January 14, 2022

Ms. Julie Murphy
Director
Colorado Oil & Gas Conservation Commission (COGCC)
1120 Lincoln Street, Suite 801
Denver, CO 80203

RE: Comments on Colorado Oil & Gas Conservation Commission Staff December 7, 2021 Draft Financial Assurance Rules, Financial Assurance Rulemaking, Docket No. 210600097

Submitted electronically via: COGCC's eFilings Portal

Dear Director Murphy:

The National Association of Surety Bond Producers (NASBP)[1] and The Surety & Fidelity Association of America (SFAA)[2] appreciate the opportunity to submit additional comments in connection with the Colorado Oil & Gas Conservation Commission (COGCC) ongoing Financial Assurance Rulemaking to address the COGCC Staff December 7, 2021,Draft Financial Assurance Rulemaking (Draft Rules). Previously, we submitted comments regarding the June 15, 2021, Strawdog Rules (Strawdog Rules). In those comments, we outlined our concerns regarding the proposed definitions of surety bond and surety company, the expanded liability placed on sureties, and the resulting financial impact on small and medium sized operators.

We are very appreciative that COGCC accepted several of our recommendations as reflected in the Draft Rules. The new definition of "surety" and changes to the definition of "surety bond" reduce unnecessary risks to sureties. The Draft Rules also provided important clarity regarding the process for submitting a claim against a bond. Additionally, the Draft Rules provide necessary flexibility by eliminating the requirement that operators using a sinking fund must provide a cash bond (though we understand that in practice many operators will nonetheless have no choice but to attempt to provide a cash bond because they will not qualify for surety bonds). Finally, we believe the reduction of the blanket bonding amounts was a key change to the Draft Rules to mitigate some burden on operators that would have been imposed by the requirements in the Strawdog Rules, though, as discussed below, we remain very concerned that most operators will not be eligible for blanket bonding

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[1] NASBP is a national trade association whose membership includes firms employing licensed surety bond producers placing bid, performance, and payment bonds throughout the United States and its territories.
[2] SFAA is a national trade association of more than 425 insurance companies that write 98 percent of surety and fidelity bonds in the U.S. SFAA is licensed as a rating or advisory organization in all states, and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience.

While we believe the changes included in the Draft Rules make significant improvements, we still have concerns regarding the Draft Rules. Our remaining concerns address the proposed definitions of “surety bond” and “Operator” and the resulting financial impact on small and medium sized operators. Also, we bring to your attention language regarding Recalcitrant Bond Providers in Sec. 706(c) of the Draft Rules. Finally, we provide comments regarding conforming changes needed to the bond form to conform to the elimination of the perpetuity requirement for surety bonds and to help mitigate the risk associated with the significant increases in the amount of financial assurance proposed by the Draft Rules. Before we address our concerns, we thought it useful to provide again information on surety bonds and how they differ from traditional insurance.

Surety Bonds—Background

A surety bond is a three-party contract by which one party (the surety) guarantees the performance of a second party (the principal) to a third party (the obligee). Surety bonds written for construction projects are known as contract surety bonds; surety bonds, such as those written on behalf of oil and gas operators, are known as commercial surety bonds. Commercial surety bonds cover a very broad array of bond obligations that guarantee performance by the principal (in this case, an oil and gas operator) of the obligation or undertaking described in the bond. As you know, they are required of individuals and businesses by the federal, state, and local governments through various statutes, regulations, and ordinances, or by other entities.

Prior to issuing a bond for plugging and abandonment, reclamation, and remediation, the surety underwriter determines if the operator—or the parent operator and all its subsidiary operators, if underwriting for related operators—has the requisite experience, equipment, management capabilities, and financial wherewithal to perform the undertaken regulatory obligations successfully. As part of its assessment during the prequalification phase, the surety evaluates the risk presented in the regulatory obligations and ascertains if such risks are within the control and means of the operator or related operators. The surety needs to be comfortable that the scope of regulatory requirements is clear, and the obligations and terms set forth in the bond are reasonable.

Surety vs. Insurance

In deciding to grant surety credit, the surety underwriter conducts in-depth analysis, also known as prequalification, of the capital, capacity, and character of the principal firm(s) during the underwriting process to determine its capability to fulfill commitments. Surety bonds are an essential means to discern qualified entities and to guarantee that enumerated obligations are fulfilled.

Although surety bonds are almost always written by insurance companies that are licensed by state insurance departments, they do not function like traditional insurance policies. Traditional insurance policies are two-party agreements, such as life or property casualty policies, which are underwritten to assume losses based upon actuarial data. Surety bonds are underwritten to prevent losses, and sureties do not expect to suffer losses from bonded obligations. Further, the surety does not “assume” the primary obligation, but is secondarily liable, if the principal defaults on its bonded obligation. A surety does not expect to suffer losses, because the surety expects the principal to perform its obligations successfully (due to the surety’s thorough vetting of the capabilities of the bonded principal) AND the surety has required a signed indemnity agreement from the principal to protect it from any losses the surety suffers as a result of having issued the bond. This means that, if a surety incurs expenses and/or pays out as a result of a claim(s), the bonded principal (or any other of the indemnitors) must reimburse the surety, and the surety has contractual and legal recourse to force the principal to do so.

