

National Commission on the BP Deepwater Horizon Oil Spill and Offshore Drilling

LIABILITY AND COMPENSATION REQUIREMENTS UNDER THE OIL POLLUTION ACT

Staff Working Paper No. 10

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I. ISSUE

In November 2010, BP estimated that its total costs from the *Deepwater Horizon* spill, including the clean-up, penalties and damages, will total nearly forty billion dollars.¹ BP has the resources to pay this enormous sum. Those who have suffered individual damages from the spill and those who wish to see the Gulf's natural resources restored are fortunate that BP, rather than a smaller oil and gas company, was responsible for the spill. However, the fact that BP is able to provide full monetary compensation for damages that it causes is no more than a fortuity, not a product of regulatory design. If a company with less financial means had caused the spill,² the company would likely have declared bankruptcy long before paying anything close to the damages caused.³

As discussed below, the current law limits the amount of liability for damages caused by oil spills. As a result, it provides little incentive for improving safety practices to decrease the likelihood of major spills, and it limits the ability of those who suffer damages to receive full compensation. In the immediate aftermath of the BP spill, several legislative proposals were introduced to change the applicable liability caps and the financial responsibility provisions of the Oil Pollution Act of 1990, as a way to address both of these problems.

The purpose of this paper is to provide background information to the Commission in support of the Commission's consideration of policy options related to liability caps and financial responsibility applicable to oil spills from offshore facilities. To that end, the paper briefly summarizes existing law and identifies some of the more significant policy issues raised

¹ Graeme Wearden, "BP oil spill costs to hit \$40bn," *The Guardian*, November 2, 2010.

² In the Gulf, the oil exploration and production industry is composed of two main groups of operators: (a) international and major integrated companies (the "majors"), and (b) independent exploration and production companies (the "independents"), who themselves are often large companies. See Rawle King, *Deepwater Horizon Oil Spill Disaster: Risk, Recovery, and Insurance Implications*, (Washington, D.C.: Congressional Research Service, July 12, 2010), 5; IHS Global Insight (USA), Inc., *The Economic Impact of the Gulf of Mexico Offshore Oil and Natural Gas Industry and the Role of Independents* (July 21, 2010), 4.

³ See, e.g., Mark Cohen et al., *Deepwater Drilling: Law, Policy and Economics of Firm Organization and Safety*, (Resources for the Future, January 2011), 33.

concerning possible amendment of current law. The paper discusses each of these issues, highlighting some of the competing concerns implicated by different policy outcomes.⁴

II. EXISTING LAW

A. *The Oil Pollution Act of 1990*

Under the Oil Pollution Act of 1990 “responsible parties,” including lessees of offshore facilities,⁵ are strictly liable for removal costs and certain damages resulting from a spill, subject to caps on liability.⁶ Responsible parties are not liable for the costs of removal or damages if violations are caused solely by an act of God, act of war, or act or omission of a third party.

Lessees are required to demonstrate financial responsibility in an amount between \$35 million and \$150 million.⁷ The Bureau of Ocean Energy Management, Regulation and Enforcement (“BOEMRE,” formerly the Minerals Management Service) defines “Oil Spill Financial Responsibility” as “the capability and means by which a responsible party for a covered offshore facility will meet removal costs and damages for which it is liable” under the Oil Pollution Act.⁸ BOEMRE’s regulations establish guidelines for the level of financial responsibility necessary, based on the estimated worst-case discharge from offshore facilities. “Worst case discharge” for a well is defined as four times the estimated uncontrolled flow volume for the first 24 hours of a spill, as set forth in the responsible party’s response plan.⁹ BOEMRE has authority to increase the required amount based on relevant operational, environmental, human health or other risks posed by the operation,¹⁰ but as discussed below, the total amount required to be demonstrated may not exceed \$150 million.¹¹ Firms may demonstrate financial responsibility in various ways, including surety bonds, guarantees, letters of credit, and self-insurance; the most common method is through an insurance certificate.¹²

Finally, certain claims for natural resource damages and “uncompensated damages” can be made to, and paid out of, the Oil Spill Liability Trust Fund (Trust Fund or Fund). The Trust Fund is currently funded by an 8 cent per barrel tax on domestic production and imported oil.¹³

⁴ For further discussion of the issues addressed herein, please refer to: Cohen et al., *Deepwater Drilling: Law, Policy and Economics of Firm Organization and Safety* and Thomas Merrill, *Insurance and Safety Incentives* (2010).

