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Who Should Pay for the Gulf Oil Spill?

Liability and incentive issues raised the by Deepwater Horizon incident

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Even with BP’s recent announcement of success in capping the oil gusher at the bottom of the Gulf of Mexico, the debate on the risks and benefits of drilling for oil offshore is likely to continue for the foreseeable future.

Many environmentalists used the incident to argue that offshore drilling should be banned or restricted. On May 7, 2010, the Department of the Interior announced it was postponing “indefinitely” the preliminary processes toward opening a new offshore drilling lease in the Atlantic, citing the caseload the oil gusher has imposed on the department.¹ Rep. Kendrick Meek and Sen. Bill Nelson, both Florida Democrats, have introduced a bill to suspend “any new exploration, development, and production activities in the outer Continental Shelf, including the conduct of seismic and other geological and geophysical surveys”² until such time as the administration has completed an investigation, report, and recommendations concerning the Deepwater Horizon incident. The legislation would also suspend ongoing offshore drilling operations unless and until the Interior Secretary certified the operations as safe.

All the proposed “solutions” mentioned above are likely to be short-lived. Rather than try to arrive at some acceptable level of risk for oil drilling, as determined and enforced by government regulators, the federal government should allow the market to price risk appropriately. That would make the risk-takers internalize the costs for those risks—which, in turn, would make those responsible for disasters bear the costs of cleanup, as well as discourage risky behavior. This paper explores the current federal risk and incentive structures for offshore drilling and offers some alternatives to managing those risks in the future.

The current liability regime. There are few better ways to encourage risky behavior than by lessening the potential costs arising from that behavior. Such an incentive structure exists for oil

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drilling today. The Oil Pollution Act of 1990 set a liability cap of \$75 million for responsible parties on certain kinds of damage caused by oil spills. The White House and many in Congress are supporting legislation to raise the cap. British Petroleum has claimed it would pay “all legitimate claims” beyond the cap, but the president of BP America refused to further clarify what that meant in congressional testimony.³ In mid-June, the White House announced an agreement with BP under which the company would fund a \$20 billion compensation fund to be administered by a third party.⁴

BP’s apparent acceptance of financial responsibility in excess of the liability cap may seem to make that cap a moot issue for now. Yet the cap remains in place. Even if the cap ends up being increased, its existence will continue to play a role in future projects.

So how did it come to be? In 1989, a drunken pilot crashed the Exxon Valdez oil tanker into Alaska’s shore, spilling millions of gallons of oil into Prince William Sound. Congress responded the following year by passing the Oil Pollution Act of 1990 (OPA). Although the Act has been somewhat modified since then, the liability structure it codified stands largely intact today.

The primary component of the OPA was the Liability Trust Fund (OSTLF), which was originally established in 1986, but had no funding mechanism before the OPA was passed into law in 1990. The OPA folded existing funds and liabilities from two other federal trust funds—the Offshore Oil Pollution Compensation Fund and the Deepwater Port Fund—into the OSTLF. As a primary continuing revenue stream for the OSTLF, OPA set a 5 cent-per-barrel tax on oil. In 2008, this was raised to 8 cents per barrel.⁵ The other main source of revenue for the fund theoretically would be civil penalties assessed by the federal government on oil companies under Section 311 of the Clean Water Act for noncompliance with oil-spill prevention and clean-up regulations and orders.⁶

The Senate Environment and Public Works Committee, in a report⁷ concerning the first version of the legislation, made explicit the goal of socializing the risk involved in drilling and transporting oil: “The Fund assures that the costs associated with a spill are compensated, not just those within the spiller’s limit of liability, through a mechanism which spreads these excess costs to all users of oil.”

