U.S. Department of the Interior
Office of Inspector General

SURVEY REPORT

SUPPLEMENTAL BONDING ISSUES ON THE OUTER CONTINENTAL SHELF, GULF OF MEXICO REGIONAL OFFICE, MINERALS MANAGEMENT SERVICE

REPORT NO. 99-I-141
DECEMBER 1998

C-IN-MMS-001.-98-R

United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

DEC 22 1998

SURVEY REPORT

Memorandum

To: Director, Minerals Management Service

From: Robert J. Williams
Assistant Inspector General for Audits

Subject: Survey Report on Supplemental Bonding Issues on the Outer Continental Shelf, Gulf of Mexico Regional Office, Minerals Management Service **(No. 99-I-141)**

INTRODUCTION

This report presents the results of our survey of selected aspects of the Minerals Management Service's supplemental bonding program on the Outer Continental Shelf in the Gulf of Mexico. The objective of the survey was to determine whether the Service's Gulf of Mexico Regional Office, in New Orleans, Louisiana, required operators to obtain supplemental bonding in accordance with applicable regulations and guidelines. This review was requested by Service officials, who asked that we focus on the implementation of existing guidelines related to requirements for revisions to or cancellation of supplemental bonds. Specifically, the Service wanted us to determine whether its controls were adequate to ensure that (1) companies were providing supplemental bonds, when required, that were sufficient to cover estimated abandonment costs; (2) supplemental bonds were held no longer than needed; and (3) supplemental bonds were released only when appropriate.

BACKGROUND

A primary responsibility of the Minerals Management Service is to manage and regulate the exploration, development, and production of oil and gas located on the Outer Continental Shelf in a safe and environmentally sound manner. The Service's Outer Continental Shelf program generated an estimated $4 billion of the total $5.1 billion of Federal receipts for oil and gas during fiscal year 1997.

The Gulf of Mexico Regional Office conducts all oil and gas leasing and resource management functions on the Outer Continental Shelf within the Gulf of Mexico and Atlantic areas. Various lease terms and conditions cover lessee rights and obligations relating to developing oil and gas resources, paying royalties, posting bonds, removing facilities, and protecting the environment. Federal regulations and the Service's requirements contained in Notices to Lessees and Operators and Letters to Lessees and Operators' further define lessee obligations. Lessees may assign[2] their lease rights and obligations to other companies. If all of the rights and obligations are assigned, the assignor is considered a prior lessee, and the assignee is considered the current lessee. If a percentage of the lease rights and obligations is assigned, the assignor and the assignees are considered to be co-lessees. All prior and current lessees have joint and several liability[3] for fulfilling the lease obligations.

According to the Service's data, as of November 1997, the Gulf Of Mexico had 7,104 leases, which contained more than 3,800 platforms and about 15,000 oil and gas wells. The platforms vary in size and complexity. Simple platforms may have only a single well, whereas major platforms may have multiple wells, living quarters, production equipment, and pipeline facilities. From 1942, when oil and gas development began in the Gulf of Mexico, through November 1997, 5,423 platforms were installed and 1,605 platforms were subsequently removed from the Gulf. Of the 3,800 remaining platforms, about 780 were considered to be major platforms.

The financial liability for abandoned facilities is the Region's estimates[4] of the costs to remove platforms, plug wells, and clear sites in the Gulf of Mexico if those facilities are no longer needed. Further, according to the Service's Technical Information Management

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'Notices and Letters to Lessees and Operators are formal documents that provide clarification, description, or interpretation of a regulation or Outer Continental Shelf standard; provide guidelines on the implementation of a special lease stipulation or regional requirement; provide a better understanding of the scope and meaning of a regulation by explaining the Service's interpretation of a requirement; or transmit administrative information such as current telephone listings and a change in the Service's personnel or office addresses.

[2]An assignment is a transfer of all or a portion of the lessee's recorded title interest in a lease.

[3]"Joint and several liability refers to the sharing of rights and liabilities among a group of people collectively and also individually." (Law Dictionary, Steven H. Gifis, Barron's Legal Guides.)

