CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Douglas W. Elmendorf, Director

May 20, 2011

Honorable Gerald E. Connolly
U.S. House of Representatives
Washington, DC 20515

Dear Congressman:

This letter responds to your recent letter regarding CBO's analysis of an amendment you proposed to H.R. 1229, the Putting the Gulf of Mexico Back to Work Act. That amendment concerned the liabilities of owners and operators of oil and gas drilling platforms that operate in the coastal waters of the United States. CBO estimated that adoption of the amendment would have a net cost to the federal government.

I understand that you expected adoption of the amendment would result in a savings to the government relative to current law. For most legislative amendments, CBO does not have sufficient time to explain our estimates in writing, and the cost estimate for your amendment was delivered to your staff over the telephone. This letter attempts to clear up some misunderstandings in your letter and provide a fuller explanation of why CBO estimates that the amendment would have a net cost to the federal government.

The Proposed Amendment

Your amendment to H.R. 1229 would change a portion of the liability scheme established by the Oil Pollution Act of 1990 (OPA) for the owners and operators of oil and gas drilling platforms that operate in the coastal waters of the United States. Specifically, the amendment would make those owners and operators subject to unlimited liability for any damages caused by an oil spill resulting from offshore platforms.

Liability Under Current Law

Under the OPA, the owners and operators of an offshore oil or gas platform are liable for:

- 100 percent of the costs to remove oil from a spill in the coastal waters of the United States. (In this case, removal means to contain and remove oil spilled as a result of the incident and to mitigate damages to the public health, wildlife, and private property.)

- Any damages (including those to natural resources, real or personal property, loss of government revenues or public services, and loss of profits and earnings capacity) caused by the oil spill; liability for such damages may be limited by a cap of $75 million for any single oil-spill incident.

It is important to note that the cap on liability for damages caused by an oil spill does not apply if the discharge of oil results from a violation of federal operation, safety, or construction regulations, gross negligence, or willful misconduct. The cap also does not apply if a responsible party is found to have demonstrated a "lack of cooperation" with the federal government.

Under current law, up to $150 million is available to the U.S. Coast Guard (USCG), the Environmental Protection Agency, and other federal agencies to spend without further appropriation to respond to each oil-spill incident that occurs in the coastal or inland waters of the United States. Additional amounts, up to $850 million, also are available to pay claims for response costs and damages caused by a spill. In total, the per-incident cap on federal direct spending is $1 billion. All of those amounts are derived from the Oil Spill Liability Trust Fund (OSLTF). The primary source of revenue for the fund is a tax on oil produced in or imported to the United States. The OSLTF seeks reimbursement from a responsible party for all removal activities and any damages owed. Such recoveries may not be immediately realized and can take several years to be collected by the government.

The Deepwater Horizon Spill

Following the oil spill at the Deepwater Horizon facility in the Gulf of Mexico in 2010, the USCG and other federal agencies began spending funds from the OSLTF to respond to that spill. To date, the OSLTF has spent or obligated about $625 million on response activities. (The Congress enacted Public Law 111-191 to allow the Coast Guard to receive advances from the OSLTF for addressing the Deepwater Horizon spill, up to the $1 billion limit on per-incident spending, above the amount normally available for response—$150 million.) The fund has recovered those amounts from parties responsible for that spill.

CBO and the Administration expect that spending from the OSLTF for the Deepwater Horizon spill will reach the $1 billion limit on spending for a single incident during fiscal year 2012. We also expect that the USCG will eventually recover almost all of those funds because the responsible party remains financially solvent, nearly all of the OSLTF spending for this incident is expected to be for removal costs, and as noted above, the responsible party is 100 percent liable under current law for all such costs.

Further, in this case, the owner of the drilling platform has voluntarily agreed to compensate private parties (as well as the federal government and state and local governments) for valid claims for damages that are in excess of its potential limit on legal liability of $75 million. The firm reports that it has spent around $4 billion to pay such claims so far. We note that the $75 million cap on damage claims is a "potential" limit because there has been no determination yet of whether the spill at the Deepwater Horizon facility was caused by a violation of any federal operation, safety, or construction regulation, or whether the firm's actions were grossly negligent.

How Frequently Do Large Oil Spills from Platforms Occur?

In its 2010 annual report to the Congress, entitled *Oil Pollution Act (OPA) Liability Limits*, the U.S. Coast Guard reported that since enactment of OPA in 1990, the Deepwater Horizon incident is the only oil spill from a platform facility that has resulted in damages greater than $75 million. The report also notes that, between 1990 and 2010, there were 49 other oil-spill incidents from platforms. One of those spills had a total incident cost (that is, response costs plus damage claims) of about $12 million. The other 48 incidents each had total incident costs of less than $2 million.

Estimating the future likelihood of large oil spills from platform facilities is difficult. The historical record is sparse. In addition, changes over time in market conditions, federal laws and regulations, and industry practices may make future risks different from past ones. Weighing the available information, some government and outside analysts have concluded that major spills will remain uncommon, and CBO concurs with those findings.

How Would the Amendment Reduce Future Federal Spending?

Your amendment would reduce net spending from the OSLTF under the following circumstances:

- There was a significant spill from an oil platform that resulted in damages greater than $75 million, and

- The OSLTF used its funds to pay damage claims to private parties or state and local governments rather than providing reimbursement for removal costs, and

- The liability cap for damages was in effect because the responsible party was found not to have violated any federal operation, safety or construction regulations, or be grossly negligent, and

- A liable firm did not choose to pay damage claims in excess of the liability cap in order to serve its long-term public relations and political interests, and

- A liable firm remained financially solvent after paying oil-spill removal costs and damage claims and had sufficient funds to reimburse the OSLTF for payment of damage claims on behalf of the firm. (Increasing liability limits for damage costs is not useful if expenditures for response costs have left the responsible party bankrupt.)

