

Bureau of Ocean Energy Management Unveils Tougher Guidelines for Supplemental Bonding on the US Outer Continental Shelf

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The new guidelines restrict the ability of a company to rely on the financial strength of co-lessees to avoid additional supplemental bonding requirements.

On July 14, the US Department of the Interior Bureau of Ocean Energy Management (BOEM) issued a Notice to Lessees and Operators (NTL No. 2016-01) that changes—and in some respects clarifies—BOEM's policy and process for determining additional security requirements (i.e., supplemental bonding) for lessees of federal oil and gas leases, and owners of pipeline rights-of-way (ROW) and rights-of-use and easement (RUE) on the Outer Continental Shelf (OCS).

NTL No. 2016-N01 provides detailed procedures to be used by BOEM to analyze a lessee's (or owner's) financial ability to carry out its decommissioning obligations in order to determine if and when BOEM will require additional security to cover such obligations, pursuant to 30 CFR § 556.901(d)-(f). NTL No. 2016-N01 supersedes the prior notice on this subject (NTL No. 2008-N07) and becomes effective as of September 12, 2016.

NTL No. 2016-N01 provides changed guidance in four significant areas, which are analyzed in further detail below:

0. Eliminates waivers of supplemental bonding previously available to companies meeting certain standards for financial capacity and reliability, and substitutes a more limited self-insurance scheme instead.
0. Prohibits a company from relying upon the financial strength of a company's co-lessees or co-owners unless those co-lessees or co-owners specifically allocate part of their self-insurance capability for that purpose.
0. Provides for consideration of 100% of a company's decommissioning liabilities for every lease, ROW, and RUE in which it holds an interest when determining required supplemental bonding.
0. Updates the standards used to determine financial capacity, record of compliance, and

reliability, which are certain key factors used to determine whether supplemental bonding is necessary.

These are essentially the positions taken by BOEM during its public review period on this subject last year. It does not appear that material changes were made to take into account industry complaints.

Combined Financial Strength and Reliability of Co-Lessee's and Qualified Self-Insurance

BOEM previously granted waivers of supplemental bonding for a lease, ROW, or RUE if BOEM determined that one or more of the co-lessees or co-owners of the applicable OCS asset met its tests for sufficient financial capability and reliability. Similarly, BOEM also excluded from the decommissioning liability calculation the full amount of the decommissioning liability on leases, ROWs, and RUEs on which there was a financially strong co-lessee or co-owner.

These policies are no longer in effect under NTL No. 2016-N01. Now, when determining whether a company needs to provide supplemental bonding, BOEM will consider 100% of a company's decommissioning liability for every lease, ROW, and RUE in which a company holds an ownership interest. In information provided last year for the public review period, BOEM described this requirement as "100% of the decommissioning liability for every lease, ROW and RUE in which it holds a lease," and it is unclear whether the reference in NTL No. 2016-N01 to "your decommissioning and other liability" instead of "the decommissioning liability" was intended to change that approach, given each lessee's potential liability for the entire amount under applicable regulations.

Furthermore, a company will no longer be able to avoid posting additional security in the case where there is a financially strong co-lessee or co-owner of the applicable OCS asset. BOEM will permit lessees qualifying for self-insurance to share it with co-lessees and operating rights holders by allocating the self-insurance to a particular lease, ROW, or RUE, but this sharing will need to be expressly designated in a notice to BOEM.

Qualified self-insurance will, in practice, be more limited than the coverage of the prior exemption guidelines, which allowed for decommissioning liability to be as much as 50% of a company's net worth; the new guidelines limit self-insurance to 10% of a company's tangible net worth.

Updated Supplemental Bonding Guidance—Factors Used For Determination

In considering the need for supplemental bonding with respect to an OCS lease, ROW or RUE, BOEM analyzes a company in light of (a) financial capacity; (b) record of compliance; (c) reliability; (d) projected financial strength; and (e) business stability (collectively, the Factors). NTL No. 2016-N01 provides new guidance and criteria for satisfying factors (a), (b), and (c) above, and these revisions are discussed below.

Note that under NTL No. 2016-N01 the test (and each factor) now applies to each lessee or owner on an individual basis, whereas the prior NTL only required that one co-lessee or co-owner of the applicable OCS asset met the applicable test in order to avoid a supplemental bonding requirement.

Financial Capacity

30 CFR § 556.901(d)(1)(i) requires companies to prove that their financial wherewithal is “substantially in excess” of existing and anticipated lease and other obligations. Under NTL No. 2008-N07, BOEM previously granted waivers to companies demonstrating (a) a net worth equal to or greater than \$65 million, (b) cumulative decommissioning liability less than or equal to 50% of such net worth, and (c) a certain level of production.

The abovementioned three-prong list was replaced in its entirety by NTL No. 2016-N01. BOEM now requires companies to demonstrate their financial wherewithal by proving they meet minimum thresholds for various financial ratios, such as the following:

- Cash Flow from Operations/Total Debt
- Current Ratio
- Earnings Before Interest and Taxes/Interest Expense
- Quick Ratio
- Return on Assets
- Return on Equity
- Total Debt/Capital
- Total Debt to Earnings Before Interest and Taxes, Depreciation, and Amortization
- Total Debt/Equity

BOEM has established [benchmarks for each ratio](#) set forth above. In addition, the company’s financial statements used to calculate the ratios may not be more than 12 months old.

Record of Compliance

The prior NTL applied a generic test of compliance to a lessee or owner (i.e., asking whether a company had a record of compliance with applicable laws, regulations, and lease terms) and did not expressly take into account the record of a company’s affiliates and subsidiaries. NTL No. 2016-N01 provides more detail on what will be examined to determine a record of compliance, and expressly includes a company’s affiliates and subsidiaries when determining a record of compliance. The test examines whether any such entities have been

- assessed civil penalties by BOEM or the Bureau of Safety and Environmental Enforcement (BSEE);
- found by BOEM or BSEE to be noncompliant with any lease, plan, or permit term or condition;
- cited by any other agency with jurisdiction on the OCS for noncompliance with any regulation; and
- cited for nonpayment or underpayment of rents, royalties, interest bills, civil penalties, or

inspection fees, where the citation has been referred to the US Department of the Treasury for collection within the past five years.

Reliability

Previously, reliability was measured based upon a number of factors including credit rating, prior successful operations, and “other factors.” NTL No. 2016-N01 clarifies that reliability will be determined strictly by reference to a party’s credit rating by Moody’s, Standard and Poor’s, or by its trade references.

Other Criteria

In addition to the Factors, NTL No. 2016-N01 also references certain other criteria that may be used to consider a company’s financial ability to carry out its OCS obligations, including transfer of working interests, production payments, off balance sheet transactions, contractual defaults, suspensions, debarments, and/or violations of US law.

Acceptable Forms of Security

NTL No. 2008-N07 addressed several methods of providing supplemental bonding, including surety bonds, US Treasury securities, and indemnities (guarantees) from a third party. NTL No. 2016-N01 provides additional detail on how guarantees, funded abandonment accounts, and other “tailored plans” can be used to satisfy supplemental bonding requirements.

Phased-In Timetable for Compliance

In order to implement the new guidelines set forth in NTL No. 2016-N01, BOEM will send a letter notifying a subject company of any additional security requirements now required and the time period in which they must be provided. Additional security for properties may be submitted through a “tailored plan” that allows the company to provide the additional security over 360 days. In contrast, NTL No. 2008-N07 allowed for periods of as long as four years to fund supplemental bonding requirements. Sole liability properties may not be phased-in.

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