Definition of Surety Bond — Presents uncertain risks

The proposed definition of a “surety bond” continues to add uncertainty for sureties. As we pointed out previously, it is unclear what is intended by permitting the operator to receive “a contingent reversionary interest in the surplus” if the operator meets all its obligations. This seems to be a gross misperception of what constitutes a surety bond, as if a surety bond is a pool of escrowed funds. Use of ambiguous or inapplicable terms significantly increases the sureties’ liability exposure because they are unsure of what the obligation ultimately may be, resulting in the strong likelihood that sureties would not be willing to write such an obligation, or would only issue such bonds for the strongest businesses financially. This term runs afoul of the industry’s definition of a surety bond. Accordingly, we recommend deleting from the definition of “surety bond” the following language:

> “The Operator providing a Surety Bond has no contract or property interest in the Surety Bond other than a contingent reversionary interest in the surplus, if any, which arises after the Director has determined that the Operator has complied with all Plugging and Abandonment, Reclamation, and Remediation obligations pursuant to Rule 706.a, or after a Buying Operator has filed a satisfactory replacement Financial Assurance pursuant to Rule 218.e.(4).”

706. Recalcitrant Bond Providers — Increases risks

While our previous comments did not address this issue, we believe the authority granted to the COGCC in Sec. 706(c) of the Draft Rules will increase the risk to sureties in the event there are any claims against a surety bond, especially given the drastically increased financial assurance requirements in the Draft Rules. Currently, Sec. 706(c) of the Draft Rules provides:

> “If a third-party provider of Financial Assurance fails to comply with the terms of a financial instrument, or with a Commission order calling a Surety Bond, Letter of Credit, or other form of Financial Assurance, the Director may designate that third-party provider to be an unacceptable provider. The Director will maintain a list of all unacceptable Financial Assurance providers on the Commission’s website.”

We find it problematic that the COGCC could use this provision to deem a surety “unacceptable” and reject bonds from the surety where the surety has legally justifiable reasons for its failure to satisfy its bond obligation. Since claims against a bond by the COGCC would be subject to a claim process, we recommend the Draft Rules be amended to delete the term “surety” from Sec. 706(b)(2)(c), or in the alternative, amend that section to only allow the COGCC to reject a bond from an alleged delinquent surety only after the matter has been fully adjudicated in favor of COGCC and the surety fails to comply with the final determination.

Financial Assurances —The potential impact on sureties & small/midsized operators

We understand that pursuant to the Draft Rules, the majority of wells in Colorado would be categorized as low-producing and/or inactive wells. Under the Draft Rules, operators would be required to furnish potentially billions of dollars of new financial assurances to comply with proposed changes. With the potential liability exposure noted above in the definition of surety, and allowance for replacement financial assurance only upon change in Operator, sureties may be unwilling to write these obligations unless the Draft Rules are revised to address the issues outlined herein.

To the extent sureties continue to issue bonds, they likely would raise meaningfully their underwriting standards for operators seeking bonds for COGCC obligations based on the Draft Rules, likely leaving only the largest operators as qualifying for these bonds. As a result, the Draft Rules will reduce competition from the standpoint of eliminating from the operator pool all but the largest oil and gas operators. Small and medium sized operators effectively will be precluded from participating in this market, as sureties likely will not issue bonds for these operators without requiring collateral, because they often do not have a sufficient level of financial capital on hand to provide the surety with assurance of their fiscal strength and ability over an extended time period to fulfill such increased risks to COGCC. We understand that some parties to the Rulemaking proceeding are arguing for full-cost bonding for all of an operator's wells and our comments above apply even more strongly to that scenario—small and medium sized operators will not be able to obtain surety bonds for full-cost bonding. We believe rules requiring the same would lead to unintended consequences.

Definition of Operator — Proposed Amendment

The definition of "operator" in Draft Rules' and the financial assurance framework does not include parent holding companies. We encourage the Commission to amend the definition and framework to accommodate for the total number of wells and statuses (i.e., producing, low-producing, out of service, and inactive) owned by parent holding companies. Aggregation of related entities will more accurately reflect risk and the appropriate amount of financial assurance to require because when sureties underwrite for subsidiary companies, they typically look to the parent's assets as a whole. Furthermore, this change may create a more responsive parent operator in comparison to the individual subsidiary operator, while removing an unnecessary administrative burden of the COGCC needing to review multiple financial assurance plans of related entities when instead they could review one financial assurance plan and one bond provided by the parent company that covers the parent company and all of its subsidiary COGCC operators.

Bond Form Changes and Conforming Changes to Draft Rules

Given the change in the Draft Rules that eliminated the requirement that surety bonds be perpetual, we recommend that Form 3, State of Colorado Oil and Gas Conservation Commission Performance Bond (Bond Form), be amended by deleting the following language:

> "This bond is a perpetual instrument which shall remain in force and effect until all obligations have been met and the bond is released by the Colorado Oil and Gas Conservation Commission."

Similarly, we recommend the Bond Form be amended to provide for the release of the obligations under the bond pursuant to the conditions for release in Sec. 706. This amendment, of course, requires a conforming amendment to Sec. 706. Specifically, we recommend adding a new paragraph (6) to Sec. 706(a) to read as follows:

> "(6) The Operator obtains and provides to the Director replacement Financial Assurance in the same amount of the bond(s) the Operator seeks to replace."

Finally, we request COGCC to amend the Bond Form, and include any necessary conforming amendments to the Draft Rules, to include provisions to (1) authorize cancellation by the surety upon notice and replacement under Sec. 706 of the Draft Rules, and (2) establish that the penal sum of the bond is the maximum liability of the surety, and such sum shall not be cumulative. A Bond Form without these changes will be very problematic for sureties considering issuing bonds at the enormous amounts called for in the Draft Rules.

It is for the foregoing reasons that NASBP and SFAA jointly request COGCC to revise the Draft Rules as recommended herein to make them less stringent to allow small and medium sized firms to participate in the market and to ensure there is sufficient surety capacity to offset risks and to guarantee the important obligations of operators.

NASBP and SFAA are available to answer any questions concerning the points expressed in our comment letter.

Thank you for your consideration of our request.

Sincerely,

National Association of Surety Bond Producers

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