

Financial Assurance NTL Questions & Responses

1. How will “ownership interest” be computed? Will it be proportionate to actual interest and what will it apply to, record Title, Operating Rights, both? Specifically, would like for BOEM to affirmatively state that with respect to a lease in which a company only owns undeveloped operating rights (i.e. no operating rights in producing intervals or in infrastructure located on the lease), that company will have no bonding obligations with respect to that lease. The best example of this scenario is when a company only owns operating rights below the deepest depth ever developed on the lease. The rules and regulations do not provide clarity on this point, but BOEM should be willing to affirmatively confirm this position.

BOEM will not compute ownership interests. Record Title owners will need to negotiate with their co-Record Title Owners and Operating Rights Owners to determine which portion of the additional security coverage each company will post, adding to 100 percent coverage.

Based on 30 CFR 556.605, an operating rights owner is only liable for obligations arising from that portion of the lease to which its operating rights appertain and that accrue during the period in which the operating rights owners owned the operating rights.

2. Article III of page 5 of the NTL says that BOEM will “notify you in writing, through your designated operator” of the amount of additional security required, and that the designated operator is required to coordinate with the lessees to provide the amount of additional security for each lease. How will this work? After all, it is possible that one co-owner could obtain self-insurance, while another needs to provide additional security, and so forth. How does BOEM perceive this to work? Can BOEM clearly state who is in the chain of title? Can BOEM clearly outline in these notice letters which assets are assigned which liability and to whom? Can BOEM exclude liability assignment of assets currently under negotiation between operators until negotiations are complete? If not, how can BOEM handle these assets under active negotiation?

BOEM is interested in obtaining 100 percent coverage of the liability on the Lease. It is up to the designated operator and co-lessees to negotiate how responsibility for that coverage is handled. It is also the responsibility of the Designated Operator to provide an appropriate consolidated response to BOEM.

3. A single lessee in a lease with co-lessees may be providing BOEM with additional security through the tailored plan approach for one or more leases. How will lessee’s phased-in compliance with their tailored plan impact other lessees on a lease where BOEM has determined additional security is required? Different lessees may have different plans for when they will phased-in their additional security on a jointly owned lease. How will BOEM manage this?

BOEM is developing system enhancements to track all the various forms of financial security outlined in the new NTL including phased-in security. However, BOEM will seek the assistance of designated

operators in managing a consolidated response from all lessees on a lease to ensure that a total of 100 percent coverage of the liability assessed on a given lease is provided.

4. On Page 2 of the NTL, the first sentence in the last paragraph states: “You are responsible for ensuring that all obligations...for every lease...in which you have an “ownership Interest”. What does this mean? Is this simply confirmation of the “in-solido” (joint and several) liability of all co-lessees? It suggests that the liability for additional security will not be proportionate to working interest. Please clarify.

BOEM will not request additional security based on working interest percentage. BOEM only requires that 100 percent of the liability on the lease is covered, and it is up to the owners to negotiate between/among themselves to determine the percentage of coverage they will each provide.

5. What are BOEM’s current values for Market Average Financial Ratios?

The 2014 Market Average Financial Ratios are currently posted on our website. The ratios for 2015 will be updated and will be posted on the website shortly.

6. BOEM plans to evaluate a lessee’s financial ability to carry out its present and future obligations annually to determine whether the lessee must provide additional security and, if so, how much additional security the lessee must provide.
 - a. Will BOEM establish a set schedule for these annual meetings or will BOEM contact each lessee and schedule a meeting at BOEM’s discretion?

BOEM will not hold annual meetings but will conduct annual reviews to evaluate a lessee’s financial ability to carry out its present and future obligations. Upon receipt of BOEM’s evaluation result, a company can request a meeting with BOEM to discuss.

- b. How long after the annual meeting can a lessee expect to receive a demand letter?

A Lessee can expect to receive a demand letter within 60 days after BOEM conducts the annual review of a lessee’s financial ability to carry out its present and future obligations.

- c. If a lessee owns multiple leases, will BOEM issue a demand letter for each lease, group of leases, field or some other grouping?

The standard practice, which will be continued, is that BOEM sends demand letters to the Designated Operator for Leases, RUE Holders for RUEs, and ROW Holders for ROWs. The Designated Operator, by virtue of its Designated Operator status, has taken on the responsibility of acting for the lessees, and it must coordinate with the lessees to respond to a demand for additional security.

- d. How far in advance of these annual meetings will BOEM request updated financial information from the lessee?

Since BOEM will be conducting annual reviews to evaluate a lessee's financial ability to carry out its present and future obligations on information a lessee submits and other information in BOEM's possession, it is prudent for the audited financials to be submitted to BOEM as soon as available. Historically, BOEM has required audited financials by July 1.

