ENERGY REGULATORY UPDATE

States and Industry Groups Sue to Block BOEM's Tougher Financial Assurance Requirements for Offshore Oil and Gas Operations

By Logan Johnson, Lori Arakaki, Liz Pursley, and Matthew Hilley

The U.S. Department of the Interior has long wrestled with how to manage the risk associated with the costly decommissioning of offshore oil wells in federal waters. In recent years, the Department has released, revised, and superseded its own guidance on the amount of financial assurance oil and gas companies operating on the Outer Continental Shelf (OCS) should post.

On April 15, 2024, the Department's Bureau of Ocean Energy Management (BOEM) announced a long-awaited final rule, titled "Risk Management and Financial Assurance for OCS Lease and Grant Obligations" (the "Rule"), that took effect on June 24, 2024.[1] One of the main features of the Rule is a change to the way BOEM determines which lessees (and grant holders) are subject to posting additional surety bonds beyond the minimum required of all lessees. Under the Rule, BOEM only considers the financial stability of the current lessee and any co-lessees. If no current lessees have investment-grade credit ratings and the property does not have a sufficient level of oil and gas reserves, the current lessees must post supplemental financial assurance. This alters BOEM's prior practice of exempting lessees from supplemental bond requirements where there are predecessors in the chain of title who can share the burden of decommissioning costs.

According to BOEM, the changes are necessary to "ensure that energy companies… operating in publicly owned federal waters are able to fulfill their clean-up and decommissioning responsibilities, without taxpayers having to step in to foot the bill."[2] The Rule "reinforce[s] that current grant holders and lessees" cannot "rely[] on prior owners to cover th[e] costs" of decommissioning.[3] BOEM estimates the Rule will require companies to post $6.9 billion in new supplemental financial assurance.[4]

Opponents say the surety market cannot support the Rule's significant expected bond requirements. Because bonds will be unavailable or prohibitively expensive, those opponents say the Rule places an undue, unnecessary, and possibly fatal financial burden on smaller producers, effectively cornering the market for larger ones. Indeed, shortly after the Rule was announced, the Gulf States of Texas, Louisiana, and Mississippi, along with several oil and gas trade associations, jointly challenged the rule's legality in the U.S. District Court for the Western District of Louisiana (*State of Louisiana, et al. v. Haaland, et al.,* Case No. 2:24-cv-00820 (W.D. La.)).[5] That challenge is still in its infancy.

While it remains to be seen whether the Rule will withstand legal challenges—as well as changes to the regulatory and political landscape that may be ushered in with the new administration—large and small producers alike should be prepared to adapt to the Rule's new re quirements.

The Financial Assurance Rule

The Rule seeks to strengthen the backstops available to pay for offshore decommissioning before taxpayers are on the hook. Major changes include:

- Setting forth a framework for determining which companies must post supplemental financial insurance
- Codifying the formula for determining how much must be posted
- Requiring appeal bonds

The Rule retired the five-factor analysis and consideration of joint liability. It streamlined BOEM's evaluation to two criteria:

(1) A company's or its co-lessees' credit rating

(2) The value of known remaining oil and gas reserves, referred to as proved reserve

Who is Exempt from Posting Supplemental Financial Assurance. BOEM's existing regulatory framework for ensuring that lessees can cover post-operation liabilities (such as decommissioning) requires two forms of financial assurance: base and supplemental. All OCS producers are subject to base bond requirements.[6] The amounts are set by regulation and are calculated on a lease-specific or area-wide basis (e.g. Gulf of Mexico) based on level of activity (e.g. no approved activity, exploration plan, etc.).[7] Some OCS producers are also required to post supplemental financial assurance.

Under BOEM's pre-Rule guidance, regional directors were to decide whether to require supplemental security by considering five factors about the lessee:

- Financial capacity
- Projected financial strength
- Business stability
- Record of compliance with existing rules and regulations
- Reliability

In practice, producers were categorized into two tiers—high and low risk—based on the producer's financial strength or expected "likelihood of nonperformance of obligations."[8] BOEM's regional directors then considered whether the property was a "sole liability" one, meaning there were no "jointly and severally liable part[ies] (e.g. a predecessor lessee…)." [9] Supplemental assurance was only required if the lessee had a high risk of financial failure *and* the property was a sole liability one.[10] In other words, even financially weak producers were exempt from supplemental bonding requirements if they had predecessor lessees in the chain of title.