The Fund is divided into two smaller funds. The first is an “Emergency Fund,” which the executive branch has broad discretion to use for rapid response in cleaning up oil spills. The Emergency Fund only holds \$50 million. The remainder is in the “Principal Fund,” which is used to pay for various damages and other costs associated with oil spills. The Principal fund also has money appropriated by Congress to various other agencies—including the Environmental Protection Agency, the Coast Guard, and the Treasury—for other purposes, such as general administrative costs and research and development. The Principal Fund is also a chief source of funding for the Denali Commission, a body set up in 1998 by the once “King of Pork,” Sen. Ted Stevens (R-AK), to provide “economic development”—including infrastructure, housing, health care facilities, and subsidies to oil companies to upgrade or fix oil tanks not in compliance with the latest federal regulations—in his home state of Alaska.

The 1990 law set a cap at \$1 billion for OSTLF reserves; the barrel tax would be dropped after the Fund was full. The Energy Policy Act of 2005⁸ raised that cap to \$2.7 billion, but the Fund was projected to only hold \$1.6 billion by the end of fiscal year 2010. The OPA set a liability limit on responsible parties whereby they would have to pay cleanup costs and—absent federal regulatory violations or a finding of “gross negligence” by a responsible party—no more than \$75 million in damages per oil-spill incident.

During the OPA debate, many in Congress spoke in favor of amending the bill to lift or remove the liability. But proponents of the cap said it was a necessary part of the compromise needed to pass the bill—which had no dissent on final passage in either house. Sen. John Breaux (D-La.) justified a liability cap thusly: “There are numerous small independent companies that operate in the [outer continental shelf] knowing that they are responsible and have to show financial responsibility for \$35 million worth of damages. If you raise it to \$100 million, it is going to be a little more difficult for them to raise the test. If you put unlimited liability, they will be thrown out of participating and thrown out of providing the competition which is essential for us to get the best deal for the consumers of this country.”⁹ Any other damages beyond the \$75 million are the responsibility not of the responsible parties, but of the Fund. However, the Fund is responsible for no more than \$1 billion in payout for each incident.¹⁰

The Valdez spill led to punitive damages that were litigated for years by Exxon. OPA sought to move away from punitive damages in favor of damages that supposedly could be more objectively measured. Damages eligible for reimbursement from the OLSTF after an oil-spill incident include property damage; loss of subsistence use of natural resources; damage to natural resources, as assessed “by a United States trustee, a trustee, an Indian tribe trustee, or a foreign trustee;” loss of taxes and other revenues by federal, state and local governments; lost profits and earning capacity caused by the damage to property and natural resources; and state expenditures on safety services in response to the spill.

So, under the billion-dollar cap, private parties are in direct competition with government trustees of “natural resources” for damage claims. Hence, every dollar “won” from the OSTLF by a trustee appointed by the president (or governor, or foreign dictator) is a dollar not won by property owners or commercial fishermen. That can put private parties at a serious disadvantage due to the general tendency of government courts to favor government claimants. (Fortunately for private claimants, that institutional advantage held by the trustees is limited to half the kitty, with a \$500 million cap for damage to “natural resources.”)¹¹

Effects of the Cap. The \$75-million liability cap constitutes what is known in economics as a *moral hazard*. An oil company is only legally on the hook for \$75 million in damages in the case of a spill (unless one of the cap’s exceptions apply), so its need to buy insurance—or set aside cash reserves¹²—to cover damages for a much larger spill is substantially limited. This release from liability amounts to a subsidy for risky oil-drilling activities such as those in deep water versus, say, drilling for oil on land. For example, if two wells each have the same potential for disaster, but the damage wrought by one disaster could be expected to cost \$200 million and the other \$20 billion, the potential harm to the company’s bottom line vis-à-vis damage payouts in both cases is only \$75 million. That inability of prices to reflect actual risk subsidizes the decision to drill a riskier well.

This risk subsidy extends to insurance markets. In a recent letter to U.S. Senators, the insurance broker Lloyd & Partners said of the liability cap: “Any significant increase in this limit will cause Insureds operating in U.S. Waters to face the prospect of significant self insurance, since (depending on the amount) the insurance market will not have sufficient capacity to provide cover for this in addition cleanup costs and third party properties damage suits.”¹³ Robert Hartwig, an economist with the Insurance Information Institute, says that drilling premiums are already on the way up: “There has already been an escalation in insurance prices in the energy markets as a direct result of the Deepwater incident. Part of this is driven by the possibility of raising drillers’ liability limits.”¹⁴

The liability cap may also discourage other possible safety measures, such as redundant blind shear rams in the blowout preventer,¹⁵ that could limit the damage of a \$20 billion spill to, say, \$2 billion in damages, since both figures, however disparate, are well above the cap. Again, the riskier course is subsidized, as the liability remains basically unchanged in either case. So from a bottom line perspective, the additional expense is not justified.

