

Testimony of
The Surety Association of America
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Availability of Bonds to Meet Federal Requirements
for Mining, Oil and Gas Projects

Introduction

The Surety Association of America is a voluntary, non-profit association of companies engaged in the business of suretyship. It presently has approximately 600 member companies, which collectively underwrite the overwhelming majority of surety and fidelity bonds written in the United States, and seven foreign affiliates. The Surety Association of America is licensed as a rating or advisory organization in all states, as well as in the District of Columbia and Puerto Rico, and it has been designated by state insurance departments as a statistical agent for the reporting of fidelity and surety experience.

Surety bonds provide a fundamental service to consumers, taxpayers and the U.S. treasury and have been a vital part of business in America for more than 100 years. The role of surety bonds is to reduce or eliminate uncertainty in a variety of business transactions. For example, the majority of surety bonds are written for construction of our nation's infrastructure, which accounts for 10% of the Gross Domestic Product. In 2000, nearly \$175 billion in public works projects were under construction in the United States with surety bonds providing qualified contractors and protection against contractor failure. Surety is vital to public construction, saving taxpayer dollars and spurring economic activity. Surety also has been written for mining, gas and oil projects for many years. Again, the fact that bonds have stood behind miners and drillers has allowed the government to be sure that these projects would be undertaken responsibly and with a third party available if the permittee did not perform. The capability of the surety industry continues to be there to meet the challenges and needs of American business. However, surety bonds cannot be a panacea for all potential problems. The surety industry continues to support the need for responsible mining and drilling, reclamation and general protection of the environment, and we look forward to working with Congress, regulators, environmental groups and contractors to find a way to best do this.

SAA is aware of the difficulty that permittees are having in acquiring bonds and has been working with regulators and other stakeholders to seek ways to address this issue. We believe that the limited availability of bonds required in connection with mining, oil and gas operations results from a change in the requirements as well as a change in the current marketplace. Bonding remains a viable option to address the concerns surrounding many of the risks associated with these projects, but the responsibility of the surety must be clearly defined and must be able to be underwritten.

What Are Surety Bonds

In analyzing the availability of any type of surety bond it is critical to understand the concept behind surety bonds, how they differ from traditional lines of insurance, and why they are underwritten the way they are. The fundamental concept behind a surety bond is to guarantee that someone will perform a duty. Whether it is a duty imposed by contract, such as to build a building, pay a lease, etc., or a duty imposed by law, such as to pay customs duties or to reclaim a mining site, the bond provides an independent third party to ensure that the principal, the person who agrees to the duty, performs, or that there is money available to complete that obligation. The surety is only secondarily liable. The principal remains primarily liable. Unlike traditional insurance, a bond creates a tripartite relationship: the principal, the surety, and the obligee, the one receiving performance. This relationship is best explained by a triangle:

Principal Surety

Each of the parties has rights and responsibilities with regard to the other. While the surety has the obligation to the obligee to either perform the obligation of the principal if the principal defaults, or pay a sum of money, up to the amount of the bond, for performance, the principal remains obligated for that performance. By performing on the principal's behalf, the surety steps into the shoes of the obligee and the principal is obligated to reimburse the surety for any money paid. Theoretically, therefore, a surety should never have a loss. Similar to a bank issuing a line of credit, the surety stands behind the principal, allowing a third party to rely on that principal, knowing a third party is guaranteeing the obligation. Unlike a bank, however, sureties do not always take collateral or have the right of set off of the principal's bank account to recover amounts paid on the principal's behalf. Therefore, the surety must prequalify the principal as to performance and financial strength.

