Statement of W. Jackson Coleman

before the

United States Senate Committee on the Judiciary

Concerning

"The Risky Business of Big Oil: Have Recent Court Decisions and Liability Caps Encouraged Irresponsible Corporate Behavior?"

June 8, 2010

Statement of W. Jackson Coleman

before the

United States Senate Committee on the Judiciary

Concerning

"The Risky Business of Big Oil: Have Recent Court Decisions and Liability Caps Encouraged Irresponsible Corporate Behavior?"

June 8, 2010

I. Introduction

Chairman Leahy, Ranking Member Sessions and Members of the Committee, my name is Jack Coleman and I am Managing Partner of EnergyNorthAmerica, LLC, an energy consulting firm with offices in Washington, DC, Houston, TX, and Oklahoma. I appreciate the Committee's invitation to present my views at this hearing. Early in 2009 I retired after a career of almost 27 years in the federal government – the last six of which were spent working in the House of Representatives. From February 2007 until March 2009, I was the Republican General Counsel of the House Committee on Natural Resources, and prior to that I served from May 2003 until late 2006 as the Energy and Minerals Counsel for the House Committee on Resources.

My work in the House followed my previous fourteen years as a senior attorney at the Department of the Interior. From September 1992 until May 2003, I served as Senior Attorney for Royalties and Offshore Minerals in the Office of the Solicitor with the Minerals Management Service (MMS) as my primary client, and prior to that, from January 1989 until September 1992, I served as Senior Attorney for Environmental Protection and legal advisor to the Department's Office of Environmental Affairs. My first work on offshore oil and gas issues began during the

period from March 1982 until August 1985 when I was Special Assistant to the Associate Administrator of the National Oceanic and Atmospheric Administration.

Prior to my service at NOAA, I served on active military duty as an Army Judge Advocate General's Corps Captain from June 1978 until March 1982. My post-secondary education was completely at the University of Mississippi, except for graduate work in legislative affairs at the George Washington University. I received a Juris Doctor degree from the University of Mississippi School of Law in 1978 and a Bachelor of Business Administration in Accountancy degree from the University of Mississippi in 1975.

The focus of this hearing is on a variety of liability issues related to offshore oil and gas production. The ongoing, tragic oil spill in the Gulf of Mexico – tragic for the families of those killed and injured, including the Jones family represented here today, to all of whom I extend my deep condolences, but also tragic for the environment and the energy security aspirations of the American people – is unequaled in size in our nation's history and has resulted in numerous legislative proposals to amend the Oil Pollution Act of 1990 (OPA 90) and other applicable laws, and in actions by the Administration related to offshore oil and gas operations. I will focus my testimony primarily on the breach of contract case law for federal offshore oil and gas leases and the potential liability of the United States for breach of contract as a result of a few of these legislative proposals and executive branch actions. First, however, I will present a few facts about offshore oil and gas and our national debt.

II. Offshore Oil and Gas and our National Debt

The approximate daily oil consumption in the United States is 20 million barrels, with about 60%, or 12 million barrels per day, imported. Our largest source of foreign oil is Canada, but the

majority of our imported oil comes from other nations. Our yearly amount of imported oil totals more than 4.2 billion barrels. As of the time of the last Department of the Interior Offshore Oil and Gas National Assessment of offshore oil and gas resources in 2006, just over 14 billion barrels of oil had been produced from the federal offshore and more than 15 billion barrels of already discovered oil reserves were available to be produced. Further, the National Assessment estimated that exploration and production activities in the federal offshore would, in the mean case, eventually produce an additional 86 billion barrels of currently undiscovered oil – assuming the offshore lands containing this oil are reasonably made available for leasing and production. These two amounts combine to an expected future production from the federal offshore of 101 billion barrels – sufficient to eliminate all oil imports by the United States, at current levels, for almost 25 years.

Similarly, the National Assessment estimated that just over 153 trillion cubic feet of natural gas have been produced from the federal offshore and that more than 60 trillion cubic feet of already discovered natural gas were available to be produced. Further, the National Assessment estimated that exploration and production activities in the federal offshore would, in the mean case, eventually produce an additional 420 trillion cubic feet of currently undiscovered natural gas – assuming the offshore lands containing the natural gas are reasonably made available for leasing and production. These two amounts combine to an expected future production from the federal offshore of 480 trillion cubic feet of conventional natural gas – sufficient to totally provide for the United States' current annual consumption of natural gas for more than 20 years.

