Mining and the Vanishing Surety Bond Market

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Over the past several years, operators in the mining and oil and gas industries have found it increasingly difficult to fulfill financial guarantee obligations required by government regulators with the typical mechanism of choice, (i.e., surety bonds), because of surety companies' large-scale withdrawal from the natural resources markets. The associated financial credit crunch has prompted mining companies to seek and post alternative forms of collateral. This turn of events has had significant negative consequences for the hard rock mining, coal mining, and oil and gas industries, which are referred to collectively as the "mining industry" in this article.

The distressed surety bond market and the corresponding implications for the mining industry have received widespread attention. In July 2002, the House Resources Subcommittee on Energy and Mineral Resources held hearings to address the perceived contraction in the surety bond market as it affects the mining industry. Those hearings underscored the widely accepted view that changes in the surety market have virtually eliminated the availability of surety bonds for the majority of hard rock mine operators, and greatly increased the burden of obtaining a financial guarantee for coal operations as well as for oil and gas projects.

After providing some background with respect to use of surety bonds in the mining industry, this article discusses some causes of the current difficulties affecting the surety bond market for the mining industry, and consequences to the mining industry, both ongoing and potential, if the surety bond market does not improve. The article also reviews some suggestions for alleviating the problems associated with the persistence of a limited surety market.

Surety Bonds and Mining

The mining industry is subject to a number of laws that trigger financial guarantee obligations. For example, the Department of the Interior's Bureau of Land Management (BLM) has promulgated regulations for locatable minerals (3809 Regulations) requiring that the estimated reclamation costs for even the smallest of mining projects be secured by a financial guarantee. *See, e.g.*, 43 C.F.R. §§ 3809.500 to 600; *see also* 36 C.F.R. § 228.13 (setting forth the United States Forest Service's bonding requirements). The 3809 Regulations require that mining companies guarantee the existence of financial resources to fund site reclamation following mining operations, including most exploration, extraction, and development activities on public lands where the mineral interest is owned by the United States or was patented after October 21, 1976. Similarly, the Surface Mining Control and Reclamation Act (SMCRA), applicable to surface coal mining on public and private lands, requires performance bonds to cover the estimated costs of reclamation. *See* 30 U.S.C. §§ 1201 *et seq.* Additionally, regulations implementing the Mineral Leasing Act, applicable to coal, oil, gas and certain other minerals located on public lands, require lease bonds. *See, e.g.*, 43 C.F.R. § 3452.3(b) (BLM regulations under the federal coal management program establishing a bond requirement to secure a lease). In the case of recent federal coal leases, the bonds also are required to cover deferred bonus amounts, which can amount to many millions of dollars. Many states have enacted statutes with respect to state and private lands that substantially parallel the bonding requirements of federal law. *See, e.g.*, IDAHO CODE § 47-512; NEV. REV. STAT. § 519.210; UTAH CODE ANN. § 40-8-14.

Surety bonds typically have been the preferred guarantee mechanism for the mining industry, and have been used widely in the mining industry to ensure that companies meet the required obligations associated with reclamation of the property disturbed by mining operations. Because surety bonds allow mining companies to satisfy financial guarantee obligations without tying up initially the cash that will be required to perform reclamation after mining, the bonds provide a means for mining companies to free the significant amounts of capital needed to develop a mining project. As a result, the unavailability of bonding mechanisms, such as surety bonds, can have profound implications for the mining industry.

A surety bond differs from a traditional insurance policy and is more like a banking instrument than an insurance product. Like insurance coverage, surety coverage reduces the uncertainty related to a business deal. Unlike insurance, however, the surety bond ensures the performance of a principal—the mining com-

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pany—on behalf of a third-party beneficiary, typically the state or federal government. The surety company writes a bond based on an assessment that a principal will be able to perform its obligations.

