

# Background

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## Oil Spill Liability: A Plan for Reform

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**Abstract:** *Current law states that oil or gas companies do not have to pay more than \$75 million in liability costs for accidents they cause—no matter how great the damages. Republicans and Democrats agree that the cap is too low. But simply raising it to another artificial level, or eliminating it entirely without other reforms, is not the easy answer, tempting as it might seem. A higher cap, or none at all, means very little as long as crucial safety, regulatory, and liability issues continue to be ignored, and public concerns are unaddressed. Government regulatory oversight is necessary, but liability insurance must be privately managed, with claims assessed and paid out by an independent administrator. Safety and preparedness measures must also be independently reviewed and approved. Above all, taxpayers must be protected from footing the liability costs for industry-caused disasters. The Heritage Foundation provides a comprehensive plan for responsible and commonsense measures to ensure offshore oil and gas safety, keeping the public informed and government bureaucracy in check.*

The Deepwater Horizon oil spill in the Gulf of Mexico has brought a number of important policy issues regarding offshore drilling to the surface. One contentious issue is the extent to which offshore oil and gas operators are held liable for any accidents they may cause. Republicans and Democrats agree that the current liability cap of \$75 million is too low. Members of Congress have called to raise the cap to \$10 billion or remove it entirely.

### Talking Points

- Under current law, oil and gas companies do not have to pay more than \$75 million in liability costs for accidents they cause—no matter how great the damages.
- Nearly everyone agrees that the cap is too low, but simply raising or eliminating the cap without other reforms means little as long as crucial safety, regulatory, and liability issues are ignored.
- Congress should establish an insurance and claims process that assigns full risk of offshore drilling to the responsible party and allows victims to be fully compensated, while protecting companies from frivolous lawsuits.
- The oil and gas industry should establish an independent Organization for Offshore Safety Operations to monitor real-time safety data, certify best practices, and, when appropriate, share information with federal regulators.
- Safety and preparedness measures must also be independently approved, and taxpayers must be protected from footing the bill for industry-caused disasters.

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The problem with these approaches is that they do not address the fundamental problem of the current system: It does not sufficiently align risk and liability with individual behavior. It starts with a very low liability cap and then forces all participants to contribute to a government-mandated trust fund to pay for damages. The result is a system that socializes risk by spreading the costs across the entire industry, creating a divide between behavior and financial risk. Simply raising the cap without more comprehensive reform would fail to fix the systemic problems and could effectively shut down offshore drilling entirely if activities are made unreasonably and artificially burdensome.

Instead of simply increasing or removing the cap, Congress and the Administration should develop a new approach that accurately assigns risk to all offshore operations, including exploratory drilling, production, and tanker movements; holds operators fully liable for their actions; and guards against frivolous lawsuits. Such a system should rely on market-based mechanisms and be built around private insurers and professional risk assessors.

Specifically, such a regime should include:

- **A multi-tiered insurance and liability system** that relies on private insurance to cover liability for normal operations and a voluntary insurance pool for liability exceeding \$1 billion;
- **An industry-funded organization governed by an independent board to reduce the likelihood of spills by setting and enforcing safety standards at individual sites**, collecting safety data, sharing best practices, and working with government regulators; and
- **A pre-positioned industry-funded preparedness and response capability, certified by an independent organization**, to deal aggressively and effectively with accidents if they do happen, as well as **a more robust and integrated federal oversight and national response**.

All three pieces—insurance, safety standards and inspection, and preparedness and response will work together to reduce the likelihood that a future

spill will occur, and reduce the economic and environmental damage if it does occur.

## Current Law

Oil spill costs should be regarded as consisting of two basic types: cleanup costs and liability costs. First, under current law, the responsible party must pay all cleanup costs. This approach is correct and needs no reform. Second, the liability costs are the costs incurred by individuals, businesses, and communities that suffer as a result of the oil spill. Under U.S. law for offshore facilities, the responsible party (in the Deepwater Horizon case, BP) is directly responsible for no more than \$75 million of these costs. Liability costs above \$75 million up to \$1 billion are funded by the Oil Spill Liability Trust Fund (OSLTF). The OSLTF is financed by an eight-cent-per-barrel tax on imported and domestic oil.

