, where BOEM provides for exemptions for certain lessees and leases based on Issuer Credit Rating or third-party credit model, the Government and ultimately US Taxpayers are unnecessarily taking on the risk of decommissioning obligations. SFAA contends that the purpose of BOEM is not to underwrite and assume risk on behalf of U.S. taxpayers in the normal course such as a surety company, but rather to enforce the rules and regulations. BOEM's evaluation criteria for exemptions is too simplistic and thus will inevitably lead to taxpayers footing the bill when an exempt lessee cannot meet its

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[2] Soroushian, J. (2016, April 22). Credit Ratings in Financial Regulation: What's Changed Since the Dodd-Frank Act? FinancialResearch.gov. Retrieved August 24, 2023, from https://www.financialresearch.gov/briefs/2016/04/21/credit-ratings-in-financial-regulation/

[3] Rating Agency Data Aided Wall Street in Mortgage Deals. GRETCHEN MORGENSON and LOUISE STORY. NYT April 23, 2010. http://www.nytimes.com/2010/04/24/business/24rating.html

decommissioning obligations. The oil and gas industry is so volatile that even the healthiest of operators one day can become financially distressed the next, and the credit ratings of an entity are only a small piece of its overall ability to meet the decommissioning obligations.

The oil and gas commodities markets have exhibited significant volatility in recent years. This volatility has driven quick and dramatic changes to both reserve values – which fluctuate daily with price – and credit ratings for operators. In pricing environments such as 2014 and 2020, pricing largely made the Gulf of Mexico basin non-economic. Were BOEM's proposed rules in effect during those times, most of the leases that would be afforded an exemption by BOEM under the Proposed Regulations would have been non-compliant on a 3:1 reserve value to decommissioning evaluation. Should BOEM have performed a point-in-time evaluation and determined that leases were non-compliant with the Proposed Regulations, it would have required financial assurance for those leases during a period where there would have been no appetite from any financial assurance provider to bring the lease into compliance. This would have placed the taxpayers at tremendous risk should pricing not have improved. Similarly, should BOEM have waited to evaluate the reserve value to decommissioning amounts on an annual basis, it would have put taxpayers at risk during the downcycle pricing event without having required financial assurance for the leases that would have been non-compliant on a point-in-time basis. As such, BOEM's proposed use of reserve valuations effectively puts the taxpayer at risk on a basis that is subject to an industry's volatile commodity pricing environment, backed by the taxpayer assuming risk.

Surety bonds transfer taxpayer risk to entities that provide stable credit strength independent from the sector that BOEM is regulating, and that has independent governmental regulations governing capital standards, pricing, and conduct. SFAA respectfully submits that financial assurance providers like sureties are better positioned than BOEM to underwrite these risks to ensure that U.S. taxpayers are protected.

5. <u>Many open questions remain for SFAA and its members with the Proposed Regulations.</u>

a. It appears that BOEM will no longer require the initial lessee to provide financial assurance or guarantee once the lease is assumed by a new lessee that either qualifies to operate without financial assurance or posts its own financial assurance. Since several leases are being drilled with BOEM relying on the guarantee of current lessees and predecessor lessees, it seems some of the "private bonds" (where current lessees provide security to a predecessor lessee) would no longer be required. What is the timeframe for reducing the guarantee of the original lessee? For example, would that guarantee by a predecessor be reduced over a three-year period, just as the proposed requirement is for the current lessee to provide financial assurance over a three-year period? Has BOEM factored "private bonds" written between the transferring parties where the new lessee provides assurances to the predecessor in its decommissioning liabilities calculations?

b. How will BOEM proceed if an operator fails to meet its decommissioning obligations? Will BOEM first seek recoveries from the predecessors on the lease and/or will it proceed against the bonds

posted by the predecessors, or will it first pursue the current lessee? This is critically important for the sureties to understand when underwriting lease operators and the Gulf of Mexico lease marketplace generally, specifically whether to continue to write in this space or how to change the terms under which they will continue to write bonds for lease operators.

