SUBJECT: Insurance option for guaranteeing abandoned well plugging

COMMITTEE: Energy Resources — committee substitute recommended

VOTE: 7 ayes — West, Farabee, Corte, Crabb, Crownover, Gonzalez Toureilles, Howard

0 nays

WITNESSES: For — Adam Haynes, Texas Independent Producers and Royalty Owners Association; Morris Burns, Permian Basin Petroleum Association; Ben Sebree, Texas Oil and Gas Association; William Stevens, Texas Alliance of Energy Producers; Jeff Willard, OWL Energy Holdings, LTD

Against — None

On — Godwin Ohaechesi, Texas Department of Insurance; (*Registered, but did not testify)* Ken Hodges, Texas Farm Bureau

BACKGROUND: Natural Resources Code, sec. 91.104, requires a person or entity operating one or more active or inactive oil or gas wells to file a bond, letter of credit, or cash deposit under sec. 91.103 to protect the state from the financial liability of abandoned wells and to ensure plugging. Sec. 91.104 gives operators the choice of filing individual or blanket bonds as acceptable forms of financial security. Each bond must include as a condition that the operator plug and abandon all wells and control, terminate, and clean up pollution associated with all oil and gas activities covered under the bond. The bond amount requirements, laid out in secs. 91.1041 and 91.1042, also apply to operators who file letters of credit or cash deposits.

The 77th Legislature in 2001 established the current bonding program to minimize the state's financial responsibilities for the plugging and clean-up of abandoned wells. Although the Railroad Commission (RRC) has used the Oil Field Cleanup Fund (OFCU), partially funded by fees collected under section 91.104, to plug more than 16,500 wells since 1991, thousands of abandoned wells remain unplugged. At the end of 2004, the state had more than 110,000 inactive oil or gas wells. Of that amount, almost 16,000 were considered by the RRC to be abandoned.

The money collected under the current bonding program does not match the liability faced by the state. During fiscal 2003, the RRC collected on two bonds and six letters of credit for a total of $535,575 with an estimated $2,296,757 plugging liability for 240 abandoned wells (based on $2.50/foot). During fiscal 2004, the RRC collected on one bond and eleven letters of credit for a total of $546,928 with an estimated $1,532,298 plugging liability for 161 abandoned wells (based on $2.50/foot).

DIGEST: CSHB 380 would allow the Railroad Commission to accept well-specific plugging insurance as an additional form of financial assurance. Persons or entities who obtained well plugging insurance policies for each well bore they operated would effectively have met the requirements laid out in secs. 91.103 and 91.104, provided their insurance policy met the conditions specified in the bill. Among other conditions, the well-specific plugging insurance policy would have to:

- be approved by the Texas Department of Insurance (TDI);
- name the state as the owner and contingent beneficiary of the policy;
- name a primary beneficiary who agreed to plug the specified well bore;
- be fully prepaid and not be subject to cancellation or surrender;
- continue in effect until the specified well bore had been plugged; and
- provide that benefits would be paid when, and not before, the specified well bore had been plugged in accordance with RRC rules in effect at the time of plugging.

A properly executed insurance policy would exempt the covered well from bond amount requirements cited in secs. 9.1041 and 9.1042 because the policy would guarantee the plugging of the well. Any benefits under well-specific plugging insurance policies paid to the state as contingent beneficiary of the policy would be deposited in the OFCU to be used for well plugging and surface remediation.

The bill would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2005, and would apply only to operators filing on or after the effective date.

SUPPORTERS SAY:

CSHB 380 would offer oil and gas well operators an innovative alternative to bonds, letters of credit and cash deposits while guaranteeing full coverage of plugging costs. Unlike the other bonding methods, insurance would pay 100 percent of the plugging expenses because it would be designed to pay every policy sold. Because the policies would have to be approved by TDI, each operator would have to maintain capital and surplus according to the agency's guidelines. Well plugging insurance is modeled after life insurance, which is designed to pay out, so the reserve ratio most likely would fall within 80-90 percent of the future expected benefit. To ensure compliance, insurance companies would be subject to annual field examinations for the first three years, as well as be required to submit quarterly financial statements.

The insurance benefit would relate directly to the liability as service companies would agree to plug wells whenever necessary in exchange for the insurance benefit. The insurance policy would convert a plugging liability into an asset of the property that would stay with the property until the well was plugged, thereby increasing the value of the property. If the primary beneficiary failed to perform, the state would move in as contingent beneficiary and receive the benefit.

Plugging insurance would resolve the issue of operators' inability to obtain bonds. The bond market has not taken a significant interest in well-plugging financial assurance because it is not the purpose for which the market was designed. Most primary bond writers are writing bonds only for large amounts or as an incidental. Insurance would give operators a viable alternative.

Moreover, bonds are relatively expensive, so many independent operators must file letters of credit. A letter of credit goes against the operator's line of credit at its bank, holding a large amount of working capital "captive" and inhibiting an operator's loan capacity while producing no revenue. Well-specific plugging insurance would allow operators to use the capital that would otherwise be tied up by a letter of credit. That capital would better serve the financial and oil and gas industries because an operator could, for example, use the money for industry projects, such as starting a new well or improving on an existing one.

OPPONENTS SAY:

Well-specific plugging insurance is an untested product not yet used in Texas or any other state. Because it is untested, concerns remain about how to implement and maintain the industry and reserve funding. Although the reserve ratio would likely fall within 80-90 percent of the expected future benefit, the reserve would not be held by TDI. Rather, the insurance company itself would hold the reserve amount. While TDI would require quarterly financial statements from insurance companies, these statements would not be verified. Thus, TDI might not always be aware of whether a company was maintaining its reserve requirements.

Additionally, an insurance company selling well plugging policies would not be required to deposit a minimum surplus with TDI in order to receive licensure. TDI has statutory authority to require a minimum deposit from new life insurance or property and casualty companies or companies that appear to be in financial trouble. However, as no such authority exists over plugging insurance companies, it is possible that a company could refuse to put down a minimum deposit even if one were requested by TDI. Unavoidable costs and lengthy hearings could result from such disputes. Unless this is clarified, the well-specific plugging insurance industry could require a significant amount of monitoring by TDI.

OTHER OPPONENTS SAY:

Although CSHB 380 would provide a necessary and useful option for oil and gas well operators, a guaranty fund for the industry might ensure a more prudent and efficient system.

NOTES:

HB 380 as filed would have calculated policy benefits for bay and offshore wells based on sec. 91.1041(b) provisions. The committee substitute would calculate the policy benefits based on the amount required by the RRC rules for a bay or offshore well that is not producing oil or gas, regardless of whether that well is producing oil or gas.

According to the fiscal note for CSHB 380, the Legislative Budget Office estimates no significant fiscal implications to the state, but did report that the Railroad Commission expects some additional computer programming costs would be required.