Thus, the liability-cap subsidy undermines market pricing of risk. Proposals in Congress¹⁶ to raise the liability cap—to \$700 million, a year's profits,¹⁷ or \$10 billion¹⁸—would represent a move to a freer market. It is important to remember that if an oil firm were bankrupted by a spill, its wells and infrastructure may not be destroyed, and instead sold to another firm.

By maintaining a large amount of cash on hand to pay claims quickly through an administrative process, the Oil Spill Liability Trust Fund can provide important assistance to claimants with time-sensitive needs. However, those funds come from firms throughout the industry via taxes, so the fund also poses the problem of *socialized risk*, whereby an entire industry is made liable for the acts of individual firms. The Fund, by imposing an across-the-board, one-size-fits-all tax on oil production to fund the Fund, forces careful drillers to pay for the mistakes of the careless, rather than buy insurance priced according to each firm's safety record.

Under the current cap-and-Trust regime, even a proper apportioning of responsibility cannot fully recompense claimants. Absent regulatory violations or a finding of gross negligence, damages guaranteed to private-sector claimants in a multi-billion oil-spill incident could be less than \$600 million, given the possibility that half of the Fund's billion-dollar maximum payout could go to government bodies.

In the Gulf incident, BP quickly promised to pay out all "legitimate claims" of damage, as defined in the 1990 Oil Pollution Act, beyond the cap and the Trust Fund expenditures. That promise, carried out properly, is good politics and important to maintain public goodwill. BP subsequently committed to establish a \$20 billion fund, which may or may not cover the full extent of damage which it caused.

There is still an important role for courts to determine liability. Many market proponents are wary of the possibility of high-dollar jury verdicts, and jury selection—attorneys often seek to impanel only the least knowledgeable or educated—raises legitimate concern. But in complex cases, there is no better option than an open, public trial to get all the facts out about what happened, what was damaged, and who is responsible. An impartial jury would have a greater chance of making the correct decisions on those matters, than, say, a politicized investigative commission appointed by the White House.¹⁹ And as messy as jury trial can be, a jury consisting of private citizens would be more impartial when deciding how to split limited damages between private claimants and government-run "natural resource" trusts.

Absent a liability cap, the key question is how best to reward damages in a way that internalizes the negative external costs in a risky enterprise such as oil or gas extraction. Any legislation—whether by Congress, or when necessary, by state legislatures—should adopt a strict-liability standard. That would be the most efficient way to resolve damages to well-defined private property such as real estate or fishing equipment as per the Coase Theorem, which holds that the optimal resolution of externality problems such as pollution can be negotiated among parties who have clearly defined rights to private property.²⁰

It might also be useful to make some kind of delineation between proven oil extraction techniques and experimental and therefore riskier techniques, such as deep-water drilling. While alternate liability regimes may be feasible for proven techniques, those riskier techniques should be subject to strict liability for all private and public damages in order to be sure the utmost caution is taken when risking the most catastrophic kinds of spills. The definition of which techniques qualify as the most risky and which do not could be done via statute and revised periodically as technology improves.

Conclusion. In the wake of the Deepwater Horizon incident, political pressure to limit and ban offshore drilling is on the rise. The answer is not to ban offshore drilling, but to correct the errors in the liability and insurance markets that helped precipitate the disaster. Raising or eliminating the liability caps would encourage more prudent behavior by oil companies and the insurance companies and bond markets that finance them. Raising the caps after the fact obscures the ways in which interference in the market likely encouraged risk taking. Congress should consider repealing the entire Trust Fund structure, which socializes risk among prudent and imprudent firms and encourages imprudent behavior.