These papers are posted on the Commission’s website, www.oilspillcommission.gov.

⁵ This discussion is limited to the liability cap for offshore facilities, although OPA covers liability for vessels and other sources as well.

⁶ 33 U.S.C. § 2702. Compensable damages are damages for: natural resources; real or personal property; subsistence use; revenues; profits and earning capacity; and public services.

⁷ 33 U.S.C. § 2716(c).

⁸ 30 C.F.R. § 253.3.

⁹ 30 C.F.R. § 253.14(a)(1).

¹⁰ 30 C.F.R. § 253.13.

¹¹ *Id.*

¹² 30 C.F.R. § 253.20-32; King, *Deepwater Horizon Oil Spill Disaster: Risk, Recovery, and Insurance Implications*, 7. For a more detailed discussion of how firms currently demonstrate financial responsibility *see id.*, Merrill, *Insurance and Safety Incentives*, 7-9.

¹³ 33 U.S.C. § 2712 (a)(4). In October 2008, Congress raised the tax per barrel from \$0.05 to \$0.08 until January 1, 2017, and to \$0.09 from January 1, 2017 to December 31, 2017. Congress also removed the \$2.7 billion cap on the Fund. Emergency Economic Stabilization Act of 2008, P.L. 110-343, 122 Stat. 3860; *compare* 26 U.S.C. § 4611 (2007) *with* 26 U.S.C. § 4611 (2010).

B. *Current Limitations on Liability and Compensation*

The Oil Pollution Act currently limits liability and compensation for damages caused by a spill from an offshore facility in three ways. First, it caps liability for damages from a spill from an offshore facility at \$75 million per incident.¹⁴ This limit does not apply if the incident was proximately caused by a responsible party's gross negligence, willful misconduct, or violation of applicable Federal safety, construction, or operation regulation.¹⁵ The limitation on liability also does not apply to civil and criminal penalties under federal and state law, oil spill removal costs under federal law, or claims for damages brought under state law.¹⁶

Second, under the Oil Pollution Act, the highest level of financial responsibility a covered facility must demonstrate is \$150 million, the amount required for facilities whose worst-case discharge volume exceeds 105,000 barrels.¹⁷ Thus, even though an offshore facility is potentially liable for damages that exceed \$75 million (for example, in the event that the responsible party acted with gross negligence), it is not required to demonstrate actual capacity to pay damages beyond \$150 million.

Third, if the responsible party is not able to compensate all of the damages caused by the spill, the Trust Fund is available to cover certain damages.¹⁸ However, the amount authorized per incident is limited to \$1 billion¹⁹ and, until recently, the overall limit on the Fund was \$2.7 billion.²⁰ As of June 2010, the Fund's balance was approximately \$1.5 billion.²¹

Thus, in the case of a large spill, there is no certainty under current law that a company would have the financial means to fully compensate victims of the spill. Moreover, the Trust Fund would likely not provide sufficient backup, and a significant portion of the injuries caused to individuals and natural resources as well as government response costs could go uncompensated.

¹⁴ 33 U.S.C. § 2714(a)(3).

¹⁵ *Id.* § 2704(c)(1).

¹⁶ *Id.* § 2718. See Cohen et al, *Deepwater Drilling: Law, Policy and Economics of Firm Organization and Safety*, 30-31.

¹⁷ 33 C.F.R § 253.14.

¹⁸ 33 U.S.C. § 2712.

¹⁹ 26 U.S.C. § 9509(c)(2).

²⁰ Even where the Fund gets reimbursement from the responsible party, the amounts the Fund initially paid out are counted against the \$1 billion limit. Thus, in the BP/*Deepwater Horizon* case, even though BP has reimbursed the Fund for over \$500 million spent on government response activities, the fact that the Fund was used for those response activities means that less than \$500 million is available to compensate damages going forward. Government Accountability Office, *GAO-11-90R Deepwater Horizon Oil Spill: Preliminary Assessment of Federal Financial Risks and Cost Reimbursement and Notification Policies and Procedures* (November 12, 2010). This issue could be addressed in legislation.

²¹ Hearing on Liability and Financial Responsibility for Oil Spills under the Oil Pollution Act of 1990 and Related Statutes, Before H. Comm. on Transportation and Infrastructure, 111th Cong. (2010) (statement of Craig Bennett, Director, National Pollution Funds Center), 3.

