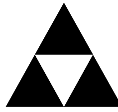

AMERICAN ACADEMY *of* ACTUARIES

Committee on Environment and Public Works

United States Senate

Hearing on
S. 3305, the "Big Oil Bailout Prevention Liability Act of 2010"

Statement of Gary Josephson, FCAS, MAAA
Casualty Practice Council
American Academy of Actuaries

June 9, 2010

Chairwoman Boxer, Ranking Member Inhofe, and distinguished members of the Committee, on behalf of the American Academy of Actuaries' Casualty Practice Council, I appreciate the opportunity to provide written testimony on the proposed bill S. 3305, the "Big Oil Bailout Prevention Liability Act of 2010."

The American Academy of Actuaries ("Academy") is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

The continuing catastrophic impact of the Deepwater Horizon event highlights the importance of improving the effectiveness of companies' risk management practices, as well as the importance of informed, involved, and competent regulation and oversight. A comprehensive risk management program requires the use of disciplined processes for identifying, assessing, measuring, monitoring, controlling, and mitigating risks. Risk management activities often include developing pre-event safety measures, mitigating risk through transfer to insurance companies or capital markets, and minimizing the financial impact of losses or damage to reputation through post-event mitigation efforts. In some circumstances, risk avoidance is the most appropriate strategy.

The potential financial impact of any given risk should be a strong element in a company's decision-making as to the use of its resources to manage the risk or to avoid the risk altogether. More money and effort will be spent to prevent or contain a risk that has a very high financial or reputational cost than for one with a low cost. To the extent that laws or regulations specify penalties or limit the costs related to certain events, such laws and regulations will be important factors in determining a company's risk management plan and the continued effectiveness of its risk management activities.

It is our understanding that the proposed legislation will increase the statutory limit of liability of some entities that are responsible for oil spills from $75 million to $10 billion. We do not have an opinion as to whether a specified liability limit (or any limit) is appropriate. Statutory limits exist in different contexts for a variety of reasons. Both the current and proposed caps do not limit a company's responsibility for clean-up costs. For the Deepwater Horizon event, such costs are likely to be many multiples of the current $75 million liability limit. However, a higher limit could provide companies with an additional incentive to strengthen their risk management practices and reduce the likelihood and potential consequences of a similar event in the future (i.e., through pre-event safety measures).

With the exception of risk avoidance as a risk management technique, risk management practices do not eliminate the possibility of future catastrophic events. As such, an increase in the liability limit will affect a company's strategy for managing the potential financial impact of such risks. To the extent that oil companies can transfer the financial consequences of catastrophic events (through insurance or capital markets mechanisms), insurers or investors are very likely to require enhanced risk management practices as a condition of coverage. There may, however, be some companies for which the potential financial consequences (either in the self-funding

requirements or the insurance costs of increasing the liability limit) will exceed their capacity to assume or finance the risk. We would expect that most companies in this position would change their business activities to those that are within their financial capacity. Thus, another possible consequence of the bill could be a reduction in the number of companies in this industry.

The retroactive nature of the proposed bill could serve as a disincentive to investment in important but inherently risky business operations. At any given time, risk management practices reflect both current and anticipated conditions, including existing laws and regulations. Implementing a retroactive increase in liability limits signals the potential for future retroactive increases. As such, although companies may have deployed their risk management resources effectively when considering existing laws and regulations, the potential for retroactive changes to these laws and regulations increases the residual uncertainty of their obligations and decreases the positive effect of risk management initiatives. If businesses believe the limit is subject to change retroactively, the significant uncertainty of when, why, and how much is likely to suppress desirable and prudent investment.

Conclusion

The higher limits reflected in the proposed bill may serve as an incentive to strengthen risk management practices and reduce the likelihood and consequences of a similar event in the future. We view those as positive outcomes. A consequence of the higher limits may be that some companies will leave the industry due to their inability or unwillingness to finance the increase in risk.

We believe that the retroactive nature of the bill does not serve to enhance risk management practices. Instead, it introduces a significant element of uncertainty due to the possibility of unanticipated future government action. This uncertainty could also lead to improper allocation of risk management resources and may suppress investment in important but inherently risky business operations.