[4]The Region's estimates of the costs to remove platforms, plug wells, and clear sites were based primarily on actual costs reported by companies for these activities. The Region determined that the companies' actual costs varied significantly for removing platforms and clearing sites according to the depth of the water at the site of the platform. Accordingly, the Region's estimates of the costs to remove platforms ranged from $350,000 to $1,500,000 and to clear sites ranged from $150,000 to $500,000 depending on the water depth. The cost to plug a well was estimated at $100,000.

System,' as of our review, the abandonment liability for removal of all facilities in the Gulf of Mexico was about $5.6 billion.

The Code of Federal Regulations (30 CFR 256.52) requires every lease to be covered by a general bond to ensure lessee compliance with all terms and conditions of the lease. For leases issued since August 1993, the amount of the general bond increases as development of the leased acreage progresses from exploration through production. According to the Code of Federal Regulations (30 CFR 256.52 and 256.53), the amounts for each stage of development are as follows: (1) the minimum bond is $50,000 per lease or $300,000 per area when there is no development on the lease, (2) the bond is $200,000 per lease or $1 million per area when there is a proposed Exploration Plan[6] or an approved Exploration Plan and the lease is being assigned, and (3) the bond is $500,000 per lease or $3 million per area when there is a proposed Development and Production Plan' or an approved Development and Production Plan and the lease is being assigned. According to the Technical Information Management System, the Region had general bonds totaling $388 million as of November 1997 covering all 7,104 leases in the Gulf of Mexico.

The Code of Federal Regulations (30 CFR 256.53(d)) permits the Service's Regional Director to require a supplemental bond when it is determined that additional security over the general bond amount is necessary. Notice to Lessees and Operators 89-07, dated December 15, 1989, describes certain lease-specific events that would cause the Service to analyze the need for supplemental bonding. These events include an assignment of the lease, the submission of certain operational plans, or an indication that the lease operator has had financial difficulties. Notice to Lessees and Operators 89-07 also permits the Service to exempt certain companies from supplemental bonding if the companies have been determined to be financially capable of fulfilling their lease abandonment obligations. The Service's Letter to Lessees and Operators dated November 5, 1993, states that a company may be exempted from supplemental bonding when 25 percent of the company's net worth equals or exceeds its estimated lease abandonment costs and the company meets or exceeds one of the following standards: (1) has 500 employees, (2) has a net worth of $35 million, (3) has annual oil and gas sales of $45 million, or (4) was restricted from joint bidding on Outer Continental Shelf leases. As of November 1997, 8 1 companies with interests in the Gulf of Mexico met these requirements (referred to as exempt companies), while 101 companies did not meet these requirements (referred to as nonexempt companies). Of

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[5]The Technical Information Management System is a database containing geologic, economic, leasing, and other information related to the Service's Outer Continental Shelf program.

[6]The Code of Federal Regulations (30 CFR 250.33) states that before beginning exploration activities, lessees are required to submit an Exploration Plan for Service approval. The Plan should describe the proposed type and sequence of exploration activities with a timetable for their performance.

'The Code of Federal Regulations (30 CFR 250.34) states that before commencing production activities, lessees are required to submit a Development and Production Plan for Service approval. The Plan should provide a description of and time schedule for development and production activities, including the dates and sequences for drilling wells and installing facilities and equipment.

the 101 companies, 42 companies had provided supplemental bonds covering $245 million of liability for facilities abandonment, and 59 companies had not provided any supplemental bonding.

SCOPE OF SURVEY

In performing our survey, we reviewed data on existing facilities and bond coverage from the Service's Technical Information Management System, examined selected lease and bond documents, and interviewed or contacted Service officials about bonding requirements. To respond to the Service's request, we performed a limited review of the Service's release of bonds. Our audit work was performed at the Gulf of Mexico Regional Office; the New Orleans District Office in New Orleans, Louisiana; and the Service's Royalty Management Program offices in Lakewood, Colorado.