c. We further understand that existing lessees who need to post financial assurance can provide the financial assurance over a three-year period, but the proposal does not indicate what happens when a lessee who had previously qualified to operate without providing financial assurance at your measurement date ceases to qualify at some point in the future. Will there be a specific timeline for posting the additional assurance in the case of a lessee experiencing a downgrade at some point in the future? If a lessee experiences credit rating fluctuations while utilizing the three-year ramp-up, what happens to the financial assurances they provided?

d. What would happen to the lease if a lessee was unable or unwilling to post financial assurance as required by BOEM while operating under a current lease? Based on SFAA's meeting with BOEM, it is our understanding that BOEM will still have all of its current rights available to it where a lessee fails to meet its obligation to post supplemental financial assurance.

e. How will the financial assurance amount be calculated? Will financial assurance calculations consider any additional private security (e.g. Private Bonds, decommissioning escrow funds, letters of credit, etc.) guaranteeing decommissioning performance provided by a current lessee in favor of a predecessor lessee?

f. How frequently will BOEM require lessees and individual leases to be evaluated? Does BOEM intend to standardize reserve assessments and measurements? BOEM expects companies to have reserve information as a matter of general operations – will BOEM have any verification mechanism?

g. Will a "negative event" (Section 556.903) continue to be the bankruptcy, insolvency, or suspension or revocation of the charter or license of the financial assurance provider?

h. If a lessee appeals BOEM's demand to require financial assurance, per Section VIII of the proposed rules (page 42148) BOEM would require an appeal bond (referred in the Proposed Rules as "appeals bond"), and the Proposed Regulation indicates "if the appeal is unsuccessful, the appeals bond could be replaced or converted into bonds to cover the supplemental financial assurance." Would such a conversion be required by the surety providing the appeal bond? We request that such a requirement be at the option of the surety, understanding that the lessee would need to provide financial assurance in some form.

i. In the event a surety allowed forfeiture of a bond in an amount demanded by BOEM (in accordance with 556.902(a)(3)), which is in an amount less than the amount of the bond, would BOEM be able to make a further "forfeiture demand" on the balance of the bond? We see reference to a surety being able to avoid forfeiture if the surety agrees to complete corrective

action even if the amount of such corrective action exceeds the amount of the financial assurance. We also see that any amount forfeited by the surety not utilized to fund the corrective action is returned to the entity that paid BOEM. The question is whether, when the amount of forfeiture is less than the bond amount, BOEM can make further claims?

j. BOEM's proposed second criterion to evaluate the requirement of supplemental financial assurance based on "a 3 to 1 ratio of the value of proved oil and gas reserves on a lease to the decommissioning liability associated with these reserves" leaves open the option to Lessee to abandon certain infrastructure and equipment in bankruptcy. This creates a decommissioning liability for either a predecessor, provider of financial assurance (such as a surety), or the government. Recent offshore bankruptcies show that sophisticated financial parties will use existing bankruptcy law to abandon obsolete equipment and sell proven reserves to new entities. To remove the incentive that exists in the current law, BOEM should implement an accountability program similar to the Applicant Violator System administered by the Office of Surface Mining (OSM) in the coal industry. Such a program should bar any officer from being employed in the oil and gas industry whose company does not fulfill a decommissioning obligation. An effective program that holds individual oil and gas company officers accountable for transferring oil decommissioning costs to predecessors, the government, or other third parties will reduce the incentive to abandon offshore infrastructure.