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If any lessee has an investment-grade credit rating, or the property has a sufficient level of proved reserves ($3 for every $1 in decommissioning liability), the lessee is exempt from supplemental security requirements. The existence (and financial strength) of predecessor lessees is irrelevant. In adopting this one-size-fits-all approach, BOEM rejected the option of setting a lower supplemental bonding requirement for lessees with financially strong predecessor lessees, as BOEM had suggested in a 2020 proposal jointly prepared with BSEE.

Small, independent producers will look to partner with larger ones with investment-grade credit in order to avoid the Rule's supplemental financial assurance requirements. Larger producers may find opportunities to partner or take over lease interests from smaller producers at prices they would not otherwise see without the Rule.

How Much Supplemental Financial Assurance Must Be Obtained. The Rule additionally codifies the use of probabilistic estimates based on industry-reported expenditure data (publicly available here) from BOEM's sister agency, the Bureau of Safety and Environmental Enforcement (BSEE), to establish the amount of supplemental financial assurance that must be posted.[12] Under the Rule, the supplemental bond must be sufficient to cover a P70 probabilistic scenario, meaning the financial assurance is expected to have a 70% likelihood of satisfying the full cost of decommissioning. This codification provides increased certainty to companies evaluating the cost of acquiring a lease or grant or continuing to operate one.

Appeal Bonds. The Rule also requires that companies "seeking to stay a supplemental financial assurance demand pending appeal must, as a condition of obtaining a stay of the order, post an appeal bond in the amount of supplemental financial assurance required."[13] In practice, this likely means a company that cannot afford to obtain supplemental security will also be unable to post an appeal bond.

Litigation will likely ensue to determine the effect of the Rule on indemnification and risk allocation provisions, and, in particular, whether BSEE should require jointly and severally liable predecessor lessees to cover decommissioning costs before calling supplemental bonds.

Legal Challenges to the Financial Assurance Rule

On June 17, 2024, state and industry parties challenged the legality of the Financial Assurance Rule in *Louisiana v. Haaland,* filed in the Western District of Louisiana. They are seeking equitable relief from BOEM's action in the form of an order declaring the Rule unlawful, as well as an injunction preventing BOEM from implementing the new regulations.

The plaintiffs argue that BOEM has far exceeded its statutory authority in promulgating the Rule. They say the Rule is unnecessary in light of the well-settled and long-standing practice of holding all leaseholders in the chain of title jointly and severally liable for future decommissioning costs.[14] According to the plaintiffs, "BOEM is asking small and mid-size companies to acquire financial assurance from surety companies to bail out the major[] [companies] from liability" those larger companies had assumed when assigning leasing rights to the small and mid-size companies.[15]

BOEM, for its part, says that the Rule "does not change or undermine joint and several liability" for predecessors.[16] BOEM maintains that it has "authority to pursue predecessor lessees for the performance of decommissioning."[17] But the plaintiffs contend the Rule omits a key clarification: whether BSEE will "call supplemental bonds" before *or* after BSEE attempts "to require all predecessor lessees to cover decommissioning costs."[18] This critical distinction will affect the cost and availability of financial guarantees, as well as estimations of the cost to acquire or continue to operate leases and grants, which in turn will affect negotiations for such assignments.[19]

The plaintiffs also contend that the government's risk assessment is overstated, and therefore the Rule is unnecessary. They say the "government has almost never paid [] decommissioning liabilities" in the 75-year history of offshore leasing.[20] According to the complaint, the government has assumed only "0.3% of the $17 billion in decommissioning costs associated with lessee bankruptcies since 2009."[21]

Beyond being unnecessary, the plaintiffs contend the Rule will be counterproductive, too. They point to a cascading effect of negative financial consequences they say will bankrupt small and mid-sized independent companies, leading to even more "orphaned properties" and "unpaid decommissioning obligations."[22] The plaintiffs argue the bond market cannot support BOEM's estimated $6.9 billion in newly required assurance.—and, even if it could, the cost would be too high for small and mid-size producers to sustain.[23] The result, plaintiffs say, will be a spate of bankruptcies, ultimately culminating in "a decrease in production of about 55 million barrels of oil from the Gulf of Mexico over a ten-year period," which will "destroy 36,000 jobs, prevent the payment of $573 million in royalties to the U.S. Treasury, … and cause a GDP decline of $9.9 billion."[24]