Based on discussions with experts and review of the available evidence, CBO has concluded that the probability of *all* of these circumstances occurring in a given year is very small. Because your amendment would reduce net spending from the OSLTF *only if* all of them occurred, CBO has therefore concluded that your amendment would reduce expected net spending from the OSLTF in a given year by a very small amount.

By establishing unlimited liability for damages caused by oil spills from oil and gas platforms, it is possible that the amendment could cause a responsible party to pay more funds than it would under current law directly to local governments, private individuals, and companies that have valid damage claims. However, any such payments for damages would not necessarily reduce net spending from the OSLTF because the $1 billion per incident is available for other purposes besides paying damage claims.

Your letter suggested that CBO's estimate of the budgetary cost of the amendment should consider the possibility that, following a future major oil spill causing significant damages, the Congress might choose to enact laws providing funds to cover the cost of such damages. That might happen, but CBO does not assume future Congressional action when preparing cost estimates of proposed legislation; instead, we estimate the cost of proposals by comparing them to costs that will occur under current law. Under current law, only the specified amount of $1 billion per oil-spill incident is available from the OSLTF to respond to oil spills and to pay ensuing damages.

How Would the Amendment Increase Future Federal Spending?

Your amendment would reduce offsetting receipts of the federal government by diminishing the amount of bonus bids that oil and gas operators would pay to explore for oil and natural gas on the Outer Continental Shelf (OCS). That reduction in offsetting receipts would amount to an increase in direct spending.

Specifically, the federal government leases the rights to develop the oil and gas resources on the OCS in exchange for payments of bonus bids when leases are awarded; annual rental fees on nonproducing leases; and annual royalties based on the value of any production. Over the next 10 years, CBO estimates that those bonus bids, fees, and royalties will amount to about $100 billion, with bonus bids alone representing roughly $10 billion. While the great majority of oil and gas production from the deep waters of the OCS stems from the operations of major international firms, about half of the bonus bids from that region that are received by the government are from smaller, independent firms.

Your amendment would subject lessees to unlimited liability for damage claims resulting from oil spills from offshore platforms. The expected increase in payments for such claims in a given year would be small, for the reasons explained above. Indeed, some industry analysts have suggested that the Deepwater Horizon spill has become the de facto industry standard for liability, suggesting that many firms—particularly the large, global operators that have sufficient net worth to self-insure against disasters—would anticipate needing to cover all valid damage claims even in the absence of legislation requiring unlimited liability. However, smaller firms that rely on third-party insurance to pay damage claims would probably face the risk of paying larger claims under your amendment and would therefore pay higher costs for insurance.

That increase in costs would reduce the economic profitability of some marginal drilling prospects and thereby reduce the amount that some potential lessees would be willing to pay for the right to develop certain oil or gas resources. This effect would occur even if oil prices remain elevated. High oil prices increase the value of the government's oil resources, but raising the expected costs of drilling for some lessees would reduce their potential profitability—and thus reduce bonus bids—for any given level of oil prices. Smaller firms that produce natural gas from the shallow waters of the OCS would also be affected by the amendment. Their economic perspectives differ from those of the major firms focused on producing oil in deep water areas.

The extent of the impact on bonus bids would depend on the characteristics and strategic choices of firms, such as the riskiness of their operations (drilling gas wells in shallow water may be less risky than drilling in deep water, for example), their financial strength, and their ability to collaborate with other partners. Finally, some analysts have suggested that if sufficient insurance coverage is not available to cover the potential costs of an oil spill, some of the smaller producers may opt to discontinue operations in the OCS. Based on consultations in July 2010 with insurance and financial industry experts, oil industry experts, and oil and gas firms, CBO estimated that removing liability limits would reduce bonus bids by about 1 percent and that most of that impact would occur in the first few years as firms adjusted to the new policy.

CBO does not appear to be alone in the view that competition for leases would probably decline, to at least some extent, if lessees faced unlimited liability for damage claims resulting from oil spills. The National Commission on the BP Deepwater Horizon Oil Spill and Offshore Drilling noted in its final report:

> *Any discussion of increasing liability caps and financial responsibility requirements must balance two competing public policy concerns: first, the goal of insuring that the risk of major spills is minimized, and in the event of a spill, victims are fully compensated; and second, that increased caps and financial responsibility requirements do not drive competent independent oil companies out of the market. A realistic policy solution also requires an understanding of the host of complex economic impacts that could result from increases to liability caps and financial responsibility requirements.*[1]

The Net Effect of the Amendment on Future Federal Spending

In sum, your amendment would lower and raise different components of federal spending. The amendment would lower net spending from the OSLTF

1. National Commission's Report to the President on the BP Deepwater Horizon Oil Spill and Offshore Drilling, *Deep Water, The Gulf Oil Disaster and the Future of Offshore Drilling* (January 2011), p. 284.

under a combination of circumstances whose probability of occurring in a given year appears to be very small, so the expected savings to the government are very small. At the same time, the amendment would raise spending by reducing offsetting receipts collected through bonus bids for the right to develop oil resources on the OCS. Although the effect on the amount of bonus bids would be small relative to the total expected amount of such bids, in CBO's judgment, it would be larger than the expected savings for the government through the OSLTF. Therefore, CBO estimates that your amendment would have a net cost to the federal government.

I hope this information has been useful to you. If you have further questions about CBO's cost estimate for this amendment or other concerns with how CBO approaches its cost-estimating work, please do not hesitate to contact me.

Sincerely,

Douglas W. Elmendorf

Douglas W. Elmendorf
Director

cc: Honorable Chris Van Hollen
Ranking Member
House Budget Committee