III. AMENDING EXISTING LAW

A. *Legislative Proposals*

During the 111th Congress, members introduced bills that would have addressed, in different ways, the unfavorable impacts of limitations on the liability cap and financial responsibility requirements. The bills contain provisions that would do some or all of the following:

- Eliminate the liability cap for offshore facilities²²
- Change the financial responsibility requirements by raising limits or requiring the Secretary of the Interior to review requirements²³
- Require participation in a mutual liability pool²⁴
- Increase the amount of available per incident funding in the Trust Fund²⁵

Congress, however, was unable during the 111th Congress to reach the compromise necessary to secure passage of any relevant legislation.

B. *Relevant Considerations in Developing Policy Options*

Raising or eliminating the liability cap and increasing financial responsibility serve two distinct, important policy goals. First, changing existing law in this manner could create stronger incentives for firms to internalize risk and operate more safely offshore. And second, such steps would provide greater assurances that, in the event of a major spill, there would be adequate funds available to compensate for damages and costs caused by such spills, without requiring the taxpayer to bear the burden of compensation.

There are a variety of ways that existing law could be modified to further these overall objectives:

- Raising the liability cap, using a phased in approach

²² Consolidated Land, Energy, and Aquatic Resources Act, H.R. 3534, 111th Cong. (“CLEAR Act”). § 702 (2010) (as passed by House); S. 3663, 111th Cong. §102 (2010) (“Reid Clean Energy bill”); Restoring Ecosystem Sustainability and Protection on the Delta Act, S. 3763, 111th Cong. (2010) S. 3763, 111th Cong. § 6 (2010) (“RESPOND Act” or “Landrieu bill”) (liability between \$250 million and \$10 billion is borne by mutual liability pool; liability over \$10 billion is borne by responsible party).

²³ CLEAR Act, § 703 (raises financial responsibility for offshore facilities to \$300 million; may be less based on certain criteria); Reid Clean Energy bill, S. 3663, § 306 (every five years, the Secretary of the Interior will review minimum financial responsibility requirements, make adjustments for inflation, and make recommendations to Congress on financial responsibility requirements.)

²⁴ RESPOND Act, § 7 (pool provides insurance for costs between \$250 million and \$10 billion; premiums are based on amounts set by the Secretary of the Interior).

²⁵ Reid Clean Energy bill, S. 3663, § 5001 (Increases amount available per incident to \$5 billion; increases per barrel tax to 45 cents). *See also* Hearing on Liability and Financial Responsibility for Oil Spills under the Oil Pollution Act of 1990 and Related Statutes, Before the Comm. on Transportation and Infrastructure, 111th Cong. (2010) (statement of Thomas Perrelli, Associate Attorney General) (describing Obama Administration proposal that increases per incident limit).

- Raising financial responsibility requirements, using a phased in approach
- Ensuring an evaluation of risk by the regulator in setting criteria for financial responsibility levels, and/or by insurance companies in determining premiums
- Increasing the per-incident limits on payout from the Oil Spill Liability Trust Fund

Relationship of liability caps and financial responsibility limits. At the outset, it is important to note that it is unlikely that raising or eliminating the liability cap will have the desired effect of providing incentives for safe practices or ensuring full compensation for victims, unless demonstrated financial responsibility is required at levels commensurate with the cap.²⁶ The debate over the Oil Pollution Act liability cap has focused primarily on increasing or eliminating the liability cap itself; discussion of financial responsibility requirements has been secondary. However, if the liability cap is increased without a corresponding increase in financial responsibility requirements, then a firm could meet its financial responsibility requirements and still go bankrupt before paying even a small fraction of the damage associated with a spill. The liability limit would, in effect, be irrelevant.²⁷ Some have argued that the financial responsibility requirement should be *higher* than the relevant liability cap, in order to ensure that the responsible party is capable of paying the full range of damages, costs and penalties applicable under federal and state law.²⁸

1. General policy reasons for raising the cap and increasing financial responsibility requirements for offshore facilities

