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The Oil Pollution Act of 1990's

Certificates of Financial Responsibility

The following is an edited and updated version of a speech given by Cheryl J. Trench, Executive Vice President of the Foundation to the **Winter Fuels Outlook Conference** sponsored by the U.S. Department of Energy and the National Association of State Energy Officials on November 4, 1994.

OPA's COFRs

Certificate of Financial Responsibility

- **Shipowner must show it can pay for spill**
- **Same as limited liability:**

  $1,200 per gross registered ton for OPA
  300 for CERCLA
  $1,500 total

  If many, show $1,500 per grt for largest
  For VLCC, about $200 MM
  For 80,000 DWT, about $65 MM

- **Tankers in U.S. waters on or after Dec.28**

The Oil Pollution Act of 1990's ("OPA's") so-called "COFR" requirement is very current, very important, and very complex. It is often misunderstood. First of all, "Certificates of Financial Responsibility" or "COFRs" do not impose unlimited liability.

OPA says that you must show you can pay for your oil spill. In the case of a tanker, the shipowner is responsible. The shipowner must prove that it has enough money to pay for a limited liability spill. Hence, a shipowner must show it has the ready resources to pay $1,200 per gross registered ton under OPA plus $300 per gross ton under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA," more popularly known as the Superfund). Upon the appropriate showing, the U.S. Coast Guard issues a Certificate of Financial Responsibility.

A "gross registered ton" is a measure of a ship's internal volume; the more commonly used "deadweight ton" is a measure of a ship's cargo carrying capacity. Gross registered tons are equal to about half of the deadweight tons. A VLCC, a "Very Large Crude Carrier," will require a showing of about $200 million. A fleet owner must show the financial resources to cover $1,500 per gross ton on the largest tanker it wishes to have certified.

Any tanker in U.S. waters (including the 200-mile Exclusive Economic Zone) on or after December 28, 1994 must have an OPA COFR. The tanker needs a COFR only when it enters U.S. waters; a ship not scheduled to come to the U.S. before February, for example, does not need a COFR until then. The Coast Guard proposed the rule in September 1991 and published the final version on July 1, 1994. Thus, the requirements are not a surprise.

The Tricky Part

"Guarantor"

"Direct Action"

Limited Defenses

Unlimited Liability

"Limitation on Guarantor's Liability"
-- Cold Comfort

If the substance of the rule is not new, why is there such intense concern and controversy surrounding the coming deadline? Because there are a number of elements in OPA that have unsettled the traditional insurers of the tanker industry, the shipowners' mutuals called "Protection & Indemnity Clubs" or "P&I Clubs." The P&I Clubs have been central to the shipowners' showing of financial responsibility under the old regime, the Federal Water Pollution Control Act. With the new COFR requirement more than 10 times the old one, many companies see no way to comply in the absence of P&I Club participation.

OPA classifies as a "guarantor" any entity that "provides evidence of financial responsibility" for a shipowner. Aguarantor can be sued directly for any costs or damages associated with an oil spill. In the event of a spill, both the shipowner and the guarantor must advertise in the local media that they are responsible and are available to be sued for cleanup costs and damages.

Furthermore, OPA provides only limited defenses to the guarantor, the same ones that are available to the shipowner. The guarantor can assert that the spill was caused by an act of God, an act of war, or the act of an unrelated third party. (The guarantor can also assert that the spill was caused by the willful misconduct of the shipowner.) If any of these is proven, the guarantor is released from liability. Importantly, however, the guarantor cannot assert any of the other standard policy defenses routinely used in marine insurance, including that the shipowner didn't pay its premiums or that the shipowner did not maintain the tanker in accordance with industry standards and the insurance contract.

The P&I Clubs, and others, are afraid of the ease with which OPA imposes unlimited liability. Liability limits, not surprisingly, are broken in the case of a shipowner's gross negligence or willful misconduct. But the limits are also broken in the case of a shipowner failing to follow an applicable Federal safety or operating regulation. Many fear that virtually any spill will involve breaking some regulation, and hence will subject the shipowner to unlimited liability. The P&I Clubs further fear that if they stand as Federal guarantors they will be subject to direct action liabilities under state statutes, putting them in an uncontrollable maelstrom of litigation and liability.