The \$75 million cap is waived if the responsible party is found to have acted with gross negligence or willful misconduct, an issue which has not yet been resolved regarding BP. Even so, BP has repeatedly stated it will pay all costs incurred by the oil spill. Although the current system seems to be working in terms of BP financing the full costs of its mistakes, the problem is how it impacts normal operations and procedures elsewhere in the industry. The Oil Pollution Act of 1990 addresses liability for onshore and offshore oil and gas operations.<sup>1</sup> While this paper focuses only on offshore operations, its principles and concepts could apply to the oil and gas industry broadly.

## A New, Market-Based Approach

Congress should reform the Oil Spill Liability Trust Fund and remove the \$75 million liability cap, replacing it with a new system that accurately assesses the risks of offshore oil and gas operations and appropriately assigns those risks to industry operators. Companies must demonstrate to federal regulators an ability to insure against the liability risk associated with specific offshore oil and gas operations (exploration, extraction, and transportation, etc.) in federal waters. Private risk assessors will determine liability-coverage requirements for

1. Oil Pollution Act of 1990, amended on December 29, 2000, at <http://epw.senate.gov/opa90.pdf> (July 30, 2010).

specific activities and federal regulators will certify that liability requirements are met. The means for meeting liability-coverage requirements will not be limited, but may include self-insurance, insurance pools, dedicated assets, or private insurance policies. The federal government will create a private, tiered insurance framework and administrative process to manage claims. The central element of the insurance framework will be a private and voluntary pooled insurance fund for claims above \$1 billion. The claims process will ensure that legitimate claims are paid fully and efficiently while protecting responsible parties from frivolous lawsuits.

The current liability system distorts the *ex ante* risk of oil and gas operations in two fundamental ways: (1) The artificially low cap of \$75 million established 20 years ago does not fully or directly capture the risk of offshore operations; and (2) Rather than placing responsibility with the responsible company, the OSLTF shifts responsibility to the entire industry and, ultimately, the federal government, thereby reducing the incentive for individual companies to operate safely.

**The Role of Private Risk Assessors.** Private risk assessors, not bureaucrats and politicians, should determine the liability associated with covered activities. These professionals maintain the specialized knowledge and expertise to accurately assess the risk of offshore oil and gas operations. They use many variables, such as safety records and depth and pressure of wells, to calculate their conclusions. Private insurers can then use that information to determine the premiums required to insure against potential liabilities. Removing the process from government control will help to ensure more objectivity.

**Accurate Risk Assessment: More Innovation, Less Risk.** By not assigning proper responsibility for risk, the \$75 million liability cap can decrease the value of safe operations. Congress should be wary of a fix that mandates one safety technology or procedure over another or a set of blanket safety standards for the entire industry. Such mandates reduce the incentive for companies to innovate and create new technologies. Accurate risk assessment and holding each company liable for that risk increases the incentive to reduce risk—each company will have a financial incentive to continuously strive for safety

improvements—thereby resulting in more innovative approaches to safety and preparedness.

### **A 3-Part Plan for Safe Offshore Gas and Oil Operations**

**1. A Tiered Insurance Program.** Congress should establish an insurance and claims process that fully assigns risk of offshore oil and gas operations to the responsible party and allows victims to be fully compensated, while protecting companies from frivolous lawsuits.

**A \$1 Billion Threshold per Accident.** Liability of up to \$1 billion per accident, indexed for inflation, would be the responsibility of the operator. To remain in operation, the liable party must demonstrate to federal regulators an ongoing ability to meet the up to \$1 billion liability threshold in the event of an accident. This requirement could be met through individual private insurance or pools, or by some other means, including the pledging of company assets and pooling of resources among individual companies. Assets identified and pledged against the \$1 billion threshold must remain unencumbered for the duration of the exposure, meaning they could not be used as collateral in another financial transaction.