The procedure for developing the amount of the financial guarantee varies depending on the jurisdiction. A number of agencies have used guidelines that establish presumptive surety amounts or ceilings based on the acreage of the project, ranging from approximately $2,000 to $5,000 per acre. The trend in recent years has been to move away from acreage calculations toward regulators' estimates of what they would be required to pay to third-party contractors to perform the reclamation. In that regard, agencies have projected costs based on third-party sources such as the *H.E. Means Construction Manual* and the *Caterpillar Performance Handbook*, with wide-ranging supplemental additions for intangible considerations such as administration and oversight costs. Recently, the cost projection approach has often resulted in financial guarantee obligations in the tens of millions of dollars. Surety companies, in turn, have typically set premiums based on a percentage of the bond amount; for example, 1 percent of the bond amount per year, which percentage has varied significantly depending on the financial strength of the operator.

There are alternatives to surety bonds for providing required financial assurance, but those options are not feasible for most operators. For example, most agencies allow operators to provide certificates of deposit, letters of credit or cash equal to the required dollar amount of the financial guarantee. Given the substantial up-front cash investment required for mining projects, many industry members lack the ability to post a cash bond in lieu of surety. Certificates of deposit present the same hurdle. Letters of credit also have not proven to be useful alternatives to cash, as banks reportedly have required that mining companies provide 120 percent to 200 percent of the surety amount as collateral. In other words, to secure a letter of credit for a $30 million bond, banks today may demand collateral exceeding $36 million before issuing the letter of credit.

The capital used to fund these alternative forms of financial assurance can be expected to be unavailable to the operator for the duration of the project, or at least a substantial portion of the project. Regulators in most jurisdictions are authorized to allow partial bond releases for concurrent reclamation upon determining that a portion of the disturbed land has been successfully backfilled, regraded, and stabilized as necessary to conform to the operator's reclamation plan. The partial bond release provides one means of freeing some capital prior to closure and most often corresponds with the regrading of waste rock and the stabilization of tailings facilities. The benefits of partial bond release are often limited, however, by regulations or policies that require a relatively large percentage of the total financial guarantee (often 30 percent to 40 percent) to remain in place until all reclamation has been completed successfully. *See, e.g.,* 43 C.F.R. § 3809.591. Moreover, in practice, concurrent reclamation takes time to implement and does not typically serve to return capital to a self-bonded operator in the early phases of an operation, when capital is needed most. Additionally, significant portions of an operating mine cannot be backfilled or regraded while operations are ongoing, thereby constraining the funds available for release. As a consequence, many operators have not viewed cash bonding and similar forms of financial assurance as acceptable replacements to surety bonding.

Surety bonds have been used widely in the mining industry to ensure that companies meet the required obligations associated with reclamation.

Financial Distress in the Surety Industry

In the congressional hearings during the summer of 2002, the president of the Surety Association of America (SAA), Lynn Schubert, testified that a report released by SAA in May 2002 provides evidence of the potentially devastating conditions facing the surety bond industry. In particular, the ratio of premiums to losses was reported at 82.5 percent for the year ending 2001, compared with a corresponding loss ratio of 29 percent in 1999. The 1999 loss ratio reflected the general profitability of the surety industry throughout the 1990s. The recent problems for the surety industry stemmed from the convergence of a number of events.

SAA testified that while the terrorist attacks of September 11, 2001 did not affect surety companies directly, their parent companies, which are property and casualty insurance companies, were impacted enormously. According to SAA, the subsequent erosion in capital triggered longer-term conservatism in the underwriting market. High-profile bankruptcies, such as those of Enron and Kmart, resulted in substantial losses in the insurance industry, further enhancing the scrutiny of transactions by underwriters. These problems have been accompanied by a shrinking supply of surety companies due to mergers, bankruptcies, and unilateral decisions by surety providers to leave the business. According to one source, the availability of surety is constrained due to the presence of

fewer surety companies than in the past. Reportedly, five of the twelve largest surety providers were acquired or exited the business between 1998 and 2001.

The impacts of the recent events on surety providers similarly have affected the reinsurance market. In order to limit financial exposure, surety companies historically have entered into agreements with reinsurance providers. For example, a surety company may contractually agree to be liable for a percentage or predetermined amount of the bond liability with any additional amounts covered by the reinsurer. If the bond is forfeited, the reinsurer is typically liable for the agreed upon dollar amount to the surety provider and not to the beneficiary of the bond. In the face of an increased frequency of claims and losses, however, the risk averse reinsurance industry has been less willing to enter into such agreements. The corresponding effects on the reinsurance market further undermine the availability of surety. The cumulative impacts of the financial distress in the surety market and the decrease in available reinsurance have been accentuated by circumstances particularly unique to the mining industry.

