12-1-2010

Newsroom: Logan on BP's Oil Spill Exposure

Roger Williams University School of Law

Newsroom

Logan on BP's Oil Spill Exposure

Dean David Logan was interviewed by Reuters for the second time in a single week, here commenting for a report on BP's potential oil spill costs.

From Reuters: "SPECIAL REPORT: How BP's oil spill costs could double" by Tom Bergin

In the print edition, Dean Logan's quote got pulled into a prominent place in the layout (see image, below right). ***To read the entire Reuter's Special Report in PDF form, click here.***


profits and legal costs to arrive at a total cost of $1 billion. But a month after the accident, then-CEO John Browne said the final bill would be "significantly" less than that and analysts put the total cost at around $300-400 million, a figure the company appeared comfortable with.

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By 2008, though, BP had paid over $2 billion in compensation claims related to Texas City, while lost profits and repairs had cost another $1 billion at least. Claims remain outstanding, so the final tally could be even higher.

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LONDON, Dec. 1, 2010 (Reuters) — Last month, BP increased by $8 billion the financial provisions it was taking for the Gulf of Mexico oil spill; the company's shares rose. Better-than- expected underlying profits and upbeat comments from new Chief Executive Bob Dudley were taken by the market as a sign the company had turned the corner and would soon return to pumping out steadily rising dividends.

Key to this sanguine outlook is confidence that the new estimate of the total cost of the spill -- $40 billion -- will be sufficient. "We think that $40 billion adequately provisions for the liabilities that are outstanding so far," said Mark Lacey, Fund Manager at Investec Global Energy Fund. Paul Mumford, fund manager at Cavendish Asset Management, went further, saying the provision is likely to be overly conservative: "You might well find that you get provision write-backs," he said, hinting the bill could be lower.

That optimistic view may turn out to be true. BP executives have said this is their "best estimate" of costs, adding they could turn out lower. But history shows there is ample scope for nasty surprises from BP. The London-based oil giant -- last year it was the biggest non-state controlled oil and gas producer in the world -- has so far consistently underestimated the scope and potential cost of the Gulf spill. It also has a track record of low-balling disasters, including the fatal Texas City refinery blast in 2005. Not only has the company underestimated the cost of repairing equipment and ecosystems in the past, it has also made overly optimistic assumptions about legal challenges.

That may be happening again.

CEO Dudley, an American who took over from Briton Tony Hayward in October, has said a $20 billion fund BP created to compensate victims of the spill should cover all damages claims. The lawyers who are suing BP don't think so.

"The total value of the claims already registered could exceed the amount of money that has been dedicated to pay the fund," said Texas-based trial lawyer Brent Coon, who represents victims of the explosion and subsequent spill and who was prominent in litigation against BP after Texas City.

"Then you have the claims that have not been filed yet, and claims from those indirectly impacted, and shareholder derivative claims ... You have very large potential claims that could, in total, be exponentially greater than the amount set aside."

Zygmunt Plater, Professor of Law at Boston College Law School, agrees. "In the short term, it's in everyone's interests within the company to low-ball -- but the portents are there for a realistic inflation of $20-$50 billon," he said.

An analysis by Reuters of the potential fines, damages, costs related directly to the leak, compensation and the damage to BP's business suggests the final spill bill could, over the long term, end up much higher than BP's latest provision -- perhaps even more than twice as much. Much hinges on whether U.S. courts find the company was "grossly negligent" in the run-up to the disaster, but there are other risks. BP declined to comment for this article, beyond stating that it stands by its statements on the likely costs and that its estimates are based on the assumption that it was not grossly negligent.

"UNPRECEDENTED STRING OF BAD NEWS"

BP's inability to gauge the true scope of the spill in the early days in April is well documented. After the Deepwater Horizon rig sunk, following an explosion which killed 11 workers, the company initially hoped to staunch the flow of oil from the well by activating shut-off valves with subsea robots. In case this didn't work, it started drilling a relief well to permanently plug the well from below. A week after the blast, the company said the well would take three months to complete and cost $100 million -- but that would be the most expensive part of the whole response operation. Combining this with the daily expenditure that BP reported at the time suggested a total bill of $200 million. BP hinted then that even this calculation was pessimistic.

As estimates of the spill flow increased -- it eventually became the worst in U.S. history -- so did the cost. From an initial 1,000 barrels per day to 5,000 bpd, it finally reached 62,000 bpd. In June, BP told analysts the cost of containing and cleaning up the spill would be $3-6 billion. By mid-September, the response effort alone, excluding damages claims, had cost BP $8 billion.

Investment analysts were forgiving of these errors. The disaster seemed to grow worse and worse making accurate estimates difficult. "It was an unprecedented string of bad news," Simon Hawkins, oil analyst at Ambrian said last month.

But even after the well was capped, BP appeared no more adept at forecasting costs. Twelve days after it had sealed the top of the well, on July 27, the company said the likely cost of the spill would be $32 billion. On November 2, it hiked its estimate by another 25 percent, or $8 billion.