Notes

¹ *Federal Register*, “Notice of indefinite postponement of comment period on and cancellation of public meetings to scope for an Environmental Impact Statement (EIS) for Proposed Mid-Atlantic Oil and Gas Lease Sale 220,” Vol. 75 No. 88, May 7, 2010, <http://www.mms.gov/offshore/PDFs/FedRegNotice050710.pdf>.

² *To suspend certain activities in the outer Continental Shelf until the date on which the joint investigation into the Deepwater Horizon incident in the Gulf of Mexico has been completed, and for other purposes*, H.R. 5222, 111th Congress, 2nd Session, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h5222ih.txt.pdf.

³ Written Testimony, Lamar McKay, Chairman & President, BP America, United Senate Energy & Natural Resources Committee, May 11, 2010, http://energy.senate.gov/public/_files/McKayTestimony051110.pdf.

⁴ Eamon Javers, “With \$20 Billion Fund, BP Limiting Liability: Feinberg,” CNBC.com, (original CNBC link has expired), http://beforeitsnews.com/story/83/227/With_20_Billion_Fund,_BP_Limiting_Liability:_Feinberg.html.

⁵ *Energy Improvement and Extension Act of 2008*, H.R. 7201, 110th Congress, 2nd Session, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h7201ih.txt.pdf.

⁶ United States Code, 33 Ch 26 § 1321, “Oil and hazardous substance liability,” http://www.law.cornell.edu/uscode/33/uscode_sec_33_00001321----000-.html. Those penalties can be as high as \$1,000 per spilled barrel of oil for not complying with clean-up protocol orders given by the Administration's National Contingency Plan.

⁷ Senate Report 101-94.

⁸ *Energy Policy Act of 2005*, H.R. 6, Public Law 109-58, August 8, 2005, 42 USC 15801, <http://www.doi.gov/pam/EnergyPolicyAct2005.pdf>.

⁹ Russel V. Randle, ed., *Oil Pollution Deskbook*, Environmental Law Institute, 1991, p. 450.

¹⁰ Internal Revenue Code, Title 26, Subtitle 1, Subchapter A, § 9509 (c)(2)(a), http://www.law.cornell.edu/uscode/html/uscode26/uscode_sec_26_00009509----000-notes.html.

¹¹ *Ibid.*

¹² BP has no external insurance for this kind of spill and will pay damages out a “self-insurance” fund of cash reserves.

¹³ “Impacts of Increased Liability Limits on Deepwater Operations,” American Petroleum Institute Briefing Paper, May 24, 2010, <http://www.scribd.com/doc/31626343/Impacts-of-Increased-Liability-Limits-on-OCS-Operations>.

¹⁴ E-mail to the author, June 1, 2010.

¹⁵ David Barstow, Laura Dodd, James Glanz, Stephanie Saul, and Ian Urbina, “Regulators Failed to Address Risks in Oil Rig Fail-Safe Device” *The New York Times*, June 20, 2010, <http://www.nytimes.com/2010/06/21/us/21blowout.html>.

¹⁶ The 1957 Price-Anderson Act, which establishes a similar liability cap for nuclear power plants, has been challenged and upheld by the Supreme Court; hence any reform to the liability cap would have to come through the Congress rather than the judiciary.

¹⁷ *Oil Spill Response and Assistance Act*, S. 3375, 111th Congress, 2nd Session, <http://frwebgate.access.gpo.gov/cgi->

bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s3375is.txt.pdf.

¹⁸ *Big Oil Bailout Prevention Liability Act of 2010*, S. 3305, 111th Congress, 2nd Session,

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s3305is.txt.pdf.

¹⁹ *Executive Order -- National Commission on the BP Deepwater Horizon Oil Spill and Offshore Drilling*, May 22, 2010,

<http://m.whitehouse.gov/the-press-office/executive-order-national-commission-bp-deepwater-horizon-oil-spill-and-offshore-dri>.

²⁰ Ronald H. Coase, "The Problem of Social Cost," *Journal of Law and Economics*, Vol. 3 No., 1960, pp. 1–44.