Availability of Surety to the Mining Industry

The National Mining Association's Interim Report of its Surety Work Group, issued in September 2002, indicates that the loss experience for mining bonds has been no worse than that experienced generally by the surety industry. Nonetheless, the unique circumstances related to the extractive industry have curtailed dramatically the availability of sureties for mining companies now as compared to the 1990s. In particular, the mining industry's ability to obtain financial guarantees is directly affected by the duration of the surety commitment, the downturn in the market for minerals, recent regulatory changes, and the changing surety industry.

First, in contrast to most nonmining projects, the obligations related to mining reclamation often are of indefinite duration and can extend for decades or longer. Regulators increasingly have responded to this long-term exposure to risk by a wariness to release any portion of a surety as reclamation is performed. Delay in bond release provides further evidence to surety companies that the duration of risk is highly uncertain, and thus makes them less willing to provide new or increased surety to the mining industry.

Second, the depressed metal prices of the 1990s precipitated, among other things, a number of bankruptcies in the hard rock mining sector of the industry. Surety companies were called upon to forfeit bonds, something that had rarely happened in the past. As a result and as indicated above, surety companies became increasingly reticent to underwrite mining operations absent substantial amounts of collateral.

Third, and concomitantly, regulatory developments have changed the playing field. The bankruptcies in the hard rock mining sector enhanced the regulators' scrutiny of bond amounts and resulted in widespread increases in required financial guarantee, regardless of the financial health of the operator. Additionally, agencies increasingly have focused on the sufficiency of bond amounts in the context of extremely long-term risks, such as the potential for water treatment, with the regulators concerned that issues may arise decades or centuries after mine reclamation has been completed. *See, e.g.*, MONT. CODE ANN. § 82-4-338. While regulators can look to sites where long-term water treatment has posed immense environmental and financial challenges, the increased bond amounts are often implemented regardless of actual risk projections. The corresponding requirements can create financial guarantee obligations spanning a hundred years or more. Hundred-fold increases in bond amounts by state and federal agencies are not atypical. *See* Jim Carlton, *Mining Firms in U.S. Face Crisis Over Cleanups*, ASIAN WALL ST. J., July 24, 2002. An increase of that magnitude may not be affordable and contributes to a company's inability to obtain surety.

The insolvency of certain surety providers has triggered further regulatory response that, in some situations, has affected mining companies' ability to obtain financial guarantee. For example, certain states have promulgated rating requirements mandating that operators switch from surety companies that are not sufficiently rated. *See, e.g.*, UTAH CODE ANN. § 40-8-14; UTAH ADMIN. CODE R647-4-113. The rating requirement has had more indirect negative consequences. For instance, the bankruptcy of Frontier Insurance Company reportedly resulted in the downgrade of the investment rating for at least one major coal company. One particular investment service determined to downgrade the company "in part because of its need to replace hundreds of million of dollars of reclamation bonds written through Frontier." *See* Bill Estep, *NY Insurer's Woes Worry Coal Industry; Takeover of Reclamation Bond Firm Prompts KY to Suspend Certificate*, LEXINGTON HERALD LEADER, Aug. 29, 2001, at 41.

Mining companies are finding, as a result of the circumstances described above, that they are unable to obtain surety even with positive balance sheets and legitimate, long-term operating records. *See, e.g., Hearing Before the Comm. on House Resources, Subcomm. on Energy and Mineral Resources*, 107th Cong. (July 23, 2002) (statement of Ken P. Done, Director of Treasury Services, Rio Tinto Services, Inc.). Even where surety has remained an option, the associated conditions currently imposed, such as requiring full collateral, often are not possible options.

Compounding the problem for some companies, another regulatory change has been the amendment of the federal surface mining regulations to eliminate cor-

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porate guarantees by operators as an allowed method of meeting financial guarantee obligations. This amendment has precluded even the most financially healthy of mining companies from seeking that viable alternative to the surety market.