**Industry-Funded, Privately Managed Insurance Under Government Oversight.** The second level of insurance would be a voluntary insurance pool with a placeholder target of \$10 billion funded by responsible parties to cover legitimate liability claims above \$1 billion. The final target should use the total liability costs of the BP oil spill as a point of reference. Any remaining funds from the Oil Spill Trust Fund should be transferred to this pool. Participating companies would fund the pool through fees (or premiums) paid per barrel of oil produced, or per barrel imported. This premium would vary based on a safety rating from an independent safety organization on a case-by-case basis for each company. (The proposed creation of such an organization is described below.)

- **Independent and private.** The insurance pool would be independently and privately managed for the sole purpose of fund withdrawal if a participating party needs it. The responsible party would then be required to replenish the fund.

To ensure timely payment, a repayment penalty would be introduced at a predetermined interval and increased as the repayment period extended. Although the fund would fall under federal oversight, it would remain privately held and managed.

- **Impartial and fair claims process.** Congress should establish an administrative process to manage claims and distribute funds. It should further establish an appeals process to ensure that all legitimate claims are met. It would have the additional benefit of ensuring that *only* legitimate claims are met, protecting responsible parties from frivolous lawsuits.
- **Voluntary.** Participation in the insurance pool should be voluntary. Companies that believe they run efficiently and are better served by covering their own risks should be permitted to do so. Similarly, should an accident occur, nothing would compel the responsible party to use the pool if some other form of remediation were available and more advantageous.
- **Conditional.** To participate in the fund, a company must first undergo a safety evaluation by an independent organization to determine that it operates at acceptable safety levels, thus protecting existing fund participants against undue risk. Once accepted into the fund, the company will enjoy all the benefits and responsibilities of existing fund participants. One of these responsibilities will be the legal obligation to repay any fund withdrawals according to the conditions of fund participation even if a company chooses to exit the fund.
- **Taxpayer protection in case of pool depletion.** The possibility exists that the costs of a particular event may outrun the pool's available balances. The pool requires a robust, certain financial backstop to ensure the costs are not shifted to the taxpayers but remain the responsibility of the company involved or, in the event the company fails, of the industry generally. The industry itself should provide this backstop. The manager of the pool would charge each participating firm a special levy in proportion to the previous year's payment sufficient to ensure a positive balance remains in the pool after all valid claims are paid.

These special levies would be in the nature of a loan from the companies to the pool to be repaid as credits against future and regular contributions to the pool. Then, after the event, as the liable company makes payments to the pool, the pool would be replenished. If, and to the extent, the liable company is unable to make its payments, the credits from those companies that paid the special assessment would be extinguished.

In a free market, industry players unable to cover their own economic liability would likely have created a pool voluntarily, but government-created caps and the trust fund have eliminated the need to do so. The private pool would be different from the current government-run system since it would foster incentives to balance risk, unlike a government-run system indifferent to markets. This would be done through the creation of an independent safety organization and its ability to influence insurance premiums based on a company's safety rating.

**2. Organization for Offshore Safety Operations.** In addition to a private risk-insurance-based system, the oil and gas industry should establish an independent Organization for Offshore Safety Operations (OOSO) to promote safety. While Congress should not compel the creation of OOSO, industry would be well served by establishing it since it would improve safety standards as well as public perception of offshore drilling safety. OOSO would resemble the Institute of Nuclear Power Operations (INPO), created after the partial meltdown of the Three Mile Island nuclear reactor.