The thunderous noise of these fears drowns out OPA's "Limitation on Guarantor's Liability." OPA specifies that a guarantor is only liable for the amount it has guaranteed -- the COFR amount, $1,500 per gross ton. The P&I Clubs have no confidence that such a limitation will hold, and thus have steadfastly refused to become OPA guarantors. They will continue to provide insurance cover as before.

Other parts of the insurance market, however, are confident the limitation will hold, and have developed new mechanisms to comply with the COFR rules.

How Do You Show Financial Responsibility?

- **Self-insurance (small vessels, U.S.-based)**
- **Insurance (NOT FROM US! say the P&I's)**
- **Surety Bond (financially and operationally above reproach)**
- **Guarantee (esp. subsidiary guarantee)**
- **Other evidence**

  New commercial alternatives

There are a variety of ways to show financial responsibility:

Self-insurance. Because the regulations pit U.S. assets against worldwide liabilities, self-insurance is only a practical avenue for companies with only small tankers (where the required COFR level is therefore small) and/or for companies with U.S. operations exclusively.

Insurance. While the P&I Clubs have vehemently refused to participate as guarantors, some shipowners are exploring the use of captive insurers (private insurers set up to serve one customer or group exclusively).

Surety Bond. To use a surety bond, a shipowner must be like Caesar's wife: above reproach. Surety companies don't expect to have to pay out their bond, and they pick their clientele carefully to avoid it. No surety company approved by the Treasury Department can individually issue a bond large enough to cover large tanker COFR requirements, so consortiums of sureties have come together to fill the gap. The packaging of surety bonds is one of the impressive examples of the creativity the market is showing in developing COFR compliance mechanisms. Traditional surety bonds are an expensive option, but they avoid taking on any risk of someone else's liability through a mutual organization. An innovative twist on the surety bond option is discussed below.

Guarantee. While OPA and the Coast Guard allow the use of a third-party guarantee to cover a COFR, no one expects it will be your rich grandmother. Companies have created subsidiaries to stand as guarantors, another innovation.

The biggest innovations, however, have come from the commercial insurance market in developing new compliance mechanisms. The oil company tanker fleets and the fleets owned by governments are likely to find ways to comply from the choices above. The "independent" tanker market, on which the U.S. depends for some 70% of its crude oil imports, needs some new way of proving their financial responsibility. Three have appeared.

The Commercial Alternatives

- **OPA Club**

  Pro: One master bond to cover many owners and many tankers. Economical, simple.

  Con: Mutually cover others' losses.

- **First Line**

  Pro: No mutual obligation. Economical, simple.

  Con: We're waiting, and waiting and . . .

- **Shore Line**

  Pro: Excess pollution cover of $300 MM.

  Con: Moving target. Cost?

The most important message here is that the market has shown a willingness to respond to opportunity, and continues to respond by refining rates and program design. Each of these new programs depends on routine P&I cover being in place. Therefore, each expects to pay out unreimbursed sums as a guarantor only if the P&I Club is able to assert a non-OPA defense in the event of a spill.

OPA Club was the first alternative to get Coast Guard approval. Insurance brokers and surety companies came together to create one master bond, an umbrella to which many shipowners and their tankers could guarantee. The shipowners guaranteeing to the bond will indemnify OPA Club for any losses incurred as guarantor, and will provide letters of credit to stand behind the indemnification. While the mechanism is economical, some potential custotmers have expressed concern over the mutual indemnification aspect of its design. (In response, the creators have developed an insurance vehicle to cover the letters of credit.) See update addendum.

First Line has been under development for some years, and has deliberately kept a low profile during that time. The basic structure is known -- an organization that will stand as an

OPA guarantor and provide insurance for a shipowners' losses (up to the COFR amount) not covered if a P&I Club asserts a non-OPA defense. First Line's care in keeping a low profile until all the details were finalized has also been the biggest cause of concern. It has been on the edge of an announcement for weeks, but yet one more detail always pops up to be worked out. In particular, First Line has negotiated with the P&I Clubs to ensure their cooperation. Without it, First Line would need to re-assess the viability of the scheme. See update addendum.