Our audit was made, as applicable, in accordance with the "Government Auditing Standards," issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures that were considered necessary under the circumstances. As part of our audit, we evaluated the system of internal controls to the extent we considered necessary. We found internal control weaknesses in the Service's supplemental bonding program. Our recommendation, if implemented, should improve the internal controls in this program. We also reviewed the Department's Report on Accountability for fiscal year 1997, which includes information required by the Federal Managers' Financial Integrity Act of 1982, and the Senice's annual assurance statement for fiscal year 1997 to determine whether any reported weaknesses were within the objective and scope of our review. Neither the Accountability Report nor the Service's assurance statement addressed the Service's supplemental bonding program.

PRIOR AUDIT COVERAGE

The Office of Inspector General has not issued any audit reports on the Service's supplemental bonding program. However, in May 1994, the General Accounting Office issued the report "Interior Can Improve Its Management of Lease Abandonment" (No. GAO/RCED-94-82), which recommended that the Service "complete a rulemaking to place time limits on the phase-in of both the increased general bond amounts and supplemental bonding under the new criteria." The new criteria that the General Accounting Office was referring to were the increased general bond amounts specified in the Code of Federal Regulations (30 CFR 256) and the Service's procedures for requiring supplemental bonds specified in its Letter to Lessees and Operators dated November 5, 1993. In May 1997, the Service published rules that established December 8, 1997, as the date by which companies were required to comply with the increased genera1 bond amounts. However, as discussed in the Results of Survey section, we found that the Service had not established a time limit for obtaining supplemental bonds.

RESULTS OF SURVEY

The Gulf of Mexico Regional Office had not obtained sufficient supplemental bonds to cover the estimated facility abandonment costs for offshore platforms, wells, and other facilities. A November 5, 1993, Letter to Lessees and Operators stated that effective November 26, 1993, the Service

> . . . may require additional security in the form of a supplemental bond or bonds on a case-by-case basis to ensure present and future compliance with all lease obligations. Factors to be examined by the authorized MMS [Minerals Management Service] officer in determining the need for supplemental security include, but are not limited to, a lessee's financial ability, record of meeting obligations, and projected financial strength.

The Service developed objective standards for making these financial assessments in the draft document "Supplemental Bond Procedures" but did not formally approve or publish that document. In addition, the Region had not reviewed 59 nonexempt companies to determine whether supplemental bonds were required because, according to Regional personnel, Regional policy provided for a supplemental bonding review only when lease activity caused a review to be conducted. The bond coverage for these 59 nonexempt companies was $107 million less than the estimated liability for removal of all facilities for their leases. As a result, the Government could be responsible for facility abandonment costs of $107 million for those leases that had insufficient bond coverage.

Bond Adequacy

At the time of our survey, the Gulf of Mexico Region had not periodically reviewed the adequacy of lessees' or operators' supplemental bond coverage. Notice to Lessees and Operators 89-07 states:

> Supplemental bonds may be deemed necessary, under the provisions of 30 CFR 256.61 [redesignated 30 CFR 256.531 after operations or production have begun, prior to approval of: assignments of interests in leases, designations of operator, exploration plans, development and production plans or development operations coordination documents, or at any other time, where the Minerals Management Service infers that the obligee may not have the financial wherewithal or expertise to carry out the obligations of the lease. Such inference may be drawn when the obligee has demonstrated a failure to comply with royalty or rental payments, failed to comply with OCS [Outer Continental Shelf] operating regulations, or otherwise indicated a potential inability to carry out the obligations of the lease.

Regional officials said that these guidelines did not provide for periodic reviews of the adequacy of supplemental bonding on either a company or a lease basis and that unless

activity on a lease caused a supplemental bond review to be conducted, they would not periodically perform supplemental bond reviews. We also noted that the Region's existing guidelines did not provide objective standards upon which to base such a review. The Region's draft document "Supplemental Bond Procedures," which a Regional official said would be issued in August 1998, stated, "A review of each lessee's cumulative potential liabilities will be initiated immediately following implementation of these new procedures. A review of each lessee's cumulative potential obligations will be conducted annually." Regional officials told us that after the new guidelines are issued, they intend to perform annual reviews of the adequacy of bond coverage for all leases and request additional supplemental bonding when necessary.