Implications for the Mining Industry

A recent decision by the Interior Board of Land Appeals (IBLA) highlights some of the negative implications that can result from the combination of events discussed above. In *Coeur Rochester, Inc.*, 156 IBLA 372 (June 12, 2002), IBLA reviewed a BLM determination requiring a hard rock mining company to post a replacement reclamation bond when the surety provider became financially insolvent. The facts of the case are illustrative of circumstances widespread throughout the mining industry. In that case, bond coverage on the property was maintained through a combination of surety (25 percent) and corporate guarantee (75 percent) for a total of $8,435,267. The state and federal regulatory agencies—the Nevada Division of Environmental Protection (NDEP) and the BLM field office—sought to increase the bond amount by more than 100 percent (to approximately $21 million) to address what the decision characterizes as an increase in reclamation liability associated with an update of the reclamation plan. Initially, the revised bond amount was to be posted within sixty days of the agencies' determination. The agencies subsequently agreed to authorize a phased funding of the increase, allowing the mining company to post its obligation in incremental amounts. The mining company's surety provider was unable to increase the bond, given that the revised amount exceeded its underwriting limit, and sought to countersecure the excess bond amount with reinsurance. The surety company was facing financial hardship, however, and ultimately was declared insolvent. Those circumstances triggered BLM to issue a notice requiring the mining company to "immediately" post the entire sum of a replacement bond—an amount of more than $17 million.

IBLA ruled that the insolvency of the surety company provided adequate grounds for BLM to seek immediate bond replacement. Moreover, the existence of reinsurance provided no benefit to the mining company. The decision notes that the surety company's insolvency raised the possibility that the reinsurance agreement would not be enforceable, and IBLA also emphasized

that the terms of the reinsurance agreement did not give the government the right to collect any dollars directly from the reinsurer. The IBLA determination in *Coeur Rochester* provides evidence of the potential exposure mining companies face as a result of, among other things, exponential bond increases and the uncertain economic circumstances faced by the surety industry.

The problems associated with the surety market are not limited solely to the current operators of mining projects, and could have widespread economic and enforcement consequences for a variety of other companies. In particular, mining properties appear in many companies' historic property portfolios. These links to properties increasingly could become the focus of, albeit generally ill-suited, federal or state CERCLA-type enforcement actions and efforts to substitute funding mechanisms in the absence of other more productive long-term solutions. Given the other viable solutions to bonding issues, reliance on these potentially protracted, resource-intensive approaches to funding mine reclamation are unwarranted.

There are signs that the limitations in the current surety bond market may prompt revisions to natural resource development policy that could lead to additional bonding hurdles for the mining industry. Those issues may be driving, at least in part, regulators' planning with respect to long-term bond requirements. The Office of Surface Mining (OSM) has contemplated promulgating performance bond regulations to address acid mine drainage under SMCRA. In May 2002, OSM published an Advanced Notice of Proposed Rulemaking (ANPRM) to consider developing financial assurance requirements to address acid mine drainage. 67 Fed. Reg. 35,070 (May 17, 2002). The ANPRM sought comments on, among other things, those provisions that would deny mine permits where acid mine drainage cannot be avoided and where long-term water treatment would be required. While the National Mining Association (NMA) and others providing public comment maintain that the "avoidance" provisions are inconsistent with SMCRA, the proposal can be seen as illustrating the influence of the surety market circumstances on natural resource development policy. The implications of a surety bond requirement for acid mine drainage potentially are very significant. As NMA speculates in its comments, the inclusion of acid mine drainage liability with existing reclamation bond requirements could result in operations shutting down for lack of bond coverage and, given that state bond pools are typically designed to cover the costs of reclamation rather than long-term treatment costs, the insolvency of certain of those bond pools.

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Potential Solutions

The Department of the Interior has initiated an interagency bonding task force to evaluate the mining-related issues associated with the lack of surety. The task force is currently gathering information and has prepared a report that should be available publicly in 2003. Additionally, experts from federal government, state government, the mining industry, and the surety providers collectively have identified a number of ideas to consider in resolving the current state of surety bonding for the mining industry. Several of these considerations are identified below.