Shoreline Mutual has re-formatted itself several times. It is currently providing both a COFR guarantee and excess pollution cover of $300 million. The excess pollution cover comes *on top* of conventional P&I cover of $500 - 700 million. Given the possibility for large liabilities under OPA, the off er of excess pollution insurance has been favorably received. Whether it can be competitively priced remains debatable.

With all of these plans, P&I Club cooperation is essential. An announcement on the P&I Clubs' role is expected momentarily and it could make the difference between a smooth run to the December 28 deadline and a real problem. Thus, there is still a concern, the outcome is still unknown and the time is growing short. Two things are clear: the Coast Guard will be flexible in working with shipowners but it believes that without a pending deadline progress will stop.

The next few weeks will tell.

Update Addendum

Since November 4, 1994, the date of this speech, there has been important movement on a number of fronts.

> **On November 11 First Line declared itself open for business.** It has applied for approval from the Coast Guard. In spite of an unexpected snag, approval may still be granted momentarily. First Line's rates vary by the type of oil carried and the age of the tanker. For example, they range from 8 cents per barrel for one voyage to 4 cents per barrel for ten voyages for an old Suezmax tanker (the 140,000 deadweight ton size routinely used for shipments out of West Africa) carrying crude oil. First Line fees for new Suezmax tankers are 7 to 2.5 cents per barrel depending on the number of voyages.
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> **First Line has given stiff new competition to OPA Club.** Whether the competition will undermine OPA Club's viability remains to be seen. At this point, it appears that OPA Club will be forced, at a minimum, to scale back the size of its bond if First Line moves forward.
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> **More tankers have qualified for COFRs without use of one of the three commercial alternatives, including one of the most important Gulf Coast lightering firms and an important operator of large crude carriers.** As of November 22, 296 tankers have received COFRs. Among them are the Neptune Orient lightering fleet and AP Moeller's fleet of large crude carriers. The two represent critical segments of the market. Without the lightering fleet, one of the most commonly discussed temporary contingency plans -- bringing a crude carrier outside the 200-mile OPA jurisdiction and lightering from there-- would be untenable. Even routine movements would be impaired in the absence of COFRs for the lightering fleet. The large crude carriers, whether Very (VLCC) or Ultra (ULCC), require large COFRs: $200 to 300 million. If OPA Club scales back the size of its bond, such tankers would be unable to obtain COFRs using OPA Club as their guarantor. First Line, at least initially, may also be unable to cover this large-tanker segment of the market. Hence, to the extent that the large tankers can get COFRs without one of the new compliance mechanisms, the chance of a problem lessens. If it covers the COFR requirement on their own, furthermore, the shipowner incurs no incremental cost to cover the widest swath of its ships, hence allowing for re-deployment from foreign to U.S. trades as necessary.

The first hurdle on the way to the December 28 deadline was the mid-November liftings out of the Middle East. These have taken place as expected, even though some shippers have contingency plans to put volumes into Caribbean storage or to lighter outside the 200-mile limit While liftings from Europe and West Africa may still have a short lead time, the market is clamoring for certainty. Any missteps at this point -- including the potential faltering or failure of one of the new compliance mechanisms -- take on magnified significance.

It is important to note again, however, that even if a problem with getting COFRs is discernible in early December, it will not inexorably lead to a problem getting supplies after

December 28. A problem might be righted with a combination of re-deployment and a temporary fix like the contingency plans noted above. Whether these avenues are realistic solutions, even temporary ones, depends on the characteristics of the COFR'd fleet. In order to make such a situation work, the market would likely require more efficient information on tanker needs and availability than the current norms, and the razor-thin capacity balance would likely lead to volatile freight rates.

A problem can also be righted with a delay in implementation. The Coast Guard is loathe to delay, since progress will likely stop, and the run-up to implementation will likely be shaky no matter when the rule takes effect.

Now, the next few weeks have to tell.