Without adequate **bond** coverage, the Government may have to pay to remove abandoned facilities. The Service had not reviewed the supplemental bonding of 59 nonexempt companies as of November 1997. The Service's Technical Information Management System produced a report that showed that the 59 nonexempt companies had a facility abandonment liability of $107 million that was not covered by bonding as of November 1997. The largest unbonded liability was $9.6 million, and the smallest was $50,000. During our survey, the Region was also revoking the supplemental bond exemptions of companies that no longer met the exemption standard. These companies also needed supplemental bond coverage reviews. Based on information contained in the Bond Allocation Detail Reports* for 3 of the 59 nonexempt companies, we found the following:

- The first nonexempt company was responsible for 17 leases that contained 17 sites, 26 platforms, and 123 wells. The estimated cost to remove these facilities was about $29 million. However, there was an exempt co-lessee for four leases that had an estimated abandonment cost of $4.1 million. Therefore, the facility abandonment liability for the company was about $24.9 million. Total bond coverage of the nonexempt company's abandonment liability was $23.2 million, which consisted of a general bond of $3 million and 10 supplemental bonds of $20.2 million. The unbonded liability was therefore about $1.7 million.

- The second nonexempt company was responsible for 9 leases that contained 9 sites, 6 platforms, and 12 wells. The estimated cost to remove these facilities was $8 million. However, there was an exempt co-lessee for one of the leases that had an estimated facility abandonment liability of $800,000. Therefore, the remaining abandonment liability for the nonexempt company was $7.2 million. The company's abandonment liability was covered by a $3 million general bond. The unbonded liability was therefore $4.2 million.

- The third nonexempt company was responsible for 12 leases that contained 4 sites, 7 platforms, and 16 wells. The estimated cost to remove these facilities was $8.4 million. However, there was an exempt co-lessee for one of the leases that had an estimated

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*Bond Allocation Detail Reports were produced from the Technical Information Management System. Each report pertains to one company. The Gulf of Mexico Region uses the reports to grant supplemental bond exemptions, review bond coverage, and calculate facility abandonment liability.

abandonment liability of $300,000. Therefore, the facility abandonment liability for the nonexempt company was $8.1 million. This liability was covered by a $3 million general bond, a $200,000 supplemental bond, and two additional $500,000 supplemental bonds. This resulted in an unbonded liability of $3.9 million.

Although the Service had not financed the removal of any facility, other governmental agencies that have missions similar to those of the Service have paid for the removal of abandoned facilities under theirrespective jurisdictions. For example, as of September 1997, the State of Louisiana had plugged 216 wells for State leases at a cost of $9.6 million but had a backlog of more than 3,100 wells that needed to be plugged. Since 1991, the Bureau of Land Management has spent $1.6 million to plug 131 onshore wells but has a backlog of more than 300 wells that need to be plugged at an estimated cost of more than $3 million.

According to the Service's fiscal year 1997 budget justification, many of the older facilities are operated by small independent oil companies that do not have the financial resources of the larger companies that traditionally worked on the Outer Continental Shelf during the past 40 years. As such, we believe that the Service needs to ensure that the Government is adequately protected from having to cover the costs of removing abandoned facilities.

Bond Release

In response to the Service's request, we found that the Region's procedures for bond release were adequate and that, based on our limited testing, the bonds were promptly released or appropriately retained as the situation warranted. The Region initiated procedures to release a bond when it received a request from the company that submitted the bond, which typically occurred upon lease assignment or termination. If attributable to an assignment of the lease, the Region released the bond on the original operator when it received a bond from the new operator. If attributable to lease termination, the Region released the bond when all facilities were removed and all royalties were paid. At the time of our review, 24 bond release actions were pending because of disputes or appeals regarding the removal of facilities or payment of royalties.

Recommendation

We recommend that the Director, Minerals Management Service, expedite formalizing procedures for annual lease or company reviews tcensure that the supplemental bonding is adequate. The Service should also establish a date for which all companies will be reviewed to determine whether supplemental bonds are necessary.