It is critical to understand that the beneficiary of the bond is not the principal; it is the obligee. Unlike a homeowners or auto policy where there are only two parties to the contract and the beneficiary of the policy is the policyholder, in the case of a surety bond, the beneficiary of the bond is the obligee. In the case of the bonds under discussion today, that obligee is the government. The principal remains liable for performance. Therefore, in analyzing whether or not to write a bond, a surety will review two crucial items: the likelihood that the principal will perform its obligations, and the likelihood if the principal defaults and the surety performs, that the principal will be able to repay the surety for its losses. If the surety decides to write the bond, whether or not the surety is correct in its analysis, the obligee obtains the benefit of the bond. Understanding these relationships makes it easier to understand that a surety must be able to know the specific promise it is guaranteeing and assess the risk of loss. An increase in the duties imposed under reclamation and other bonds, as well as serious increases in losses for sureties over the last two years, have contributed to the current market situation.

Federal Mining, Oil and Gas Project Bonds

As mentioned above, SAA is quite aware of the difficulty that permittees are having in acquiring bonds in today's surety market, and we are in active dialogue with regulators and mining industry to seek a resolution to the issue. For example, SAA is working closely with the Department of the Interior's Bonding Task Force to provide information and recommendations regarding bonding availability. In addition, we recently participated in a bonding meeting sponsored by the Interstate Mining Compact Commission, an organization of twenty state regulatory authorities. We believe

that the limited availability of bonds required in connection with mining, oil and gas operations is a result the risk characteristics of such bonds as viewed by an industry that has returned to tighter underwriting standards. We hope to provide information to this Subcommittee that will assist it in developing solutions.

Risk Characteristics of These Bonds

First let us address the risk characteristics of these bonds and why they present a concern to sureties. We reference specific types of bonds for illustrative purposes.

Long-term Duration

A primary risk characteristic that concerns sureties is the long-term duration of these obligations. For example, with respect to mining operations, the Surface Mining Control and Reclamation Act of 1977 ("SMCRA") requires the permittee to provide a bond to the regulatory authority which is conditioned upon the faithful performance of the requirements of the SMCRA, the applicable regulatory program and the approved permit, and the completion of the reclamation plan (30 U.S.C. § 1259(a)). The form of bond and the required bond amount depends on the controlling statute and regulation (either federal or state). However, in any case, reclamation bonds for surface mining operations are long-term obligations. A mining operation under a permit can last thirty or forty years. Considering that the duration of a reclamation bond obligation must be for the duration of the mining and reclamation operation (30 C.F.R. § 800.13), and that the bond is non-cancelable (30 C.F.R. 800.20), a surety's liability could conceivably extend for thirty to forty years as well⁽¹⁾. This creates a high degree of uncertainty and risk for the surety. To determine if a permittee qualifies for a bond, a surety makes a judgment about the operational and financial viability of the permittee. The surety essentially is making a prediction about the permittee's future performance thirty or forty years in the future. As the duration of the obligation extends further into the future, the surety's judgment becomes less certain and its risk increases. Of course, a thirty or forty year duration assumes that the operation does not have water issues such as acid mine drainage. In these cases, the regulatory authorities are holding the bond to secure treatment that may be perpetual. This raises the surety's risk to unworkable levels.

Another type of bond that illustrates the long-term and uncertain duration of bonds, this time for oil and gas operations, is the lease bond required by the Minerals Management Service ("MMS"). MMS requires lessees of Outer Continental Shelf mineral leases to provide a bond to secure compliance of all the terms and conditions of the lease (30 C.F.R. § 256.52). The leases have an initial term of five or ten years and continue for as long as oil and gas is produced in paying quantities (30 C.F.R. § 256.37). While the lease bond is cancelable, cancellation does not release the surety from liability that accrued while the bond was in effect, unless the replacement surety assumes prior liabilities (30 C.F.R. § 256.58). Further, the bond may be reinstated after cancellation if any payment of any obligations of the bond principal (the lessee or operator) is rescinded or must be restored (30 C.F.R. § 256.58(c)). Thus, the duration of the surety's liability is uncertain, even after cancellation.