BP's Chief Financial Officer Byron Grote blamed that increase mainly on a delay in completing the relief well, which meant the company needed to keep its offshore response effort going longer. In a conference call with analysts, he also cited costs related to decontamination of the thousands of ships used in the spill response and undefined administration and legal costs. BP did not give a detailed breakdown, but it is hard to see how the delay in the relief well accounted for most of the increased provision. Assuming an extra 40 days at the average cash-burn for the operation of $60 million per day gives an extra spend of only $2.6 billion. In addition to this, the well delay and many extra costs were already clear in July and could have been factored in earlier.

Nonetheless, analysts have largely accepted the company's estimates. Perhaps this is on the assumption that after months of bad publicity, the suspension of dividend payments for at least three quarters, a collapse in its share price to less than half its pre-spill level and a change of CEO, BP would take the opportunity to throw every conceivable cost into the mix and pave the way for recovery under a new boss. It's a common enough practice when corporations change CEO.

"I tend to believe BP. Given how bad it was, they basically decided to kitchen-sink it," says Peter Hitchens, oil analyst at Panmure Gordon.

WHAT HISTORY CAN TEACH US

Such an assumption, though, may not be entirely safe in BP's case. The company's record of assessing costs after past disasters is less than stellar. BP's Thunder Horse platform in the Gulf of Mexico captured front pages around the world in the summer of 2005 when a hurricane left it listing precariously. The company predicted it would take a year and $250 million to repair the damaged platform. In the end, it took almost three years to fix; analysts estimate BP spent more than $500 million.

That undershoot was nothing compared with what followed the explosion at its Texas City refinery in 2005. The blast killed 15 workers and ruined the company's carefully nurtured reputation as the green and caring face of Big Oil. Because it was a single-point disaster, the cost of Texas City should have been easier to quantify than an ongoing catastrophe like the Gulf spill. A gasoline production unit destroyed in the blast would need to be replaced, BP said. The going cost for such machinery was widely agreed to be in the region of $100-$200 million. A few pessimists added in ancillary damages, lost profits and legal costs to arrive at a total cost of $1 billion. But a month after the accident, then-CEO John Browne said the final bill would be "significantly" less than that and analysts put the total cost at around $300-400 million, a figure the company appeared comfortable with.

DEGREES OF NEGLIGENCE

Is BP making the same mistake on penalties and compensation again?

A "gross negligence" finding would require the Department of Justice to show a high degree of recklessness on the part of senior BP officials, rather than a mistake by a low-level worker. BP has blamed low-level employees and its contractors for the Deepwater Horizon rig blast.

On November 8, a report by the White House oil spill commission prompted many analysts to assume it was going to be tough to pin gross negligence on BP for the Gulf spill, and BP shares rose as a result. The commission said it had found no direct evidence of "a conscious decision to favor dollars over safety" in BP.

But the commission's co-chairmen, Bill Reilly and Bob Graham, subsequently stressed that its November 8 finding did not mean anyone was off the hook. They said a "culture that did not promote safety" had fostered misjudgments leading up to the disaster in all the companies involved. A panel of scientists conducting another probe for the government subsequently said that BP's systems for managing drilling risks were inadequate.

Some lawmakers argue that in BP's case, the culture created an incentive for employees to short-cut safety precautions without issuing explicitly dangerous orders. **David Logan, professor of law at Roger Williams University in Rhode Island**, believes there is no legal reason why a claimant could not establish gross negligence on the part of a corporation based solely on its culture. "Can you stitch together an argument of gross negligence from the corporate culture? It is possible to do that," Logan says.

THE COST

If BP is found to be grossly negligent, the U.S. Clean Water Act allows for a fine of up to $4,300 per barrel, nearly four times the $1,100 maximum BP otherwise faces. The government estimates 4.9 million barrels of oil flowed from BP's well, suggesting a maximum fine of $5.4 billion if "gross negligence" is not proven, and $21.1 billion if it is.

The company has argued that it should receive credit for the 700,000 barrels of oil which it scooped from the surface or burned, and it disputes the government estimate of the size of the spill. "I think there's room for considerable discussion there," Dudley said last month. A close study of company statements suggests BP has factored in a fine below $4 billion.

As well as adding billions to that, a gross negligence finding would prevent BP from forcing its partners to pay their share of any fine or cleanup costs. Anadarko Petroleum, 25 percent owner of the blown-out well, and 10 percent owner, Japan's Mitsui, have so far refused to pay, saying their contractual obligation to do so is void due to gross negligence on the part of the project operator, BP.

Any costs BP might recover are not included in its current estimates because accounting rules prevent this, although the company has said it does expect to recoup money from its partners and has reserved the right to sue the companies it hired to help drill the well.

