Does Unlimited Liability for Offshore Oil Drilling Make Sense?

Posted by Gail the Actuary on August 2, 2010 - 10:35am
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Friday evening, the US House of Representatives passed legislation that would remove the $75 million liability cap on economic damages incurred by offshore drilling activities by oil companies. The US Senate is expected to take up legislation in the near future that would include a similar provision.

It seems to me that it would make more sense to raise the cap, to say, $10 billion, than to eliminate it all together. At least part of the issue is that insurance companies don't provide policies with unlimited coverage, but with a limit, even a high one like $10 billion, it is possible to put together an insurance program.

For most buyers of insurance, the lack of unlimited coverage isn't an issue. In part, this is because it is hard for us to do a whole lot of damage. I can run my car into another car, but the damage is pretty much limited to that car and its occupants. Even if I run my car into a school bus, the damage is limited to the school bus and its occupants. But the recent oil spill has indicated that economic damages can in fact be very high.

The likely lack of adequate insurance availability is the major reason we see statements such as this one from Jack Gerard, President of API:

> While full details of the Senate bill are not yet available, the liability provision sticks out as a jobs killer. Requiring an unattainable level of insurance coverage for domestic energy producers on the Outer Continental Shelf will force the vast majority of American companies out of U.S. waters, according to insurers. This would cut domestic production, kill American jobs, slow economic growth and cost billions in federal oil and natural gas revenues.

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The Price Anderson Act, which limits liability for nuclear power plants, limits liability to $10 billion per claim. At this limit, the nuclear industry set us its own insurance program. It is likely that at a $10 billion limit, the Gulf oil and gas industry could set up its own program, perhaps consisting of a combination of insurance and self-insurance.

If damages are completely unlimited, Jack Gerard has outlined the outcomes he expects. I am not sure if those would entirely be the case. If liability is unlimited, and smaller oil companies operating in the gulf are not able to get insurance, I would expect the stock market valuation of these smaller companies would drop greatly, and the bigger oil companies would find them cheap to buy. So the industry might see great consolidation, with the big companies benefiting. Somehow, I don't think that this is what those drafting the legislation had in mind.

If limits are raised from $$75 million to $10 billion, the higher limits will, to some extent, raise costs for oil companies. This is in a way, a form of decreased of Energy Return on Energy Invested (EROI). More costs are now explicitly being paid for (and more money is going to fund lawyers, and expended self-insurance programs). Raising liability to unlimited would theoretically raise costs more, and have a greater impact of EROI. It might also reduce production because of less available capacity, if smaller companies drop out of the market.

If costs are higher in the Gulf of Mexico (GOM) because of lower EROI, it would seem to me that at given world oil price, less oil will be extracted from the GOM. Furthermore, in total for the world, less oil will be extracted at a given price. How this lesser amount of oil is divided up remains to be seen--it is not clear to me that the US will, in fact, purchase more imports (since it needs to somehow pay for them). The world oil price will likely rise, but oil production may still not rise very much to match the higher price. At a higher price for oil, the financial situation of all countries importing oil will likely continue to deteriorate. I am not sure anything can be done to prevent this--but raising liability to an unlimited level (or even $10 billion) will tend to make the deterioration happen more quickly than otherwise.

One thing that I might point out is that clean-up costs per barrel of oil spilled in the US are significantly higher than in the rest of the world, even with the current law, according to a study called Estimating Costs for Oil Spill Clean-ups.

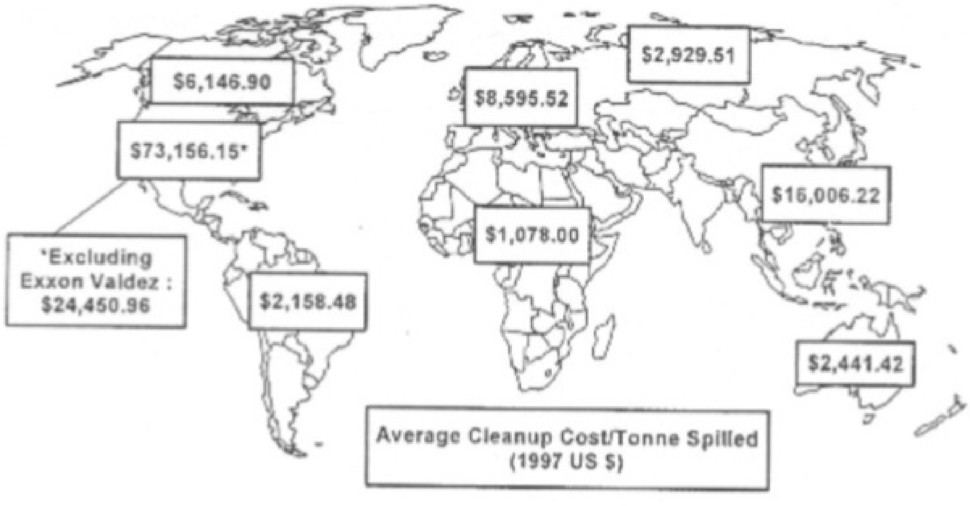

Figure 2: Average cleanup cost per tonne spilled (in 1997 U.S. $), based on analysis of oil spill cost data in the *OSIR International Oil Spill Database*.

I am not a great fan of the tort system as a way of compensating people. It is a very inefficient system. Lawyers tend to get a big share of awards. Many people who are injured do not get compensated, because of the effort required to pursue a claim, and because of a lack of records to prove the amount of the injury or the fact that the plaintiff was at fault. If the injury is truly no one's fault, no compensation is available.

Awards for similar injuries can vary greatly, depending on how deep the pockets of the defendant are. For example, average death awards vary greatly depending who caused the injury. If the one causing the injury is a driver of a private passenger auto, the cost will be relatively low. If the injury is caused by a physician through malpractice, the cost will be higher. If the cost of a malpractice injury can be charged back to a hospital, the cost will be higher yet.

For better or worse, the tort system is what we have, though. Reigning in at least a little seems like it is in most everyone's best interests.

I might point out that there are quite a number of other businesses / organizations that can do huge damages. For example:

- Farms, through their runoff, can cause dead zones in the oceans.
- Commercial fishing, through aggressive fishing techniques, can cause fish populations to drop, and average size of fish to become much smaller.
- Government officials can allow food companies to sell over-processed food to millions of people, leading to poor health and weight problems.
- Nuclear power plants can have accidents that result in radiation damages to a large number of people.

The tort system doesn't really correct all ills--it just partially corrects a few of them.

I am also doubtful the deterrent effect of unlimited liability is greater than at a $10 billion limit. An oil company certainly will be motivated to prevent damages at a high insurable limit. The insurance company providing the $10 billion limits (probably set up by the oil industry) may even help with the monitoring of standards.