# The Takeaway

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# The Oil Debacle in the Gulf of Mexico:

## An Alternative to the Coming Flood of Offshore Regulations

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*In the wake of the recent oil disaster in the Gulf, Congress appears poised to impose new bans on offshore drilling along with a strict new regulatory regime. While these measures may meet a widely felt need for swift retribution, there is an alternative policy response that can both correctly assign liability and create stronger incentives for uncompromised safety among offshore operators.*

In a stroke of grim irony, just as the Obama Administration is relaxing restrictions on offshore oil drilling, comes the largest oil spill since the wreckage of the Exxon Valdez off the Alaskan coast in 1989. Despite BP's efforts to stem the flow and contain the huge slick, almost 100,000 barrels of oil have already spewed from the Gulf's floor, with potentially grave environmental consequences.

As evidenced from recent Congressional hearings, we can expect a spate of new regulations designed to avoid future spills. The simple truth is that the BP accident is an extremely low probability, extremely high cost event.

### WHAT'S THE TAKEAWAY?

**Keep perspective on probability - and cost - of offshore drilling accidents**

**Avoid temptation to over-regulate**

**Have offshore operators bear full liability for accidents by removing the current $75 million liability cap**

**Require offshore operators to provide insurance guaranteeing full liability coverage**



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According to the U.S. Department of Energy, there have been more than 36,000 oil wells drilled in the Gulf. Yet since exploration in the Gulf of Mexico began in the 1950's, there has been only one accident to compare with BP's ill-fated Deepwater Horizon. After the blowout of the PEMEX IXTOC I well in 1979 off the coast of Mexico, oil spilled into the Gulf

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at a rate of 10,000 to 30,000 barrels per day until it was finally capped nine months later (www.incidentnews.gov/incident/6250).

Equally important is the fact that the costs of this disaster will be staggering, with BP estimating that its costs have already exceeded $450 million.

Research on low probability/high cost events tells us that prior to a catastrophe, it is human nature to underestimate both the probability of its occurrence and the resulting damage. Yet, when such catastrophes do happen, we over-react in the opposite direction. We overestimate the probability of such an event and its expected costs. Congress is running in this latter mode, and we can expect a flood of new regulations on offshore drilling. Hopefully, cooler heads will prevail.

## COOL THE REACTION

It matters critically what form these new regulations will take. Two general types are to be expected. First, the Obama Administration is likely to re-impose drilling restrictions in the offshore areas it had only recently opened for exploration. Second, Congress undoubtedly will attempt to impose new safety regulations. These could include requiring the Department of Energy to provide detailed engineering specifications on the design of blow-out preventers and other critical equipment. Or, Congress could require the continuous surveillance of offshore drilling operations by a government safety inspector. The options being discussed are endless, but they all fall under the rubric of "command and control."

The underlying logic of "command and control" is that offshore oil operators either do not have the expertise to adopt safe practices, or they know better but choose to cut corners in the absence of detailed regulations. Let's examine these two propositions.

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First, who has more expertise in designing offshore equipment and operating offshore rigs — the government, or the offshore oil industry?  The answer is obvious. That leaves us with the explanation that without "commands and controls" offshore oil operators will knowingly cut corners. Is it possible that either BP, the drilling rig owner, or the manufacturer of the blow-out preventer chose to cut corners? Yes. It is possible, too, that the cause of the accident was a combination of complex conditions that could not have been reasonably foreseen. We may never know for certain exactly what led to the accident. But whatever the cause, we need to ensure that corners are never cut in the future.

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There is a policy alternative to outright bans on exploration or to costly "command and control" policies, and it relies primarily upon markets. It answers the question, "How do we make it in the oil company's best interests to invest in the optimal amount of safety and not to cut corners?"

### ASSIGN FULL LIABILITY

To align incentives correctly, the oil company must expect to bear the full costs of spills and disasters like the one happening now. Aware of the risk of facing enormous costs, companies will have strong incentives to make the engineering and safety decisions appropriate for the drilling situation at hand. These decisions no doubt will vary with the water depth and conditions of each drill site. The drilling companies have the means to get the best information, and they have the most resources invested, to assess the risk/damage tradeoff accurately.

Yet as it is now, offshore oil operators do not expect to bear the full costs of a disaster. The Oil Pollution Act of 1990 makes operators liable for cleanup costs, but sets a $75 million (per oil spill) limit on their liability to other kinds of claims. BP's current losses have already exceeded $450 million, and oil is still leaking from the ocean floor. An offshore operator may well make different safety decisions if its claims liability threatens to exceed $450 million than if liability is limited to$75 million. We can applaud BP for its stance that it will pay the full cost of the disaster. But other operators may not accept full liability, and even BP may not have taken full liability into account when making internal decisions about safety practices.

### NEEDED POLICY CHANGES

- **Lift the current $75 million limited liability ceiling**

Offshore operators should expect to be responsible for the full costs of any environmental damage related to their activities.

There is one hitch: smaller offshore companies could accept full liability but then take shelter under bankruptcy laws in the event of a disaster. This means some additional steps must be taken.

- **Require offshore operators to provide insurance by a reputable company**

In addition to removing any limits on liability, Congress should require that any offshore operator provide an insurance policy guaranteeing full liability coverage. Full liability insurance not only protects taxpayers from bearing the cost of cleaning up environmental disasters, it also adds another layer of protection against future disasters. You can bet that private insurers like Lloyds of London would inspect very carefully the safety practices of those it insures. Furthermore, by relying on private markets, taxpayers are saved the expense of monitoring offshore operations. Full liability without the option of invoking bankruptcy laws assures that offshore operators will have no incentives to cut corners.

A great advantage of this proposal is that it leaves the decision of how best to avoid disasters to the most knowledgeable agents involved: the oil operators and their insurers. These are relatively simple changes to make, and in principle the requirements involved are no different from those any homebuyer would expect of her builder.

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## ABOUT THE MOSBACHER INSTITUTE

The Mosbacher Institute was founded in 2009 to honor Robert A. Mosbacher, Secretary of Commerce from 1989-1992 and key architect of the North American Free Trade Agreement. Through our three core programs – Integration of Global Markets, Energy in a Global Economy, and Governance and Public Goods – our objective is to advance the design of policies for tomorrow's challenges.

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