POLITICAL SETTLEMENT

Most lawyers expect BP and the Department of Justice to reach a settlement that avoids a court ruling on the degree of negligence. But even if that happens, industry rivals say politics might mean the starting-point for discussion will be the $4,300/barrel level. The spill -- and President Barack Obama's inability to halt it -- hurt the president's ratings. "The government cannot let them get away with it. After President Obama came in with the heavy foot, they just can't," the chief executive of a rival oil company, speaking on condition of anonymity because of the political sensitivity of the spill, told Reuters.

Plater, the Boston professor, says if the government sought to be aggressive it could attempt to broaden the interpretation of environmental and economic damages that BP must make good. Oil and fishing dominate employment along the Gulf coast, especially in Louisiana, the state worst hit by the spill. While most of the fishing bans have been lifted, experts say it will take years for the coast to recover. "There are different ways of measuring natural resource damages and the ecosystem services argument," Plater says. When you knock out an ecosystem, looking at the damage in terms of indirect harm to the economy could carry the cost "into the hundreds of billions".

BP's assessments of the environmental damage caused by the spill are at the optimistic end of the spectrum. A government report released in August suggested up to 75 percent of the oil had disappeared -- BP has often referred to this report, and former CEO Hayward recently told a gathering of students in Cambridge, England, that all of the spilled oil had gone. However, researchers at the University of Georgia said in late August that about three-quarters of the oil was still lurking below the surface; other studies have also pointed to the prospect of severe long-term damage. BP will be on the hook to make any such damage good.

PUNITIVE DAMAGES

Whatever BP ends up paying in fines and cleanup costs, there could be another big charge: punitive damages. Such a charge would be helped by a finding of gross negligence, though claimants could pursue punitive damages even if gross negligence wasn't proven. Exxon Mobil paid punitive damages of $1 per $1 of economic damage following the 1989 Exxon Valdez spill in Alaska when the captain of the tanker, who had been drinking, hit a reef.

Jamison Colburn, Professor of Law at Penn State University, says it is not entirely clear whether the current law covering oil spills at sea will allow punitive damages for BP, though if such damages are allowed, a one-to-one ratio would be in line with precedents like the Valdez. "Punitive damages are a wild card," he said. "It's still an open question."

In the Texas City case, BP settled all claims out of court, so a judge did not rule on punitive damages. However, lawyers say the amount paid out in settlements is consistent with an expectation there was a good chance significant punitive damages would have been awarded.

If BP were to face punitive damages, given the prevailing estimates of economic damages at around $20 billion for the Gulf spill, a fine at the same ratio could add another $20 billion to its bill.

But trial lawyer Coon says he believes punitive damages could be levied at a higher multiple, because the accusations against BP are greater than those Exxon faced. "In that accident, a drunk captain inadvertently ran his ship onto a reef. The drunk captain wasn't doing something at the request of the company," Coon said, referring to the arguments which would underpin a gross negligence claim.

LONG-TERM VIEW

What's clearly not included in BP's spill estimate is a figure related to the damage the disaster has done to its U.S. business over the long term. BP said it lost 30,000 barrels per day of production in the Gulf -- one of its most profitable bases -- in the third quarter, and expected further impacts in the fourth quarter and into 2011.

But the added regulatory scrutiny the oil firm is likely to undergo in the United States will surely add to its operating costs. Analysts at Bernstein say BP's upstream production costs could rise by 10 percent, or $280 million a year. Using the company's own internal discount rate of 9-13 percent implies the present value of a 10 percent rise in these costs would be $2.5 billion. If other areas of BP's U.S. business faced similar increases, the hit could be twice this.

In addition, some lawmakers have called for BP, currently the Gulf's largest operator, to be banned from future license rounds. "BP may find that when its application for a license goes in, it is put in the 'pending' file while Shell or someone else gets the license," said Iain Armstrong, analyst at Brewin Dolphin.

"REAL MONEY"

Tally up fines commensurate with gross negligence, punitive damages at a ratio of just once economic damages, lower production, a 10 percent rise in U.S. operating costs, and difficulties in securing new reserves in the United States, and you quickly reach a figure around $50 billion. That may not be as dramatic as it sounds: some costs could still be shared with partners and contractors, many would be tax deductible, and they would in any case probably be payable over many years. The company can likely afford even the most pessimistic estimates.

But things might not be as easy today as they were in 2005. BP's under-clubbing of the costs of Texas City was made up for by a more than doubling of the oil price between 2005 and 2008. The outlook for crude now is less bullish, which may mean the oil giant has fewer places to hide.

"A very slight miscalculation now about what we think is going to happen is magnified by the huge numbers of stake holders (who could make claims)," said **Logan of Roger Williams University**. "A billion here, a billion there and pretty soon you're talking about real money."

Despite BP's official statements, some industry analysts say the company may be expecting to have to pay more. "The way that they are selling assets and strengthening their balance, is what you would expect them to do if they were preparing for a worse scenario such as a finding of gross negligence," said one analyst who asked not to be named because he did not want to be seen questioning BP's public comments.

For full story, click here.