



October 2nd, 2014

William Barron, Director
Division of Oil and Gas
Alaska Department of Natural Resources
550 West 7th Avenue, Suite 1100
Anchorage, Alaska 99501-3560

RE: Comments on Proposed Financial Strength Measures for Offshore Platform DR&R

Dear Director Baron:

Center for Sustainable Economy (CSE) and Cook Inletkeeper offer the following comments on the Division of Oil and Gas (DOG) August 23rd, 2013 briefing paper “Possible Financial Strength Measures for Offshore Platforms South of the 68th Parallel.” Center for Sustainable Economy is a not for profit environmental economics think tank with over 15 years experience in Alaska energy issues. Cook Inletkeeper is a citizen-based nonprofit group dedicated to protecting the Cook Inlet watershed and the life it sustains. Together, CSE and Cook Inletkeeper support strong financial assurance regulations that minimize the State’s financial risks associated with unfulfilled dismantling, removal and restoration (DR&R) activities for offshore platforms and pipelines in Cook Inlet as well as fossil fuel infrastructure statewide. Strong and clear DR&R rules are especially important now in Cook Inlet, as smaller independent companies – some with questionable financial resources – are increasingly exploring and drilling for oil and gas.

In its briefing paper, DOG propose a bonding matrix meant to evaluate an individual company’s DR&R default risk, and to establish a commensurate bonding requirement. While we appreciate DOG’s efforts, we are concerned the DOG is too narrowly focused on default risk, leaving the issue of DR&R obligations and associated costs untouched. In addition, we believe firm size is an inherently unreliable financial metric, and thus should not be used as a way to exempt any company from bonding requirements. We also believe DOG should consider a company’s record of regulatory compliance in its bonding decisions. Finally, we believe the DOG should retain and make available to the public documentation that companies have secured and maintain bonds of sufficient size to offset all of the State’s potential financial liabilities. Each of these concerns is discussed in more detail below:

- 1. The State’s financial risks are a function of both the default risk of the platform owner as well as the overall costs of DR&R. While we appreciate DOG’s initial steps towards addressing the former, it is equally important to clarify DR&R obligations and associated costs.**

In the briefing document, DOG acknowledges an assessment of financial strength and estimated cost to DR&R the platform should serve as the basis for establishing a financial assurances regime.¹ While the proposed briefing document addresses the former concern, there should be a parallel effort to clarify DR&R obligations and associated costs because these remain far too ambiguous.

As DOG notes, the regulatory environment over DR&R is complex, involving a number of state regulatory agencies, statutes, regulations, provisions in unit and lease agreements, or agreements between the state and individual parties. A relatively easy reform would be to simplify this complex process by designating one agency as the lead and by ensuring that regulatory requirements are harmonized.

Another complexity is that DR&R obligations overlap with requirements for rehabilitation associated with unit operation plans. While requirements for removal of infrastructure are relatively clear, there remains a significant degree of uncertainty over standards for restoration of surface conditions, water quality, or ecological attributes of affected sites. Offshore drilling physically disrupts seafloor habitat and its ecological communities. This damage is caused not only by the actual footprint of the drill rig, but also by undersea pipelines, dredging activities, drilling muds and cuttings and other contamination of the seabed which may spread for miles. Uncertainty over leaseholder obligations to repair this environmental damage complicates calculations of requisite bonding needed to minimize financial risks to the State in the event of default. A handful of regulatory provisions related to DR&R illustrate this point well.

Alaska Oil and Gas Conservation Commission (AOGCC) regulations contain fairly explicit requirements for plugging and abandonment of wells prior to expiration of an owner's leasing rights on affected State lands (20 AAC 25.105 – 20 AAC 25.172). However, requirements related to platforms and the condition of affected lands and waters are unclear. For example, in certain situations involving the shut-down of wells drilled from a beach, artificial island, or shifting natural island, AOGCC must approve plans for “maintaining the integrity of the location” (20 AAC 25.105.d). There is no further guidance clarifying what is meant by “integrity” and how, if at all, this requirement relates to DR&R. The application of DR&R obligations to drilling wastes is another area of uncertainty. For example, regulations associated with annular disposal of drilling wastes require that operators provide the AOGCC with information to support a finding that the waste will be confined, will not come to the surface or contaminate freshwater (20 AAC 25.080 b(3)). Logically, if these standards have not been met, they should be included in the context of DR&R activities, but no such guidance is currently in place.