Minerals Management Service Response and Office of Inspector General Reply

In the October 28, 1998, response (Appendix 1) from the Director, Minerals Management Service, the Service concurred with the recommendation. Based on the Service's response

and information the Service subsequently provided, we consider the recommendation resolved but not implemented. The Service subsequently provided a target date of December 3 1, 1998, for issuance of a Notice to Lessees to implement the recommendation. Accordingly, the recommendation will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation (see Appendix 2).

Other Matters

Companies that have supplemental bond exemptions are referred to as exempt operators. As of November 1997, 8 1 companies that had oil and gas interests in the Gulf of Mexico were determined to be financially capable and therefore exempt from supplemental bonding. During our review, we found that the Region had not compared the estimated facility abandonment costs of shared leases with the net worth of either company when one or more of the co-lessees had been exempted from supplemental bonding requirements. Regional officials said that the shared lease liability was omitted from the review of co-lessees because the Regional Director had stated that leases having one or more exempt co-lessees were exempt from supplemental bond coverage. However, this is contrary to the Service's Letter to Lessees and Operators dated November 5, 1993, which states:

> A waiver of this supplemental bond requirement on a specific lease will be granted by the authorized MMS [Minerals Management Service] officer if at least one lessee meets the following criteria:
>
> 1. The MMS-estimated cumulative potential lease abandonment liability for the lessee is less than or equal to 25 percent of the most recently available and independently audited calculation of that lessee's net worth. Assumed herein is that each colessee is seoaratelv liable for 100 percent of abandonment costs. [Emphasis added.]

We found that each co-lessee was not always held separately liable for 100 percent of abandonment costs in determining supplemental bond exemptions. For example, during 1997, there were 2 1 platforms and 19 wells on Lease G-04909. The Region estimated the costs to remove the facilities at $9.4 million. Company A and Company B were co-lessees for Lease G-04909, and both companies were exempt from supplemental bonding. The Region did not add the $9.4 million to either Company A's or Company B's liability for facility abandonment when comparing the liability with the net worth of either company.

We are not making any formal recommendations on this issue because our review did not disclose any instances in which adding the total estimated facility abandonment liability for shared leases would have resulted in exceeding the 25 percent net worth of the exempted companies. However, we believe that this issue may become significant in the future as leases are assigned to companies which have net worth lower than that of existing major companies. Accordingly, we encourage the Service to develop procedures which ensure that the total estimated facility abandonment liability for leases that have co-lessees is less than

25 percent of the net worth of at least one co-lessee before it grants supplemental bond exemptions.

Minerals Management Service Response and Office of Inspector General Reply

In its response (Appendix 1), the Service disagreed with our suggestion relating to developing procedures for the total estimated facility abandonment liability on shared leases. Specifically, the Service stated that (1) its decision "to not include shared liability when two or more co-lessees are exempt was based in part on the very small likelihood that two companies financially strong enough to meet the supplemental bonding criteria for self bonding would both go into insolvency at the same time"; (2) the Letter to Lessees and Operators dated November 5, 1993, "is not current" and that it "will be correcting" the document; (3) it "disagrees" that it should "develop procedures to ensure total liability is added into a company's liability when two or more exempt companies are co-lessees ... before knowing whether a problem will develop and before knowing the exact nature of a possible future problem"; and (4) it will "continue to review and evaluate" its supplemental bonding program and "revise the program as needed" considering the option suggested in our report.

At the time of our review, the estimated facilities abandonment liability on leases that had one or more exempt co-lessees amounted to $3.2 billion of the $5.6 billion total liability. Because the issue of liability on shared leases has not resulted in any problems, it was presented in the Other Matters section of this report without a formal recommendation. However, we believe that the Service, by adopting our suggestion, would be in a better position to state that the total estimated facility abandonment liability in the Gulf of Mexico is covered by a bond or the amount is less than 25 percent of the net worth of the responsible companies. Without including the facility abandonment liability of shared leases in making its bonding exemption decisions, the Service has little support for its statement that the companies are "financially strong." We believe that the Service should take a proactive approach rather than wait for a liability problem to occur on leases that have exempt co-lessees.