k. BOEM's Proposed Regulations are intended to provide greater protection to taxpayers – not predecessor lessees. In the Proposed Regulations, BOEM states, "BSEE and BOEM regulations hold predecessors and current co-lessees responsible for decommissioning when a current lessee is unable to perform." The Proposed Regulations further state that, "the proposed rule would retain the authority to pursue predecessor lessees for the performance of decommissioning." However, BOEM is silent as to how and when the required financial assurance will be called upon. Without knowing the order of attribution of when the financial assurance is required to be utilized to fund decommissioning activity it provides an extreme amount of uncertainty to those parties being asked to provide the financial assurance on behalf of lessees. When will the taxpayer, vis-à-vis BOEM and BSEE, perform the decommissioning activities when a lessee fails to do so? Will BOEM require available co-lessees and predecessor lessees to perform decommissioning prior to BOEM/BSEE performing the decommissioning? When will financial assurance be called upon to fund decommissioning? For sureties to adequately understand the risk they are underwriting, there needs to be consistency in application. While SFAA understands BOEM's desire to retain flexibility, this is not something that can be done on an ad hoc, case-by-case basis if BOEM wants these bonds to be reasonably available in the marketplace.

Secretary's Order 3299, which gives BOEM the authority to manage the Nation's offshore energy and mineral resources, also gives the Bureau of Safety and Environmental Enforcement (BSEE) authority to enforce lessee decommissioning obligations. How often does BOEM review BSEE's Incidents of Non-Compliance (INCs) records and its Increased Oversight List? Can BOEM provide documentation of BSEE referrals of unacceptable performance that resulted in BOEM action? Surety evaluates bonding opportunities based, in-part, on the information BSEE and BOEM provide

about well-operations and operators. Recent bankruptcy proceedings involving Cox Operating revealed a situation where Cox had received multiple warnings of decommissioning responsibility violations over an extended period of time. Without this kind of information being readily available, surety carriers could find themselves offering additional financial assurances to otherwise unworthy operators that they would not have otherwise bonded. Have BOEM and BSEE worked out a more responsive and transparent violations reporting paradigm?

6. **SFAA recommends several specific clarifications and revisions within the language of the Proposed Regulations.**

a. **Page 42147.** It is our understanding that BOEM will assess the need for a lessee to post financial security annually, though this is not specified in the Proposed Regulations. The Proposed Regulation should so specify.

b. **Page 42147.** On page 42147 (part of Section VI.A) indicates that non-publicly traded companies do not have credit ratings. In fact, some non-publicly traded companies do have credit ratings, and some publicly traded companies do not.

c. **Section 556.901(d)(2).** On page 42152 (part of Section X "Section-by-Section Analysis"), BOEM discusses Section 556.901(d)(2) and references credit ratings of BBB- from S&P or Ba3 from Moody's. This reference to Moody's should be changed to Baa3, which is the equivalent of S&P's BBB- credit rating and consistent with the other credit ratings references in the proposed rulemaking.

d. **Section 556.906.** We appreciate BOEM's effort to add clarity by replacing the word "terminated" with "canceled" in paragraph (b)(1) (As stated on page 42155 of the Proposed Regulations, the term "terminated" will be replaced by "canceled.") However, we believe the term "terminated" should also be replaced by "canceled" in paragraph (b)(3). This would make that section, which refers to "additional bonds" (as opposed to the base bonds), consistent with the wording referencing the base bonds.

e. Appeal Bonds. The Proposed Regulations currently specify that an appeal bond will automatically convert to a financial assurance obligation should the lease operator lose its appeal. However, appeal bonds do not operate in this manner. The appeal bond should provide a certain number of days for the lease operator to post its financial assurance to allow the surety to underwrite the operator at the time said bond is needed. Importantly, the obligations under the financial assurance bond relate to the operator's decommissioning obligations while the appeal bond guarantees that the operator will meet BOEM's requirements for it to post security for the decommissioning obligations under the lease.