Requirements for offshore clearance of platforms contain several exemptions that have direct bearing on DR&R costs – i.e. requirements to remove the wellhead equipment, casing, piling, and other obstructions to a depth at least five feet unless otherwise approved by the Commission as adequate to protect public health and safety (20 AAC 25.172(b)). Other provisions entirely exempt operators from infrastructure removal, for instance, if a state agency “approves leaving

¹ Alaska Department of Natural Resources, Oil and Gas Division. Possible Financial Strength Measures for Offshore Platforms South of the 68th Parallel. August 23, 2013, page 7. (Hereafter “briefing paper.”)

the platform in place” or approves a “different disposition to facilitate a genuine beneficial use” (20 AAC 25.172(a); (d)).²

Unit and lease agreements are similarly vague. For example, each of the formal lease agreements signed for Cook Inlet platforms contains the following language pertaining to rights on termination: “[l]essee shall deliver up said lands or such portion or portions thereof in good order and condition.”³ To date, there has been no guidance published on what does and does not constitute “good order and condition.” Lease agreements also imply the State may require measures in the context of DR&R meant to ensure the prevention of waste and degradation of land. In particular, leaseholders are required to “carry out at Lessee’s expense all reasonable orders and requirements of Lessor relative to the prevention of waste and the preservation of said land.”⁴

DR&R obligations also overlap with requirements related to rehabilitation plans. As part of operations plans filed for each of the offshore platforms, leaseholders are required to include “plans for rehabilitation of the affected unit area after completion of operations or phases of those operations” (11 AAC 83.346 d(3)). However, and as DOG notes, at this point in time the nature of these rehabilitation plans is insufficient for assessing the risk of DR&R activities, the specific activities that will be performed by operators, and the cost and timeframe of those operations.

As part of its 2002 review of DR&R obligations for existing oil wells, the General Accounting Office affirmed that requirements for surface restoration of areas now occupied by oil and gas infrastructure are vague, and noted that many other states have “more explicit requirements that create a fixed obligation to fully restore the land according to specific standards.”⁵ Importantly, in the absence of such specific standards, it is impossible to estimate the overall costs of DR&R and the amount of bonding that would be sufficient to protect the State in the event of a default. Therefore, as part of its efforts to address the issue of offshore platform DR&R, DOG should also be working in parallel on specific DR&R guidance that will clarify all of the obligations discussed above.

As one example why this is important, consider the potential expense the State would incur in cleaning up contaminated sediments and marine ecosystems in and around platform sites – a duty that is clearly within the realm of DR&R obligations but one that has yet to be specified by AOGCC or DNR. Offshore rigs can dump tons of drilling fluids and cuttings, including toxic heavy metals, such as lead chromium and mercury, into the ocean. A single drilling platform may discharge more than 90,000 metric tons of drilling fluids and metal cuttings into the ocean, and the resulting stream of pollutants can contaminate the seabed for miles. As Defenders of Wildlife notes, “[s]trewn on the ocean floor, contaminated sediments can be carried by currents

² Additionally, some operators opt to simply “shut-in” wells for long periods of time, leaving platforms in a “lighthouse mode” where no DRR activities occur. DOG regulations should spell-out the length of time such facilities may remain in this shut-in status before DRR activities must occur.

³ State of Alaska, Department of Natural Resources, Competitive Oil and Gas Lease, The Superior Oil Company, March 19th, 1962, pp 36.

⁴ Id. at pp. 20.

⁵ General Accounting Office. 2002. Alaska’s North Slope: Requirements for Restoring Lands After Oil Production Ceases. Report to Congressional Requesters. Washington, DC: General Accounting Office.

over a mile from the rig, sharply reducing populations of small bottom-dwelling creatures that are important to the rest of the food chain and biomagnifying toxic contaminants in fish we eat.⁶ In California, shell mounds around offshore platforms are contaminated by nickel and PCBs at concentrations toxic to marine life in some locations.⁷ Without including the costs of cleaning up these environmental hazards, requisite bonding amounts could be set far too low.

2. As the recent global financial crisis illustrated all too well, there are no companies too big to fail. As such, firm size should not be a major factor in assessing financial strength and DR&R bonding requirements.