Incentives

One argument frequently advanced for raising liability caps is that significant potential monetary liability increases a company's incentive to improve its safety practices.²⁹ To the extent that a liability scheme provides incentives to internalize costs, the comparatively low \$75 million cap distorts companies' incentives to engage in practices that prevent spills.³⁰ This point has been made by numerous economists who have reviewed the Oil Pollution Act liability cap. Under basic economic theory, companies that have the potential to cause significant harm should pay for the costs they inflict; economists have thus opined that the best way to ensure internalization of risk is to require strict, unlimited liability for all damages inflicted on the public by an accident.³¹ For example, in testimony before Congress, MIT economist Michael Greenstone stated,

[T]he \$75 million cap on liabilities for economic damages means that oil companies do not bear full responsibility for oil spills. This misalignment of incentives is a classic case of moral hazard. Firms and people behave differently

²⁶ See Cohen et al., *Deepwater Drilling: Law, Policy and Economics of Firm Organization and Safety*, 45.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*, 40; Merrill, *Insurance and Safety Incentives*, 6.

³⁰ Merrill, *Insurance and Safety Incentives*, 6.

³¹ See Ishan Nath, *Economists' Perspectives on Liability Caps and Insurance for the Offshore Oil and Gas Industry in the Wake of the Macondo Blowout* (2010), 5-8, posted on www.oilspillcommission.gov (quoting numerous academic economists who stated that the best way to ensure internalization and mitigation of risk is through removal of Oil Pollution Act liability caps).

when they are protected from the consequences of their actions... Market forces require [oil companies] to make decisions about where to drill and which safety equipment to use, based on benefit-cost analyses of the impact on their bottom line. . . If the expected cost benefits exceed the expected costs, the decision to move forward will appear sound.³²

Therefore, according to Professor Greenstone, the offshore drilling liability cap “inevitably distorts” the way companies make decisions to drill.³³

The incentive argument is somewhat diminished, however, by the fact that there are significant limitations on the scope of the liability cap’s applicability. As noted above, caps do not apply to removal costs, damage claims under state law, and penalty actions, and they do not apply where there has been gross negligence, willful misconduct, or violation of applicable Federal safety, construction, or operation regulation. Thus, in the case of the *Deepwater Horizon* spill, for example, BP and/or other responsible parties may be liable for removal costs, the potential billions of dollars in civil and criminal penalties, unlimited liability for damages in some states and potentially, civil and/or criminal penalties under state law.³⁴ In any event, to the extent that a liability cap is not waived, the aggregate expected damages from a spill are lower than they otherwise would be, and this fact may have an effect on a company’s incentive to adopt more stringent safety practices.³⁵

Compensation

In addition, increased liability and financial responsibility will help insure that individuals, property owners and natural resources trustees who suffer damages but have no role in causing a spill are fully compensated. As of December 2, 2010, BP had already pledged or paid billions of dollars in damages, including through the establishment of a \$20 billion fund for private claimants and through natural resource damage assessment payments to states.³⁶ As noted above, if BP had not agreed to waive the liability cap, and the cap was not subject to one of the exceptions enumerated in Oil Pollution Act, then innocent victims would have been out of luck, or the taxpayer would have borne the burden of compensating those victims.

2. Potential impact on the insurance industry

In testimony before Congress, insurance officials and others have warned of unintended consequences of an increase in, or elimination of, the liability cap. With respect to the short term,

³² Hearing on Liability and Financial Responsibility for Oil Spills under the Oil Pollution Act of 1990 and Related Statutes, Before House Comm. on Transportation and Infrastructure, 111th Cong. (2010) (Statement of Michael Greenstone, MIT), 3.

³³ *Id.*

³⁴ See Cohen et al., *Deepwater Drilling: Law, Policy and Economics of Firm Organization and Safety*, 29-31. See The Big Oil Bailout Prevention Liability Act of 2010: Hearing on S. 3305 before the S. Comm. on Environment and Public Works, 111th Cong. (2010) (statement of Ken Murchison, Louisiana State University), 7-8.

³⁵ Cohen et al., *Deepwater Drilling: Law, Policy and Economics of Firm Organization and Safety*, 31. See also Greenstone, 4 (“We cannot know whether the result would have been different without the cap, but what is clear is that there were economic incentives for companies to cut corners. Those incentives will remain as long as the cap is set at such a low level relative to the risk”).