- e. With a public company, will BOEM wait to request updated financial information and schedule the annual meeting until after the annual reports are published?

BOEM will use publicly available financial information on public companies, and private companies will need to submit their audited financials or trade references as soon as available. Historically, BOEM has required audited financials by July 1 and has granted extensions for companies with fiscal years ending on a date other than December 31. BOEM intends to continue these practices.

- f. Realistically, how often does BOEM plan to review a company's liability and financial capability?

At a minimum, BOEM intends to annually review a company's liabilities and its ability to carry out its obligations. However, other actions on a lease (like a transfer of interest) can prompt a financial review, which will be done on a case-by-case basis.

- 7. If a lessee does not have audited financial statements but its parent does, will BOEM look to the parent's audited financial statements to determine the Financial Capacity of the lessee? If not, why not? (e.g. The BP entity that paid for the April 2010 Gulf of Mexico loss of well control event was not the BP entity that owned the interest in the Macondo lease.)

No, because BOEM does not want to have to determine whether the parent company is responsible for the liabilities of the lessee for the performance of the lease obligations. However, the parent company can provide a third party guarantee, depending on its financial strength.

- 8. In reviewing the Financial Capacity financial criteria of a lessee, will BOEM hold fast to the minimum thresholds established for the nine ratios, or will BOEM use the thresholds only as reference point in its decision process?

BOEM will use the thresholds established for each ratio to evaluate financial capacity. In order for a lessee to pass this criterion, the lessee must exceed the minimum thresholds for five of the nine financial ratios that determine Financial Capacity.

<http://www.boem.gov/Financial-Capacity/>

- 9. In BOEM's assessment of financial ability, what weight will be given to the five criteria? Is one more critical than another?

The five criteria are not weighted. BOEM does not consider one criterion to be more critical than another. All five criteria are taken into consideration to determine a lessee's financial ability to carry out its present and future obligations.

10. Under Projected Financial Strength, how will BOEM define what is meant by “significantly in excess of existing and future lease obligations” in assessing this criteria? How much in excess (e.g. a percentage or numerical amount)?

BOEM's is measuring projected financial strength by taking your proved developing producing (PDP) reserves valued using the PV10 or FMV method. 30 CFR §556.901(d)(1)(i) states “Projected financial strength significantly in excess of existing and future lease obligations based on the estimated value of your existing OCS lease production and proven reserves for future production”

<http://www.boem.gov/Projected-Strength/>

11. What is the current minimum “Credit Rating” for the Reliability Criteria? What is the current minimum “Credit Rating” to allocate your self-insurance to sole liability? How often will it be revised?

A lessee should have an Investment Grade “Bond Rating” to obtain self-insurance. Investment Grade is Moody's Baa3 or S&P BBB-. The minimum credit rating that a party must have to be allowed to apply its self-insurance to sole liability properties will be A3 (Moody's) or A- (Standard and Poor's).

<http://www.boem.gov/Reliability/>

12. In computing “Projected Financial Strength”, how will production be valued? Reserve estimates, discount factor used, ARO (present value allowed) etc.?

BOEM's is measuring projected financial strength by taking your proved developing producing (PDP) reserves valued using the PV10 or FMV method.

<http://www.boem.gov/Projected-Strength/>

13. The explanation of EBIT/Interest Expense on the website says “measures the company's ability to pay interest on outstanding debt”. Every bank in the industry measures this financial covenant as EBITDA/Interest given that DD&A is a huge non-cash item on every E&P balance sheet. EBIT/Interest is not a relevant measure in the oil and gas industry; however, EBITDA/Debt would be. In fact, with all of the impairments taken in 2015, 90 percent of the industry will record negative earnings this year making this measure not applicable. Unless changed to EBITDA or EBTIDAX this metric has no bearing on a company's ability to pay interest on outstanding debt.

The benchmarks were developed taking into account actual industry performance for EBIT/Interest so companies are not being penalized for having DD&A excluded in the metric. (e.g. the benchmarks were based on EBIT so using EBITDA would be an apples to oranges comparison) In other words, we are not interested in the absolute size of the ratio but in its relative size, compared to the same ratio of the industry.

In any case, BOEM will be evaluating and modifying the ratios on an annual basis and may make adjustments at that time.

14. Return on Assets and Return on Equity are metrics used to measure the performance of large public companies, usually without huge non-cash expenses. These metrics have no relevance to private oil and gas companies which this NTL primarily addresses. Because of large DD&A charges and periodic impairment expense caused by highly fluctuating oil and gas prices, earnings is often meaningless to private oil companies focused on cash flow. Much more relevant metrics would be Cash Flow ROA and Cash Flow ROE that measure true profitability.