While Altman's Z'-scores are a reasonably good indicator of potential default risk, company size is often not reliable. In the proposed matrix of bonding requirements, DOG proposes exemptions in part or in whole if value of equity (VE) exceeds \$100 million. This is based on the reasoning that "[a]s commonly found in the literature, size is an important predictor of default – all else being equal, larger firms are less likely to default than smaller firms."⁸

There is a substantial and growing amount of literature that contradicts this assertion. Generally known as the issue of "too big to fail" or TBTF, the focus of literature on this topic has been on explaining how gigantic financial firms with long standing records of solid financial performance collapsed in such a spectacular fashion during the recent financial crisis with little warning. TBTF is a concept driven by governments who feel they have to bail out failing financial institutions or other companies like General Motors because their failure may have severe adverse effects on the economy. Unfortunately, when firms are perceived as TBTF, they are more likely to take excessive risks. As a result, a big share of the blame for recurring financial crises has been attributed to TBTF policies and their effects on financial firms' risk taking activities.⁹

A TBTF contribution by Bhagat et al. (2012) is particularly revealing and on point because of its use of Altman's Z-score as a metric. Using a sophisticated regression on cross sectional data using Altman's Z-score as a dependent variable, the authors' overriding conclusion is this: [t]he overarching message from the regressions.is that bigger size is generally associated with greater risk. Size enters negatively and is significant at conventional levels in all models."¹⁰ The authors went further to explain why this is the case. Their explanation is that larger firms' excessive risk taking is most commonly manifested through increased leverage. And TBTF policy has been blamed by many as one of the main factors incentivizing this risk-taking behavior.¹¹

⁶ Defenders of Wildlife. 2012. Outer Continental Shelf Drilling. Impacts to Air, Water, Wildlife, Coastal Economies and Climate.

⁷ L.A. de Wit. 2001. Shell Mounds Environmental Review. Volume One. Final Technical Report. Prepared for the California State Lands Commission. Concord, CA: L.A. de Wit, Consultant.

⁸ Briefing paper at 9.

⁹ Shull, Bernard. 2010. Too Big to Fail in Financial Crisis: Motives, Countermeasures, and Prospects. Working Paper No. 601. Annandale-on-Hudson, NY: Levy Economics Institute at Bard College.

¹⁰ Bhagat, Sanjai, Brian Bolton and Jun Lu. Size, Leverage, and Risk-Taking of Financial Institutions (August 2, 2012). Available at SSRN: <http://ssrn.com/abstract=2122727> or <http://dx.doi.org/10.2139/ssrn.2122727>.

¹¹ Boyd, John H., Ravi Jagannathan, and Sungkyu Kwak. 2009. "What caused the current financial mess and what can we do about it?" *Journal of Investment Management* 7, 1-17.

TBTF plays out at the state and local level as well. Governments at all levels often make moves that insulate larger firms from the natural incentives that punish excessive risk taking in a free market. For example, in Alaska, the Parnell Administration rushed a bill through the legislature granting major tax breaks worth \$150 million or more for ailing oil refineries deemed TBTF because of their importance for jobs, the Alaska Railroad, the military, and other aspects of the State's economy.¹² Given the lessons learned from the past financial crisis, the emerging TBTF literature, and the fact that TBTF policies are clearly at play in Alaska, we believe it would be unwise for DNR to rely on firm size in its proposed bonding matrix. Exempting larger firms from bonding requirements only aggravates the market distortions caused by TBTF policies in Alaska and puts smaller, more responsible firms at a competitive disadvantage.

3. A company's history of regulatory compliance ought to be a factor in assessing default risk.

Regardless of a firm's financial strength, its history of regulatory compliance ought to be a prime factor in the required level of bonding. If a company has a history of non-compliance with other aspects of the oil and gas regulatory environment, there is no reason to believe it will not also shirk on its DR&R responsibilities or fail to follow through on them altogether if its internal calculus shows that non-compliance is more profitable (i.e. that the costs of fines and loss of bonding premiums are less than the costs of DR&R). This is just common sense. Tying DR&R bonding and other types of bonds to a firm's record of compliance also sends the correct market signals – that there are penalties for non-compliance, including loss of any favorable treatment by State regulators.

Many oil and gas companies in Alaska have a tarnished record of compliance. The Alaska Oil and Gas Conservation Commission (AOGCC) routinely issues enforcement orders against oil and gas producers for violations of standards meant to protect water quality and public safety.¹³ Hilcorp, which dominates Cook Inlet production, has been cited with 13 enforcement actions since April, 2012 – a record that prompted the Commission to note that "[t]he aggressiveness with which Hilcorp is moving forward with operations appears to be contributing to regulatory compliance issues."¹⁴ Last fall EPA settled with Shell for violations of their Clean Air Act Outer Continental Shelf permits for Arctic oil and gas exploration drilling in the Chukchi and Beaufort Seas. Shell agreed to pay \$710,000 penalty for violations of the Discoverer air permit and a \$390,000 penalty for violations of the Kulluk air permit.¹⁵ Clearly, such companies should not be rewarded with additional financial benefits in the form of exemptions from bonding requirements. We trust DNR will add this factor to its bonding matrix.