³⁶ BP, Claims and Government Payments Gulf of Mexico Oil Spill Public Report (December 2, 2010).

industry sources have testified that the offshore energy insurance market currently has a finite amount of liability insurance capacity -- in the range of \$1 billion to \$1.5 billion per company.³⁷ One insurance industry representative described a range of obstacles for insurers and purchasers of insurance, including but not limited to: 1) that the entire global energy market is limited to \$3 billion in premiums; 2) that higher liability limits would increase the demand for coverage, exhausting available capacity; and 3) that underwriting for low probability, high severity events is challenging for insurers and reinsurers.³⁸ Similarly, the Congressional Research Service, based upon a review and study of the offshore drilling insurance business, outlined potential consequences for the insurance market that would result from increase or removal of liability limits. These include: 1) the emergence of a “hard” market –high prices and limited coverage – in contrast to the “soft” insurance market for offshore liability prior to the spill;³⁹ 2) higher costs of insurance based upon higher strict liability limits, resulting in some operators choosing to self-insure;⁴⁰ and 3) reluctance of private insurers to commit capital to undefined risks, based on unknown legislative changes and litigation risk.⁴¹

It is also possible that the market will eventually adjust to the new liability regimes. According to the extensive Congressional Research Service analysis, the insurance market would likely support the use of alternative sources of insurance capacity, such as “reinsurance sidecars,” catastrophe bonds or energy insurance financial futures and options, to spread risk and increase available capital in the insurance market.⁴² Another commentator has suggested that insurance capacity may also increase if there is a shift towards writing insurance policies for facilities, rather than for companies.⁴³ In short, the potential impact on the insurance industry is uncertain; for this reason, an approach that phases in changes to the liability cap and financial responsibility requirements may be desirable.

3. Potential impact on the structure of the offshore drilling industry

Representatives of the offshore drilling and insurance industries have predicted that, in light of the current lack of availability of insurance described above, an increase in the liability cap, and certainly elimination of the liability cap, will result in an exodus of smaller, independent companies from offshore drilling operations because they would not be able to obtain the

³⁷ See, e.g., Hearing on Liability and Financial Responsibility for Oil Spills under the Oil Pollution Act of 1990 and Related Statutes, Before the H. Comm. on Transportation and Infrastructure, 111th Cong. (2010)(statement of Dr. Robert Hartwig, President and Economist, Insurance Information Institute), 13; see King, *Deepwater Horizon Oil Spill Disaster: Risk, Recovery, and Insurance Implications*, 2.

³⁸ Hearing on Liability and Financial Responsibility for Oil Spills under the Oil Pollution Act of 1990 and Related Statutes, Before the H. Comm. on Transportation and Infrastructure, 111th Cong. (2010)(statement of Dr. Robert Hartwig, President and Economist, Insurance Information Institute), 13.

³⁹ King, *Deepwater Horizon Oil Spill Disaster: Risk, Recovery, and Insurance Implications*, 17.

⁴⁰ *Id.*, 16 (“Operators may find themselves assuming or retaining higher levels of self-insurance, which might affect the BOEMRE’s offshore oil and gas leasing bidding and ultimately the royalties earned for the U.S. Treasury.”)

⁴¹ *Id.*, 15-18.

⁴² *Id.*, 17-18.

⁴³ Merrill, *Insurance and Safety Incentives*, 12 (suggesting that if insurance companies focus more on risk, they may offer policies designed for specific facilities; in turn, greater diversification of risk would induce greater insurance capacity).

insurance necessary to operate.⁴⁴ They advance several arguments for ensuring that legislation does not lead to such a result.

First, the independents develop many smaller and end of life fields that the larger firms find uneconomic or inefficient⁴⁵; thus, excluding the independents would probably result in reduced production. Second, the exit of some businesses would decrease the competition for lease sales, most likely resulting in a decrease in the amount of money the government receives for lease sales.⁴⁶ Third, excluding the independents from drilling and production would have significant negative impacts on employment and economic activity in the Gulf oil states.⁴⁷ Finally, if the elimination of or increase in the cap were applied retroactively it could cause operators to relinquish leases, which would in turn result in a decline in production in some areas.⁴⁸ These points underscored the sensitivity of the liability cap issue in early congressional debates; and were at least one reason that the Senate rejected the Reid Clean Energy legislation.