Since the report's recommendation is considered resolved, no further response to the Office of Inspector General is required (see Appendix 2).

The legislation, as amended, creating the Office of Inspector General requires semiannual reporting to the Congress on all audit reports issued, actions taken to implement recommendations, and identification of each significant recommendation on which corrective action has not been taken.

We appreciate the assistance of Minerals Management Service personnel in the conduct of our survey.

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

OCT 27 1998

Memorandum

To: Assistant Inspector General for Audits

Through: Bob Armstrong OCT 28 1998
Assistant Secretary, Land and Minerals Management

From: Cynthia Quarterman
Director, Minerals Management Service

Subject: Evaluation Report on Supplemental Bonding Issues on the Outer Continental Shelf, Gulf of Mexico Regional Office, Minerals Management Service (Assignment No. C-IN-MMS-00 l-98-R)

We appreciate the opportunity to comment on the Office of Inspector General (OIG) draft evaluation report.

We agree with the recommendation to "expedite formalizing procedures for annual lease or company reviews to ensure that supplemental bonding is adequate" and to "establish a date for which all companies will be reviewed to determine whether supplemental bonds are necessary." We had already taken steps to address these issues prior to the receipt of this draft report. We are scheduled to issue a Notice to Lessees in December 1998 to address supplemental bond procedures. At that time, we also plan to formalize internal procedures which will include establishing a date by which time we will review all companies. The Responsible Official is Chuck Hopson, Chief, Leasing Activities Section.

Although we agree with the recommendation in the report, we have comments on the sections of the report titled "Bond Adequacy" and "Other Matters."

1. On page 6 in the "Bond Adequacy" section of the report, the discussion of periodic supplemental bond reviews states that the auditors "noted that the Region's existing guidelines did not provide objective standards upon which to base such a review." As mentioned above, we are working toward issuance of a Notice to Lessees addressing and formally documenting supplemental bonding procedures, but in the meantime we have been using interim standards that are objective.

2. On page 8, the "Other Matters" section of the report criticizes the current practice of omitting shared liability from the review when two co-lessees are exempt from supplemental bond coverage. The report criticizes this policy because it is contrary to a Letter to Lessees and Operators which MMS issued in 1993. As we discussed on several occasions with the reviewers from the OIG, the decision to not include shared liability when two or more co-lessees are exempt was based in part on the very small likelihood that two companies financially strong enough to meet the supplemental bonding criteria for self bonding would both go into insolvency at the same time. The decision also reflects additional analysis and actual experience working with the program since 1993. We recognize that the 1993 document is not current, and we will be correcting that when we issue the new document in December 1998.

3. The report encourages MMS to develop procedures to ensure total liability is added into a company's liability when two or more exempt companies are co-lessees. We agree with the report that this is not a problem at this time. We disagree with the suggestion to take a predetermined action as the report suggests before knowing whether a problem will develop and before knowing the exact nature of a possible future problem. We will continue to look at all aspects of our supplemental bonding program and will revise the program as needed to ensure that companies are financially able to meet obligations. As we continue to review and evaluate our program, we will consider the option suggested in the report along with other options to strengthen our supplemental bond program.

Again, thank you for the opportunity to provide comments on the report. If you have any questions, please contact Bettine Montgomery, our Audit Liaison Officer, at (202) 208-3976.

STATUS OF SURVEY REPORT RECOMMENDATION

Finding/Recommendation Reference	Status	Action Required
1	Resolved; not implemented.	No further response to the Office of Inspector General is required. The recommendation will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation.

ILLEGAL OR WASTEFUL ACTIVITIES SHOULD BE REPORTED TO THE OFFICE OF INSPECTOR GENERAL

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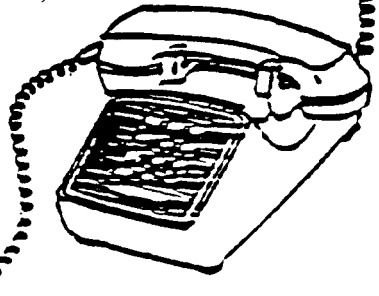
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