7. **Responses to Additional Comments Solicited by BOEM**

SFAA submits the following responses to BOEM's requested comments on the topics below:

a. "BOEM is considering the inclusion of offshore joint and several decommissioning liabilities (of the co- lessees that would otherwise have exempted the lessee from providing supplemental financial assurance) in the determination of a proxy credit rating when these liabilities are ''disproportionately high'' and may encumber that co-lessee's ability to carry out future obligations. BOEM is requesting comments on the appropriate criteria to determine what constitutes ''disproportionately high'' offshore liabilities, for example, a ratio of decommissioning liabilities to the net worth of the co-lessee above X times, or other financially significant and reasonable criteria on how these liabilities should best be incorporated into the proxy credit rating that BOEM will derive."

BOEM is seeking to modify credit ratings in a unilateral way utilizing an unregulated and undefined manner. SFAA discourages BOEM from doing so. Please refer to SFAA's broader comments to this effect in section 3 of its comments herein. SFAA reiterates that section in its entirety in response to this direct request for comment from BOEM.

b. "The use of End-of-Life (Years) in the evaluation of asset value as an alternative to using the decommissioning costs ratio. BOEM requests comments on the use of a minimum number of years of production remaining criterion to qualify for an exemption from supplemental financial assurance. Possibly, End-of-Life criteria could be an alternative to the 3:1 ratio of value of reserves to decommissioning costs."

BOEM is seeking to modify credit ratings in a unilateral way utilizing an unregulated and undefined manner. SFAA discourages BOEM from doing so. Please refer to SFAA's broader comments to this effect in section 3 of its comments herein. SFAA reiterates that section in its entirety in response to this direct request for comment from BOEM.

c. "The consideration of bond issuance ratings, in addition to issuer credit ratings, in determining the financial risk posed by lessees and grant holders. BOEM also invites comments on determining an appropriate threshold for bond issuance ratings, such as general unsecured debt ratings."

Bond issuance ratings are specifically for one tranche of security and are unique to the underlying offering associated therewith. It is therefore not applicable to the overall credit health of an entity. Therefore, it should be taken into consideration as an indicator of credit health, but not serve as a proxy to an overall credit rating.

BOEM is seeking to modify credit ratings in a unilateral way utilizing an unregulated and undefined manner. SFAA discourages BOEM from doing so. Please refer to SFAA's broader comments to this effect in section 3 of its comments herein. SFAA reiterates that section in its entirety in response to this direct request for comment from BOEM.

d. "Should BOEM exclude third-party guarantors from the requirement of § 556.902(a)(3) that guarantees must ''guarantee compliance with all obligations of all lessees, operating rights, owners and operators on the lease'' in addition to allowing a third- party guarantee to be limited in amount?"

No. If a third-party meets the U.S. government's regulatory requirements for conducting activity and assuming risk in the normal course then BOEM should not intercede with any limitation other than those required by the applicable regulatory body whose responsibility it is to regulate such a third-party.

Though well intended, SFAA fears the Proposed Rule might have unforeseen and possibly negative consequences. Requiring additional financial assurances from those lessees least able to provide it might result in increased collateral demands and downward pressures leading to an uptick in bankruptcies among small, independent operators – ultimately worsening unfunded decommissioning liabilities. Additionally, because the underlying asset – in this case well revenue – isn't apt to change, the Proposed Regulations would alter the environment such that not only would surety be unlikely to supply the additional coverage without significant, and in most cases, unavailable collateral from lessees, it would create a need for surety to reassess current contracts which could result in additional collateral demands. Given the increased risks in the market created by recent bankruptcy rulings, the Proposed Regulations could have an even stronger chilling effect on surety's appetite to participate. As is, players are already exiting the marketplace, further exacerbating capacity concerns.

Protecting taxpayers from shouldering the burden of decommissioning costs is a valid and worthwhile endeavor. SFAA remains open and willing to work with BOEM to find a way for the Proposed Regulations to achieve that goal.

Thank you for your consideration of our comments. We look forward to hearing further from you.

Respectfully submitted,

Julie Alleyne
Vice President, Policy & General Counsel
The Surety & Fidelity Association of America
JAlleyne@surety.org
202.778.3630