There are also counterarguments to the proposition that policy reform should be aimed at ensuring the ability of small companies to remain in the offshore drilling business. Economists have argued that the market should drive which businesses engage in the drilling business, and if small companies cannot afford to drill safely, they should not do so.⁴⁹ There is also some evidence that the effect on employment would not actually be substantial because there would simply be a shift in the companies that engage in drilling operations and provide jobs.⁵⁰

4. Possible ways to mitigate adverse impact on smaller, independent companies of raising the liability cap and increasing financial responsibility requirements

The impact on smaller, independent companies could potentially be mitigated in several ways. Options include:

- Raising but not eliminating the liability cap.
- Requiring pooling of risk in a mutual fund, as proposed in the Landrieu bill, which requires participation in a mutual fund. One downside to the mutual liability pool is that

⁴⁴ Hearing on Liability and Financial Responsibility for Oil Spills under the Oil Pollution Act of 1990 and Related Statutes, Before the H. Comm. on Transportation and Infrastructure, 111th Cong. (2010)(statement of Charles Anderson, SKULD North America); Liability and Financial Responsibility for Oil Spills under the Oil Pollution Act of 1990 and Related Statutes: Hearing Before the H. Comm. on Transp. & Infrastructure, 111th Cong. (June 9, 2010) (Statement of Jack Gerard, President and CEO, American Petroleum Institute).

⁴⁵ Scott Gutterman (President and CEO, LLOG Exploration Co, LLC), interview with Commission staff, November 19, 2010.

⁴⁶ Liability and Financial Responsibility for Oil Spills under the Oil Pollution Act of 1990 and Related Statutes: Hearing Before the H. Comm. on Transp. & Infrastructure, 111th Cong. (June 9, 2010) (Statement of the Honorable James L. Oberstar), 3; Cohen et al, *Deepwater Drilling: Law, Policy and Economics of Firm Organization and Safety*, 42.

⁴⁷ IHS Global Insight (USA), Inc., *The Economic Impact of the Gulf of Mexico Offshore Oil and Natural Gas Industry and the Role of Independents*, 5-6.

⁴⁸ See King, *Deepwater Horizon Oil Spill Disaster: Risk, Recovery, and Insurance Implications*, 19.

⁴⁹ Hearing on Liability and Financial Responsibility for Oil Spills under the Oil Pollution Act of 1990 and Related Statutes, Before House Comm. on Transportation and Infrastructure, 111th Cong. (2010) (Statement of Michael Greenstone, MIT), 5; Nath, *Economists' Perspectives on Liability Caps and Insurance for the Offshore Oil and Gas Industry in the Wake of the Macondo Blowout*, 18 (quoting economists Kenneth Arrow and Don Fullerton)

⁵⁰ Nath, *Economists' Perspectives on Liability Caps and Insurance for the Offshore Oil and Gas Industry*, 19-21 (quoting numerous economists who reject the theory that the impact of unlimited liability on small firms would lead to job loss).

it decreases incentives for individual firms to improve safety practices. This problem could potentially be addressed by tying premium levels to financial and safety risk posed by an individual company's activities. The Landrieu bill directs the Secretary of the Interior to determine how to set premiums.⁵¹

- Phasing in of financial responsibility requirements until the insurance industry adjusts to the demand for insurance and/or new financial products are created.⁵²

Adverse effects on small companies could also be offset by partnering with firms with deeper pockets. "Joint ventures" between larger and smaller companies already exist, and a policy change is probably not necessary to encourage such arrangements.

5. Risk evaluation: how and who

Taking Risk into Account

BOEMRE currently determines level of financial responsibility based upon potential worst case discharge, as required by the Oil Pollution Act. Although this analysis to some degree accounts for risk associated with individual drilling activities, it does not fully account for the range of factors that could affect the cost of a spill. Accordingly, in the regulatory context, staff has advised that the Commission may wish to recommend that BOEMRE require more stringent management of geological, environmental and operational risk, to ensure that the regulatory scheme better responds to potential consequences of spills, particularly in high-risk and frontier areas. Similarly, the Commission may decide to recommend that BOEMRE consider specific criteria relevant to a determination of risk, when establishing financial responsibility limits applicable to a particular company or facility. Risk criteria could include, at the least: geological and environmental considerations, the applicant's experience and expertise, and applicable risk management plans. This increased scrutiny would provide an additional safeguard against unqualified companies entering the offshore drilling market.⁵³

Congress has recently considered a variety of related reforms. The CLEAR Act, for example, raised the Oil Pollution Act's maximum financial responsibility to \$300 million. But it allowed the regulator to prescribe a lower amount, for a responsible party, based on the following criteria: (i) the market capacity of the insurance industry to issue such instruments; (ii) the operational risk of a discharge and the effects of that discharge on the environment and the region; (iii) the quantity and location of the oil and gas that is explored for, drilled for, produced, or transported by the responsible party; (iv) the asset value of the owner of the offshore facility, including the combined asset value of all partners that own the facility; (v) the cost of all removal costs and damages for which the owner may be liable under this Act based on a worst-case-scenario; (vi) the safety history of the owner of the offshore facility; (vii) any other factors that the President considers appropriate.⁵⁴

⁵¹ The Landrieu proposal applies to all companies; one potential modification, which would be favored by the majors, would be to allow the largest companies to opt out and self insure.