Industry Impacts

The Rule—if it withstands legal challenges and changing political tides—is sure to have market-wide impacts. BOEM calculates that the "$6.9 billion in additional bond demands" it anticipates issuing pursuant to the Rule will cost the industry approximately $559 to $570 million in annual compliance costs.[25]

Those compliance costs will likely impact the size and composition of the pool of operators capable or willing to operate on the OCS. By BOEM's measure, "391 companies with ownership interests in OCS leases and grants," of which approximately 271 or 69 percent are characterized as small businesses, will be affected by the expected supplemental assurance requirements.[26] By some accounts, independent producers develop 90% of the nation's oil wells and account for 54% of America's oil production.[27] Those smaller producers without investment-grade credit, or those with limited financial resources, may find it challenging to remain in (or further penetrate) the market. New small, independent producers will be unlikely to enter the market given significant costs to do so, effectively stifling competition.

The Rule is also likely to change the makeup of operating partnerships. Small, independent producers will look to partner with larger ones with investment-grade credit in order to avoid the Rule's supplemental financial assurance requirements. Larger producers may find opportunities to partner or take over lease interests from smaller producers at prices they would not otherwise see without the Rule.

Negotiations for and contractual language concerning decommissioning liability risk allocation—already fiercely debated—are likely to become even more contentious and protracted, resulting in more detailed provisions. Operating partners large and small should not only carefully negotiate indemnification language, but should look for creative solutions to address the cost of decommissioning. Litigation will likely ensue to determine the effect of the Rule on indemnification and risk allocation provisions, and, in particular, whether BSEE should require jointly and severally liable predecessor lessees to cover decommissioning costs before calling supplemental bonds.

The Rule as it stands will undoubtedly have widespread effects on the OCS oil and gas industry. Producers have some time to adjust to the Rule's new requirements over a three-year phase-in period.[28] And while it remains to be seen whether legal challenges or the new administration will alter the Rule, the industry should be prepared to address the changes it brings.

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Endnotes

1 *See generally* 89 Fed. Reg. 31544 (Apr. 24, 2024).
2 U.S. Department of the Interior, Bureau of Ocean Energy Management, *BOEM Proposes Stronger Financial Assurance Requirements for Offshore Oil and Gas Industry to Protect Taxpayers from Being Forced to Pay Decommissioning Costs,* June 27, 2023 (available at https://www.boem.gov/newsroom/press-releases/boem-proposes-stronger-financial-assurance-requirements-offshore-oil-and)
3 89 Fed. Reg. 31544.
4 *Id.*
5 *See generally* Compl., *State of Louisiana, et al. v. Haaland, et al.,* Case No. 2:24-cv-00820 (W.D. La.) ("Compl.").
6 89 Fed. Reg. at 31547.
7 *Id.*
8 *See Regulatory Impact Analysis: Risk Management and Financial Assurance for OCS Lease and Grant Obligations, Dep't of Interior ("Regulatory Impact Analysis"),* RIN: 1010-AE14, at 14–15 & Table 3 (Apr. 2024), available at https://www.regulations.gov/document/BOEM-2023-0027-2172.
9 *See Regulatory Impact Analysis,* RIN: 1010-AE14, at 14–15.
10 *Id.*
12 89 Fed. Reg. at 31552–53.
13 *Id.* at 31560.
14 Compl. ¶¶ 4, 7, 12, 34–35, 42–47.
15 Compl. ¶¶ 8, 52, 163.
16 89 Fed. Reg. at 31554.
17 *Id.*
18 Compl. ¶¶ 72–74.
19 *Id.*
20 Compl. ¶ 6.
21 *Id.*
22 Compl. ¶¶ 9, 92.
23 Compl. ¶ 90.
24 Compl. ¶ 91.
25 *See Regulatory Impact Analysis,* RIN: 1010-AE14, at 5–6, 50; 89 Fed. Reg. at 31544.
26 89 Fed. Reg. at 31546.
27 Compl. ¶ 21.
28 89 Fed. Reg. at 31546.