To provide the regulated community and surety providers with greater certainty about their financial risks, regulators and the mining industry will need to work in unison to closely evaluate and develop specific criteria that will assure both the operator and surety company of the timing for bond release. The duration of the financial guarantee obligation also needs to be clearly defined. Most mining operations do not warrant hundred-year water treatment obligations. Moreover, if such a requirement is deemed necessary and is based on scientifically defensible risk analysis, regulators, the mining industry, and the insurance industry should continue to evaluate mechanisms other than surety that are more appropriately suited for guaranteeing long-term risk.

A number of experts have identified other mechanisms as substitute financial guarantees to surety bonding. Consideration should be given to the appropriate use of self-bonding through corporate guarantees, subject to rigorous financial review (such as that currently required by the State of Nevada). That approach has worked with some other programs. For example, the RCRA Subtitle C and nuclear regulatory programs have successfully authorized closure-related corporate guarantees for years. RCRA regulations create specific qualification criteria that include the assessment of net worth in light of estimated closure costs, investment rating requirements or both. *See, e.g.*, 40 C.F.R. § 264.143. There appears to be a viable role for self-assurance, provided that the interested parties evaluate the use of self-bonding subject to specific criteria that ensures adequate financial guarantees. In addition, industry and regulators increasingly are evaluating a more expansive definition of collateral, and are considering the potential innovative use of liens or the acceptance of property pledges (including water rights, equipment, or other valuable assets) in lieu of surety bonding or cash. Given the surety providers' disincentive to underwrite the exceedingly large bond amounts typical of many mining operations,

increased flexibility regarding types of acceptable collateral may provide a means of ensuring adequate financial guarantee while reducing up-front cash requirements.

In that regard, regulators must be willing to authorize financial guarantee obligations incrementally. Industry and insurance company representatives, among others, have supported the development of mechanisms that would allow an operator to fund its financial assurance over time in lieu of an up-front payment. One example that is being considered in some current contexts would allow payments to be tied to an incremental assessment of production. Further, regulators should evaluate and consider approaches to accepting a variety of different insurance policies and other financial mechanisms, including the authorization of flexible funding mechanisms such as stock and bond investments and the greater use of revenue-generating trust fund accounts that take advantage of the time value of money. The financial guarantee requirements should be flexible, and consideration should be given to authorizing different options to cover different portions of a mining operation to both ensure adequate coverage and to provide affordable mechanisms. In that regard, NMA has suggested that regulators may be able to alleviate some of the burden on operators by accepting guarantees related to income-producing accounts.

In addition, it also may be prudent for the regulators and mining industry to further develop and modify reliance on state and group insurance funds and trust funds financed over time rather than traditional surety. Certain states such as Nevada already have successfully implemented emergency funding mechanisms as a means of providing funding at abandoned sites while the surety-forfeiture process is pending. NEV. ADMIN. CODE 519A.392. These programs could provide the framework for more widespread options to address financial assurance challenges. Others maintain that the industry should fund a pool that would provide the basis for issuance of bonds or other insurance products to address risk.

Surety providers' recent reluctance to provide reclamation bonding in the mining industry may reflect their lack of established due diligence practices. Surety companies that become familiar with the type of diligence and risk projections undertaken by mine operators may see benefits in returning to the industry by accurately assessing risks and, correspondingly, pricing bond premiums. At the same time, financial guarantee requirements developed by regulators need to be realistic and consistent. Regulators cannot expect an industry to be viable if it is subjected to what appears to be overly conservative, speculative bond cost estimates complete with inflated administrative costs, unrealistic labor and equipment costs, and other ill-defined contingencies. Thus, more effort may need to be put into developing accurate bond estimates. The federal and state task forces currently focusing on the problem will likely evaluate all these options and others.

The surety challenges facing the mining industry are symptomatic of the tension between federal and state policies that, on the one hand, promote economic development including mining, and on the other hand, require that the mining operators protect the government authorities from every conceivable financial risk. Meanwhile, the confluence of market conditions identified in this article has prompted regulators and industry to view financial risk in a new light. All participants in the financial guarantee process continue to seek greater certainty in assessing risk. While the surety market is cyclical and the future may portend greater market stabilization, the ongoing, critical evaluation of the mining industry's bonding obligations must be pursued and should, at its ideal conclusion, result in a reasonable, flexible system of financial guarantee that ensures the environmentally responsible development of domestic resources.

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