OOSO would have three primary roles:

- First, OOSO would share safety standards and practices, including quality assurance and operating and management procedures, and it would conduct evaluations of such standards. For OOSO to be successful, protecting proprietary information will be essential. Oil companies maintain their competitive advantage by investing significant resources into research and development. Without adequate protections of these investments, no company would participate in such a regime. One way that this information would be used is to create a safety rating system. Insurance companies could then choose to base their premiums in part on the rating. At a mini-



mum, the rating system, which should be made public, should be used to determine the amount each company pays into the pooled insurance fund. Companies would then have a financial and public relations incentive to achieve the best rating. A similar system works very well in the nuclear industry.

- Second, OOSO would allow more seamless cooperation between industry and government regulators. Rather than scrambling to pool knowledge and expertise from the entire oil industry after a spill of similar magnitude to the Deepwater Horizon spill, these companies could work together in voluntary cooperation with the government agencies beforehand to better prevent future accidents and improve the post-accident response.
- Third, OOSO would help ensure that regulatory actions protect public health and safety, rather than make oil extraction more difficult. An independent organization would not replace the regulations imposed by the Bureau of Ocean Energy Management, Regulation, and Enforcement (BOEMRE); instead, it would provide a much-needed alternative to potential regulatory overreaches, which we have already witnessed on the federal side. The independent organization would not, however, be industry's regulator. Rather, BOEMRE and the U.S. Coast Guard would work, for example, with OOSO to share real-time data for tracking of operations on offshore rigs and platforms. Real-time data tracking and monitoring will contribute to spill prevention, and will reveal a problem on a drilling rig or operating platform more quickly, increasing the probability of a quicker fix.

After the incident at Three Mile Island, President Jimmy Carter created a commission led by Dartmouth College president John Kemeny. The commission recommended that the nuclear industry establish a program that shares best-practices safety standards and conduct independent evaluations on the industry's operations. As a result, the nuclear industry created INPO to "promote the highest lev-

els of safety and reliability—to promote excellence—in the operation of commercial nuclear power plants."<sup>2</sup>

The oil industry needs to set up a similar organization. Consistent monitoring of offshore operations would significantly reduce a company's ability to cut corners. If OOSO found that a company did cut corners, it would apprise federal regulators of its findings.

Not only would OOSO prevent governmental regulatory overreach that could drive offshore operations to other countries, it would increase safety levels, thereby reducing the insurance premiums paid by the industry. A system of peer review and self-preservation would further reduce the risk of an accident and catch warning signs that were ostensibly missed during the Deepwater Horizon accident. Although an oil spill of the Deepwater magnitude is extremely rare, the current disaster in the Gulf of Mexico roused public fears of offshore drilling. If professional and credible, OOSO would greatly relieve the public's environmental concerns associated with oil and gas exploration and production.

Like INPO, OOSO would be structured much like a normal business, with a board of directors that includes members of industry, academia, and potentially other sectors. The board should be chaired by an industry leader. OOSO would also have an active advisory council composed of engineers and scientists with relevant knowledge. Moreover, OOSO should have the ability to create accreditation programs and education courses that would increase the operational safety of offshore laborers. Training accreditation for new workers would also be recognized by insurance companies and would be another way to keep premiums affordable.

OOSO's relationship with BOEMRE, which manages natural gas, oil, and other mineral resources offshore, would be critical. OOSO would not play an advocacy role, but instead provide complementary and timely safety information to BOEMRE. This could include tracking and monitoring real-time safety data that would provide a backstop to previ-

2. Institute of Nuclear Power Operations, "About Us: Our Mission," at <http://www.inpo.info/AboutUs.htm> (July 30, 2010).

ously undetected problems. Biannual safety evaluations by OOSO should be shared with BOEMRE to allow federal regulators to make better decisions about future sales of leases for oil and gas exploration and production. Evaluation programs as well as analysis and information exchange programs will enhance operational and safety performance and assist BOEMRE without creating additional government bureaucracy.