The benchmarks were developed taking into account actual industry performance for ROA and ROE so companies are not being penalized for having small or reduced returns (e.g. the benchmarks were based on actual ROA and ROE of the oil and gas industry). In other words, we are not interested in the absolute size of the ratio but in its relative size, compared to the same ratio of the industry.

15. Can a parent company provide a Third Party Guarantee for a subsidiary with audited financials? *Yes*

16. What financial data and what format does BOEM require for their assessment of tangible net worth? *Audited Financial Statements, PV 10, and Ratings Moody's SP&, Trade references*

17. BOEM will no longer waive bonds automatically based on the combined financial strength and reliability of co-lessees or operating rights holders, but will permit lessees qualifying for self-insurance to share it with co-lessees and operating rights holders. How will this work from a BOEM perspective and from a lessee perspective?

One or more qualifying lessees can provide their self-insurance for all or part of the liability on that lease. Any percentage of the total per-lease liability not covered by the self-insurance of a qualifying lessee can be provided in other types of financial instruments. The combination of all these forms of financial assurance must equal 100 percent of the liability on the lease.

18. If BOEM determines a lessee has the ability to use self-insurance, the lessee must notify BOEM of the amount of self-insurance he or she will allocate to each lease, ROW, or RUE in which the lessee has an interest and whether it is the lessee's intent for such self-insurance to cover the interests of other parties holding interests in those leases, ROWs or RUEs. How will this administrative work with BOEM?

BOEM is developing system enhancements to track all the various forms of financial security outlined in the new NTL including self-insurance.

19. If a company is eligible for self-insurance, what are the factors that determine 1% - 10% self-insurance range? *The 5 Criteria per 30 CFR 556.901(d)(1)*

20. Will Letters of Credit be accepted? *Yes*

21. Can a company use multiple instruments to satisfy its financial security? *Yes*

22. What are the ramifications to an operator who is unable to successfully “coordinate” the posting of security from/with a co-owner?

Each lessee is jointly and severally liable. BOEM is interested in 100 percent coverage, and it is up to the lessees to negotiate with one another and decide what portion of that liability will be posted by each lessee. However, if 100 percent coverage is not received by BOEM, the Regional Director may assess penalties under 30 CFR 550, subpart N; request BSEE to suspend production or other operations in accordance with 30 CFR 250.173; or initiate action to cancel the lease, pursuant to 30 CFR 556.1102.

23. In the event an operator goes bankrupt, prior to forcing the relinquishment of the lease and going to the predecessor operator to fulfill decommissioning obligations, can the predecessor operators have the ability to assume the lease operations and not just the decommissioning liability? If no, can BOEM recognize the bonding obligations as belonging solely and exclusively to the parties who actually own an interest in the development and production? Does BOEM intend to require additional financial security from predecessor-in-title companies in the event the current designated operator is unable to satisfy BOEM financial security requirements?

It is first up to the court to determine how a debtor transfers its lease interests like any other assets, but BOEM approval of an assignment is also required. BOEM is not in a position to require such an assignment or to avoid the processes of the court. BOEM regulations require that the interests of all record title lessees and operating rights owners be covered by financial assurance. The holders of the leases/working interests are the entities that must maintain bonding/financial assurance, and that requirement is not changed by the filing of a bankruptcy.

24. How does BOEM plan to address situations where there are predecessors in title with accrued liability but the current defaulting lessee has drilled wells and installed facilities after BOEM approved the assignment of record title into the defaulting lessee. If the defaulting lessee has no other co-owners in the lease with them, the previous record title owners are held responsible for the decommissioning liability accrued during their ownership in the lease prior to approval of the assignment into the defaulting lessee but are not responsible for any liability accrued after the assignment is approved. How will BOEM handle these situations?

If that lessee defaults where there are facilities or wells for which there is no prior lessee with liability, BOEM will require forfeiture of the security and make arrangements for the required work to be done.

25. To prevent double/triple financial security coverage, will BOEM consider bonding to a predecessor-in-title as security towards subject leases?

Subject to Regional Director approval, the BOEM Regional Director may consider accepting bonding to a predecessor-in-title as security towards a subject lease. The Regional Director may consider acceptance based on the following:

- 1. Whether the bond is a dual-obligee bond, naming BOEM as an additional obligee; or*
- 2. Whether a dual-obligee rider is made a part of the bond, naming BOEM as an additional obligee; or*

26. Is any consideration given for a project that is not expected to be abandoned for 20+ years? Since the abandonment risk is so low in the first years of the project, can a nominal amount be assessed in the early years? Can this life-cycle liability model apply to sole liability assets? Can this life-cycle liability model apply to non-sole liability assets?