¹² For coverage of this issue, see: Demer, Lisa. 2014. Parnell Administration Wants to Bail Out Ailing Refineries with Tax Breaks. *Anchorage Daily News* April 15th, 2014, available online at: <http://www.adn.com/2014/04/15/3426506/parnell-administration-wants-to.html>; Baily, Alan. 2014. "Tax credit bill passes: Legislation designed to avert closure of Petro Star refineries goes to governor." *Petroleum News* 19(17). Available online at: <http://www.petroleumnews.com/pntruncate/141409779.shtml>.

¹³ AOGCC enforcement orders are available online at: <http://doa.alaska.gov/ogc/orders/como/otherindex.html>.

¹⁴ State of Alaska, Alaska Oil and Gas Conservation Commission, Other Order No. 80, April 10th, 2013.

¹⁵ Technical details of EPA's enforcement action against Shell can be found online at: <http://yosemite.epa.gov/R10/airpage.nsf/Permits/chukchiap>.

4. DR&R cost estimates and evidence of adequate bonding should be a matter of public record.

One final comment relates to the maintenance of public information documenting that companies operating offshore platforms have secured and are retaining adequate bonds to cover DR&R costs in the event of default. As a potentially liable party, the public has every right to know what these potential liabilities may be. But as DOG is no doubt aware, companies currently do not disclose their estimates for DR&R costs because such information is considered privileged and confidential.¹⁶ Generally accepted accounting principles require that oil companies estimate their future DR&R liability, but this liability only needs to be reported on a worldwide basis. And as the GAO reports, “[o]il company spokesmen told us that their individual company estimates for DR&R liabilities on the North Slope were for internal use and not available to the public. Companies fear that if they make their internal estimates available, they could someday be used for a purpose other than the accounting estimates they were intended to be.”¹⁷ Moreover, it is impossible to indirectly estimate what each company believes its DR&R costs to be from other public records, such as Securities and Exchange Commission filings, because DR&R costs are aggregated within much larger retirement obligation line items. While one-on-one negotiated agreements can reveal DR&R costs with more precision and allow the State to negotiate adequate bonding, such costs change over time and can only be reasonably estimated until the exact nature of DR&R activities - including restoration of the impacted environment - are specified in much greater detail.

One approach that may be useful is to commission regular studies of DR&R costs for offshore platforms that could then serve as the basis for adjusting bond amounts, if necessary. For example, the Bureau of Ocean Energy Management (formerly Minerals Management Service) has retained experts to update benchmark costs for decommissioning Pacific OCS Region oil and gas facilities to guide its decisions on supplemental bonds.¹⁸ Federal oil and gas regulations provide the BOEM the authority to require additional security in the form of a supplemental bond based on calculations of the potential decommissioning liability and an evaluation of the lessee’s ability to carry out present and future DR&R obligations (30 CFR § 256.53 (a) and (b)). Alaska statutes contain similar flexibility (i.e. for supplemental risk bonds, unusual risk bonds, etc.) and so there is no reason for DOG not be proactive on reducing public liability for DR&R and commission a similar series of studies to ensure the public has accurate and up to date information on which to base bonding requirements.

Thank you for the opportunity to share these comments with you. We would like to continue to be engaged in the State’s process for bolstering financial assurance requirements for offshore platforms in Cook Inlet as well as fossil fuel infrastructure statewide. Please include both our organizations on the list to receive any future notices pertaining to this issue.

¹⁶ Rothe, Ann. 2005. Dismantling and Removal of Offshore Oil and Gas Platforms and Restoration of the Impacted Environment in Alaska’s Cook Inlet. An Overview of Requirements, Process, and Status of DR&R for the Sixteen Cook Inlet Oil Platforms. Seldovia, AK: Nuka Research and Planning Group, LLC.

¹⁷ GAO (2002) Note 4.

¹⁸ Proserv Offshore. 2010. Decommissioning Cost Update for Removing Pacific OCS Region Offshore Oil and Gas Facilities, January 2010, Volume 1. Washington, D.C.: USDI Minerals Management Service.

Sincerely,

/s/

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