### 3. Demonstrated Response and Preparedness.

Whatever the specific mistakes and systemic flaws that led to the explosion on the Deepwater Horizon rig, the oil industry and federal government must demonstrate that they can handle and contain a major spill much more effectively than they have thus far. This means that the industry and government would have to go above and beyond current safety standards (such as blowout preventers) as well as the prevention planning mandated in the 1990 Oil Pollution Act, which predominantly focused on tankers. Adequate response capabilities will reduce the economic and environmental damage of an oil spill, and help to mitigate public concerns over oil and gas exploration. The demonstrated response and preparedness would require the oil and gas industry to:

- **Assess damage of a spill accurately.** Faulty and outdated U.S. government data grossly underestimated the probability of leaked oil reaching shore.<sup>3</sup> In order to be prepared for a future oil spill, the scientific estimates must be updated continuously. OOSO should establish a relationship with scientists and engineers at BOEMRE to provide more accurate estimates of the effects of a spill. This would cause any lease purchaser to be more preemptive if there is another spill and more accurately assess risk.
- **Acquire necessary equipment.** Liable parties, such as lease holders, should prove to the Coast Guard they can provide the necessary equipment to contain and clean up an oil spill. This includes protecting marshes, wetlands, and beaches from environmental damage as well as cleaning up the

marshes and beaches if any oil does reach shore. Each operator must demonstrate that he can readily deploy boom, skimmers, dispersant, vessels, and other containment equipment.

- **Participate in disaster response.** During the containment response to the Deepwater Horizon, BP discovered that it needed to coordinate requests from states and localities, coordinate large-scale logistics, and reposition and protect assets in the event of hurricanes. Private-sector participants must have the planning, organizational, and coordinating capacity to support (whether themselves or through third parties) large-scale response and recovery assets. OOSO should offer certification for companies that routinely exercise and demonstrate these capabilities.

The demonstrated response and preparedness would require the federal government to:

- **Ensure proper and adequate federal oversight.** While BOEMRE conducts inspections below the waterline, the Coast Guard inspects above it. The inspection powers of the two agencies need to be reshaped to ensure seamless oversight of the drilling process. Furthermore, inspection, oversight, and technical and scientific assets need to be fully resourced. Regulatory requirements must be updated for current operations and technologies employed in modern deep-sea drilling.
- **Provide a complementary federal response capability.** Catastrophic environmental disaster response, including oil spills that affect coastal waters, should be managed under the National Response Framework. State and local governments are more familiar with and prepared to respond through the Incident Command relationships as conducted through the National Response Framework by the authority of the Stafford Act. On the other hand, the Incident Command system established under the Oil Pollution Act of 1990 is not well suited for handling multiple states and diverse jurisdictions within states. For example, during the Deepwater Horizon response, the Coast Guard had to estab-

3. Neil King Jr., and Keith Johnson, "BP Relied on Faulty U.S. Data," *The Wall Street Journal*, June 24, 2010, at <http://online.wsj.com/article/SB10001424052748703900004575325131111637728.html> (July 30, 2010).

lish liaison officers at the county level in order to facilitate a more harmonious relationship between local authorities and the Incident Command team. Furthermore, in the Gulf region, a major oil-producing area, preparations should account for the real possibility that there will be a major hurricane during the course of the recovery. The President may well have to exercise his authority under the Stafford Act with the Federal Emergency Management Agency (FEMA) playing the lead role in hurricane recovery. Thus, under current laws the federal government could have two competing disaster operations occurring at the same time. This is nonsensical. The Oil Pollution Act of 1990 should be amended to harmonize responses for Spills of National Significance with the National Response Framework.