BOEM will use the liability estimates provided by BSEE. As with current regulations and practices, there are opportunities for companies to fund financial assurance over time (phased-in). These requests should be proposed as part of a tailored financial plan. Phased-in additional security can be applied to Non-Sole Liability Properties at the discretion of the Regional Director.

27. As a lessee conducts more activities on the lease, (i.e. drill another wells or P&A a well) will we be expected to update our plan at that time, or is this done once a year?

Prior to approval of new activity, financial security will be required either through an amendment to an existing tailored financial plan or posting of a new financial security (e.g., a bond). BSEE will assess new activities at the permit stage and will re-assess after P&A and site clearance documentation has been processed. The lessee will be responsible for contacting Risk Management Operations Group (RMOG) to update their tailored financial plan if applicable.

28. What happened to moving the Decommissioning Liability posting requirement from the Exploration Plan to the APD? (OOC Comment: There is continuing dialog with the region that BSEE/BOEM is moving forward with this.)

BOEM and BSEE are working closely to enable companies to provide financial assurance in association with APD submittals and prior to approval of the permit.

29. Why would a change in designated operator potentially trigger a review of the financial information covering the lessees in a lease when the decommissioning liability is not changing?

While the decommissioning liability may not change, BOEM may perform an assessment of financial capacity of the operator to honor the existing financial commitments associated with the lease.

30. If the lessee disagrees with any decommissioning estimate provided to BOEM by BSEE, what will be the mechanism available to the lessee to challenge the BSEE estimate? During the challenge period, will the lessee be required to post supplemental security based on BSEE's estimate? When an asset is decommissioned how will BOEM make timely adjustments to financial liability? Our current

understanding is that bonds do not expire even for non-payment of annual premiums and that bonds do not expire unless BOEM notifies the surety, is this correct?

The lessee can submit evidence to BSEE, such as third-party estimates, and BOEM will consider pending disputes as part of the tailored financial plan negotiation process for Non-Sole Liability Properties. Ultimately, BOEM will rely on BSEE's resolution of the disputed decommissioning liability estimate to determine the required amount of additional security. For Sole Liability Properties, the BSEE estimate for liability must be posted when demanded.

31. Since BOEM is going to use BSEE's estimates when determining each company's liabilities, will BOEM revise the decommissioning liability estimates if a company can demonstrate where BSEE's estimates are not correct, for example, if we know a well has been P&A'd but BSEE still shows it as "drilling" or "T&A'd"? What is the process for BOEM to address the decommissioning liability errors versus updates? What is the BOEM/BSEE data management process for cost updates on estimated asset liabilities? With BSEE's pending liability model update, what is the timeline and associated process for new assessed value challenges?

The company should demonstrate the variance to BSEE. BOEM relies on the BSEE liability estimate to determine what facilities require decommissioning.

32. If, at any time, a lessee may request a reduction of their additional security requirement for one or more leases, the lessee must submit appropriate evidence and supporting materials to the Regional Director for their consideration. Can BOEM give us examples of what it will consider as "appropriate supporting material" to be submitted? How much time will BOEM take to make a decision to reduce the additional security amount?

Appropriate material may include new information about the financial condition of the company or the completion of decommissioning work. If it relates to matters within the expertise of BSEE, BOEM will request a report from that bureau.

33. On RUE's & ROW's for which the holder can demonstrate the existence and degree of co-ownership, will that company be "responsible" for 100 percent of the decommissioning or will it be apportioned proportionately to the co-owners?

Regardless of the number of owners of ROWs and RUEs, BOEM will only require the provision of security for 100 percent of that liability and it is up to those parties to determine how to share the costs.

34. If there is a dispute between a lessee and BSEE as to the decommissioning liability estimate BSEE has assessed associated with a lease, ROW or RUE, will BOEM defer action on requiring supplemental security on the disputed lease, ROW or RUE until the dispute has been resolved?

BOEM will consider pending disputes as part of the tailored financial plan negotiation process. Ultimately, BOEM will rely on BSEE's resolution of the disputed decommissioning liability estimate to determine the required amount of additional security.

35. How will disputes with the self-insurance allocation determination with BOEM be handled?

Please set up a meeting to discuss this issue with BOEM

36. BOEM has granted significant variances from the requirements mandated in the new NTL to companies who have worked a “tailored” plan. While we applaud BOEM for working with us, none of their current “exceptions” have been formally included in this NTL. Since the lessees plans are renewed annually, the entire industry will depend on a continuance of the exceptions on a year to year basis. How will BOEM insert predictability and certainty into its discretion when reviewing and approving tailored plans?

The tailored financial plans will not be renewed annually, but monitored on a continual basis to ensure agreed upon deadlines are met.