⁵² See Merrill, *Insurance and Safety Incentives*, 6.

⁵³ Greater regulatory focus on risk management would also likely result in increased insurance capacity, since presumably insurance companies will be more willing to provide insurance where risks are lower. Merrill, *Insurance and Safety Incentives*, 15.

⁵⁴ CLEAR Act, § 703.

Similarly, a bill introduced in the Senate would require the regulator to determine liability limits for offshore facilities, based upon: (i) the water depth of the lease; (ii) the minimum projected well depth of the lease; (iii) the proximity of the lease to oil and gas emergency response equipment and infrastructure; (iv) the likelihood of the offshore facility covered by the lease to encounter broken sea ice; (v) the record and historical number of regulatory violations of the leaseholder under the Outer Continental Shelf Lands Act (43 U.S.C. 1331 et seq.) or the Federal Water Pollution Control Act (33 U.S.C. 1251 et seq.) (or the absence of such a record or violations);(vi) the estimated hydrocarbon reserves of the lease; (vii) the estimated well pressure, expressed in pounds per square inch, of the reservoir associated with the lease; (viii) the availability and projected availability of funds in the Oil Spill Liability Trust Fund established by section 9509 of the Internal Revenue Code of 1986;(ix) other available remedies under law;(x) the estimated economic value of nonenergy coastal resources that may be impacted by a spill of national significance involving the offshore facility covered by the lease;(xi) whether the offshore facility covered by the lease employs a subsea or surface blowout preventer stack; and (xii) the availability of industry payments.⁵⁵

Roles of Government and Private Entities

There are clear benefits to having an external party evaluate risk and monitor individual firms' safety compliance. As noted above, it is appropriate for the government (BOEMRE) to play this role, to promote enhanced risk management in offshore operations and to discourage unqualified companies from performing offshore drilling operations. There is also a role for private insurance companies in evaluating risk. Unlike the government, insurance companies have both the financial incentives and the resources to monitor risk-taking and lower their own exposure.⁵⁶ If liabilities are borne by insurance carriers, carriers will also have a strong incentive to promote new safety techniques and methods by encouraging other institutions (including insured firms) to engage in such research. They may also require certification from private firms specializing in risk management.⁵⁷

6. Providing for full victim compensation

If liability and financial responsibility limits are not set at a level that will ensure payment of damages for all spills, then another source of funding will be required to fully compensate victims of a spill. The federal government could pay additional compensation costs, but this approach requires the taxpayer to foot the bill, essentially subsidizing the drilling activity.

If the Oil Spill Liability Trust Fund per-incident limit is raised, then the costs are essentially borne by those who benefit from oil production activities. Reliance on the Trust Fund to fully compensate victims would not necessarily provide an incentive to offshore facilities to mitigate risks because risks are pooled. Such a reduction in incentives counsels against having the Trust Fund be the sole source of compensation for damages in the event of a big spill. However, raising the per-incident payout limit would help ensure that victims have access to

⁵⁵Oil Spill Compensation Act of 2010, S. 3542, 111th Cong. (2010), §301(e).

⁵⁶ See Cohen et al, *Deepwater Drilling: Law, Policy and Economics of Firm Organization and Safety*, 36-37.

⁵⁷ See Merrill, *Insurance and Safety Incentives*, 15-16.

compensation without the need to seek further specific funding from Congress or otherwise burden the taxpayer.

Note that currently, there is no overall cap on the Trust Fund. From 2005 – 2008, there was a \$2.7 billion cap on the Fund, but it was removed as part of the Stimulus package in 2008. If the per-incident limits are raised, it will be important 1) that the Fund be allowed to continue to grow, and 2) that if a cap is again imposed on the Fund, the cap is significantly higher than the established per-incident limit on payouts.