In addition to the three-part plan (which would reform the Oil Pollution Act of 1990), Congress should:

- **Legislate based on information, not panic or anger.** Instead of simply removing the cap or raising it to another arbitrary level, Congress should wait to collect a more definitive estimate of how high the secondary costs will be in the Gulf. Since BP committed \$20 billion to cover all legitimate liability claims, there is no crisis and no need for a rushed policy change.
- **Create a seamless transition to the new regime.** After the BP oil spill, the Obama Administration offered little excuse for instituting a moratorium on deepwater drilling despite the fact that it brought one of the Gulf Coast's main industries to a sudden halt. Fortunately, federal judge Martin Feldman quickly ruled the moratorium "arbitrary and capricious," a ruling that was quickly upheld by a federal appeals court. Undaunted by their legal setbacks, Department of Interior Secretary Ken Salazar then announced a new moratorium on deepwater drilling. Due to industry concerns over the unpredictability of any additional moratoria, the Obama Administration's opposition to deepwater drilling has led to a *de facto* ban on all (deep and shallow) water drilling. Permit requests have already been ignored for some shallow-water drillers without explanation from federal regulators. The uncertainty alone caused by the White House has brought new offshore drilling to a halt and thus is having severe effects on the Gulf's economy that are more devastating than the spill itself. The Administration should reverse this decision immediately and place a BOEMRE inspector on each drilling rig. This would create stability for the industry, and a round-the-clock inspection process would provide the safety assurances that Members of Congress and the public demand.
- **Separate government roles.** Whether or not the alleged cozy relationship between the regulated and the regulator led to inadequate regulatory enforcement in the case of Deepwater Horizon, reform is necessary. President Obama was right to assert that the U.S. needs to revamp the Minerals Management Service—however, it must be done in such a way that clearly and definitively separates government promotion and royalty collection from government regulation. Instead of blurring the line between public and private activities—and thus responsibilities—regulatory policy should focus on providing a limited amount of strong, fair, and efficient regulatory guidance. At a minimum, those elements of the federal regulator responsible for promoting specific energy sources should not also be responsible for enforcing regulatory standards. This will require an overhaul of the MMS that should be done prudently and lead to *smarter* regulation, not more regulation.
- **Maintain responsible-party liability for cleanup.** The Oil Pollution Act of 1990 deems that the responsible party pay for all the direct cleanup costs. This should remain unchanged. In the Deepwater case, BP is currently the lead responsible party. BP, and possibly its partners, should pay for the entire environmental damage caused by the Deepwater Horizon explosion and oil leak.
- **Expand Coast Guard capacity.** Before the Deepwater Horizon incident, the Administration had proposed scaling back the capabilities of the Coast Guard National Strike Force, which is the Coast Guard's principal hazardous-materials and oil-spill response asset. These cuts should be voided. Likewise, as the frequency of major oil

spills has declined over the past decades, the service's expertise and human capital for oil spill response have been allowed to atrophy. As the Deepwater Horizon explosion revealed, in the event of Spills of National Significance in the Gulf, the Coast Guard may have to reposition assets and personnel over a large geographic area in multiple states because the oil may wash ashore anywhere. Therefore, the Coast Guard must have a much greater capacity to respond to these incidents and the ability to sustain a robust response for months without detracting from its many other vital missions. In particular, the size of the Coast Guard Reserve should be expanded and the level of training increased—but not at the expense of funding and support for other equally vital Coast Guard missions and forces.

### Thoughtful Reform

The immediate priority for Congress and the Administration should remain the environmental cleanup and determining the cause of the explosion on the Deepwater Horizon rig on April 20, 2010. By simply raising or eliminating the liability cap, Congress is trying to solve a puzzle without all the pieces. Instead of reactively creating another arbitrary cap, Congress should wait to see how much the Gulf oil spill is likely to cost and allow private

insurers to assess the true risk of offshore oil and gas operations.

Congress should create a liability system that clearly identifies risks and allocates associated liabilities, ensures that those engaged in the industry can meet their potential liabilities, protects industry from frivolous lawsuits, and assures the public that both environmental and economic damages from an oil spill can be addressed in full. The oil industry should create an independent safety organization that would provide an incentive for oil companies to explore and implement new safety and prevention mechanisms. While such an organization would greatly reduce the likelihood of spills in the future, the industry also needs to demonstrate a clear and full ability to respond competently in the event of a spill. These reforms would keep oil and gas operation safe, the public informed, and overzealous regulators in check.

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