Expanding Scope of the Obligation

Over the years the obligation covered by surety bonds for mining, oil and gas operations has expanded considerably and introduced risks that are better covered by an instrument other than a surety bond. The clearest example of this phenomenon is the relatively new requirement by regulatory authorities that liability for acid mine drainage be covered by the SMCRA reclamation bond. Under current regulation, the surety bond is fully released after completion of the three phases: backfilling and regrading, revegetation and monitoring (30 C.F.R § 800.40). With respect to actual reclamation activities - moving the dirt - the surety has a clear understanding of the scope and duration of the mining company's obligation and consequently the scope of its liability. However, the presence of acid mine drainage and the requirement to treat the water clouds prolongs the surety's obligation considerably. Historically, regulatory authorities reduced the bond penalty at the completion of phases one and two. Now, however, regulatory authorities are not reducing the bond penalty when phases one and two are completed if the site has water issues that must be treated.

The defaults that a surety can underwrite and address effectively are defaults of the permittee's performance: events that can be prevented through sound practices and compliance with the reclamation plan. A surety cannot underwrite effectively unanticipated acid mine drainage problems that require treatment in perpetuity. It appears that the problem of acid mine drainage requires a funding vehicle, and a surety bond is not a funding vehicle, but rather an assurance of performance which can be controlled. The post mining water issues should be resolved outside of the surety bond, and the surety bond obligation should be the phases of reclamation.

Limited Choices in Remediating a Default

A second risk factor is the limited approaches available to a surety in addressing a bond default. A surety often is faced on these types of bonds with forfeiture of the entire bond penalty as its only means to discharge its obligations. In the case of reclamation bonds required by SMCRA, state regulatory authorities may require the surety to forfeit the full penal sum of the bond rather than giving the surety the option to reclaim the site at possibly a lower cost. As another example, under the Federal Coal Management Program, the Bureau of Land Management requires bonds to secure lease obligations (43 C.F.R. § 3474.1). If a lease is canceled or terminated, all rentals and royalties already paid are forfeited (43 C.F.R. § 3452.3(b)). Therefore, the surety may be liable for a substantial sum rather than having the opportunity to step in and cure the default by undertaking the monthly lease payment. The likelihood of a full bond payout without opportunity to mitigate the loss to the obligee by undertaking performance increases the surety's risk and limits the availability of the bond only to those entities that have significant financial resources.

State of the Surety Market

Sureties recently have refocused on the risk characteristics discussed above as a result of a return to tighter underwriting standards. This adjustment is the culmination of a decade long underwriting cycle that recently generated significant losses in 2001. According to the report entitled "Top 100 Writers of Surety Bonds," released by SAA on May 21, 2002, the industry reported the following results for the year

ended December 31, 2001:

Direct Written Premiums: \$3,473,100,578

Direct Earned Premiums: \$3,330,170,608

Direct Losses Incurred: \$2,748,411,932

Direct Loss Ratio: 82.5%

The results reflect significantly increased losses compared to prior years. Although we are not privy to the company-specific information that would be necessary to provide an explanation that includes each and every factor, we are able to share with you some of the dynamics in general terms that led to the 2001 results. The 2001 results are a continuation of a trend that first was manifested in 2000 and are a result of market activity over the past decade. There is no one event that instantly triggered the 2001 results.

For over a decade, the surety industry had experienced considerable profitability. The positive results attracted new players to the surety market and caused existing players to battle for greater market share. Two mechanisms to attract greater market share are to reduce pricing and to relax underwriting standards. The combination of relaxed underwriting and softened pricing can create a tenuous condition, especially considering that surety theoretically is written to a 0% loss ratio.

A significant factor in surety results is the financial strength of bond principals as affected by the general health of the economy. A surety bond is written with the expectation that the bond principal will perform its obligations or hold the obligee harmless if it defaults. Therefore, financial health is crucial. According to the percentage change in Gross Domestic Product, the economy began to experience some softening in the latter part of 2000.

The softened underwriting and pricing combined with declining financial strength (as indicated by GDP) led to a downturn in results in 2000. The 2000 Top 100 Writers Report reflected a loss ratio of 45.4%, compared to a 29% loss ratio in 1999. ⁽²⁾ Further, according to the 2000 Insurance Expense Exhibit, the industry had an underwriting loss (including incurred losses and operational expenses) of \$216.3 million. The 2001 results are a continuation of the 2000 results and magnified by losses attributable to some high profile bankruptcies.

To reverse this trend, we suspect that sureties have reversed the factors that played a role in the downturn, softened underwriting and pricing. We likely will see a firming of pricing and tightened underwriting requirements in the coming years. For example, surety companies have become especially hesitant to underwrite any type of obligation that extends five, ten or fifteen years into the future. Sureties seek to control risk in part by writing obligations that have a reasonable duration.

Reinsurance companies suffered serious losses in this surety market downturn as well. In response, reinsurance companies are requiring primary sureties to retain more risk and have tightened the terms and conditions in reinsurance treaties. For example, we are aware anecdotally that certain reinsurance treaties exclude coverage for long-term obligations such as self-insured worker's compensation bonds or reclamation bonds unless specifically consented to by the reinsurer. This in turn impacts the primary sureties' underwriting decisions.

The correction in the surety market also includes a changed perspective on underwriting risk. In the past, a determination of the risk of a particular type of bond has been based on historical loss experience. If a particular type of bond generated reasonably low losses in the past it will have similar results in the future. The results of 2000 and 2001 have altered that approach. Now sureties determine risk by determining the probable maximum loss on a particular type of bond. Sureties assess their exposure by considering bond amount, duration and the likelihood of full bond forfeiture. In the case bonds required in connection with mining, oil and gas operations, the potential exposure is high, and sureties make their underwriting decisions accordingly.

The September 11, 2001, terrorist attacks did not impact surety companies directly. However, the impact was felt by the property and casualty insurance companies that are the sureties' parent companies and affiliates. The terrorist attacks caused an erosion in capital as property and casualty losses were paid out. Although much of this capital has returned to the market, insurance companies have become especially careful how capital is used. This decision regarding capital usage affects underwriting decisions as well.

Developing Workable Solutions

The surety industry has played a vital role in securing obligations to the federal government so that public interests are protected. As the surety industry returns to financial health it will continue to provide this protection. With respect to bonds for mining, oil and gas operations, we believe that it is important to examine the current bonding requirements and policies to address concerns of the permittees and their sureties, particularly the duration of reclamation and lease obligations. Such a

review likely would create a market effect and encourage surety participants to meet ongoing bonding needs of mining operations. For example, we believe that the bond obligation should be well defined and cover a specific scope of work. With respect to reclamation, the bond should be limited to the three phases and should not cover the obligation for water treatment that is uncertain and long-term. In addition, we believe that regulatory authorities should consider inserting a cancellation provision in bond forms that currently lack one. Once cancelled, the obligee should not have the ability to reinstate the bond. In addition, authority should consider that the bond term should be tied to the permit term. At the end of the permit term, the surety should have the option of renewing or not renewing the bond. We also encourage regulators to provide additional options to sureties in addressing claims short of a full bond forfeiture. As to the issue of acid mine drainage, we urge Congress and regulators to look at all options such as finite risk insurance products, pools, trust funds and other similar mechanisms.

We look forward to continued discussion with the Subcommittee, the Department of Interior, state regulatory authorities and other stakeholders to develop concrete solutions.

¹ The regulation allows a bond to be replaced by other bonds that provide equivalent coverage. 30 C.F.R. § 800.30

² The 1999 loss ratio is based on the SAA Top 50 Writers Report. This report was used in order to make a meaningful comparison. The results of 2000 and 2001 Top 100 Reports are gross and before reinsurance. The 1999 Top 100 Report's results are net of reinsurance. Therefore, the 1999 Top 50 Writers Report which reflects gross results was used for the sake of consistency.

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