One might ask, "What is the value of these reserves and resources to the American people?" This can be measured in many ways. The direct value of receipts to the Treasury from producing these reserves and resources, at $75/barrel of oil and $5 per thousand cubic feet of natural gas, is

approximately $1.8 trillion dollars in royalties (assuming an 18% royalty) and $2.7 trillion in corporate income tax receipts from producers, for a total of $4.5 trillion. This sum does not include any up-front sums paid to obtain the leases, nor the tax revenues derived from the jobs that will be created to directly produce these resources, nor the indirect and induced economic impacts of producing these American energy resources owned by the American people. Even without those additional benefits and others, the direct corporate taxes and oil and gas royalties will pay off more than one-third of our current national debt without raising taxes on the American people. However, these vast offshore resources will never pay off any of the national debt if they are not made available for leasing, drilling and production.

Additionally, it is important to note that these offshore resource numbers do not include natural gas hydrates which international public and private research has now proven will be able to be commercially produced in the near future. More than 99% of America's 320,000 trillion cubic feet of natural gas hydrates are located in the deepwater federal offshore. If the deepwater offshore is closed to production, virtually this entire resource will be wasted and the American people will achieve neither the financial bounty nor the environmental benefit from this vast, clean energy resource that they own. If even only 1% of this resource is eventually producible, it would add 3,200 trillion cubic feet of natural gas. In the Gulf of Mexico alone, the Department of the Interior projects that more than 7,000 trillion cubic feet of natural gas hydrates are located in sediments likely to be producible reservoirs. Production of this 1%, or 3,200 trillion cubic feet, of our natural gas hydrate resources would generate approximately $3 trillion in royalties and about $4.5 trillion in corporate income tax on this production from the lessees, for a total of approximately $7.5 trillion. When combined with the prior $4.5 trillion, a total of $12 trillion will result from production of offshore oil and natural gas, including natural gas hydrates. This

sum almost completely pays off the current national debt without raising taxes. Further, this amount could easily be 50 to 100 percent higher because it is based on decades old seismic surveys in moratoria areas which are expected to significantly underestimate recoverable resources. As the Department of the Interior stated in its February 2006 OCS Inventory Report to Congress mandated by Section 357 of the Energy Policy Act of 2005, "**True knowledge of the extent of oil and natural gas resources can only come through the actual drilling of wells**. Estimating undiscovered resources, no matter how sophisticated the models and statistical techniques employed, is an inherently uncertain exercise that is based on hypotheses and assumptions, with **the results limited by the quality of the underlying geologic data**." (**emphasis** added). The Department also stated, "**Frontier areas such as parts of the Eastern Gulf of Mexico and other offshore areas under congressional or executive withdrawal offer the potential of larger field-size discoveries** . . . the risk-based **estimates in frontier areas ordinarily will have been seen as far too conservative** if later exploration demonstrates that the area is hydrocarbon-prone."

Some have said that the oil and gas industry is trying to produce oil in water that is just too deep. First, the offshore drilling industry is capable of drilling in 12,000 feet of water and deeper, and that more than 80% of the oil production in the Gulf is from leases in more than 1,000 feet of water. Second, oil must be produced where it is found. According to the 2006 National Assessment, of the 45 billion barrels of oil left to be discovered in the Gulf of Mexico, all except 3.5 billion barrels, or 92% is located in water deeper than 650 feet. The current 500 foot drilling moratoria in the Gulf of Mexico makes those 41.5 billion barrels unavailable for exploration and future production. Finally, we can all agree that the nation needs to continue to push the development of even better and safer technology and implement procedures that will

help ensure that an accident of this type never happens again, and in the outside chance that it does that we have in place more aggressive and effective oil spill response mechanisms that shut down the well and clean it up much quicker.

I also want to mention that the American people, even after more than six weeks of this record spill, continue to strongly support offshore oil and gas drilling. In late March before the accident, a Rasmussen poll reported that 72% of the American people supported producing oil and gas from the offshore. On May 6th, after more than two weeks of spectacular television coverage of the explosion and spill, a Rasmussen poll reported that 58% of the American public still supported offshore oil and gas drilling, and only 23% opposed. Almost a month later, on June 1st, another Rasmussen poll reported that support for offshore oil and gas drilling remained at 58%, and only 20% opposed. The rest were undecided. So, it is clear to me that the American people have maintained strong support for offshore oil and gas production and they understand why it is so important for our nation.

III. *Mobil v. U.S.* and its Progeny

Since 1992, my career has predominantly focused on offshore oil and gas law and it has frequently included significant responsibilities related to breach of contract liability issues. Beginning in 1992, I was the lead Department of the Interior attorney for *Conoco v. U.S.*, 35 Fed. Cl. 306, later *Marathon v. U.S.*, 177 F. 3d 1331, and finally *Mobil Exploration and Producing Southeast, Inc., v. U.S.*, 530 U.S. 604, 120 S.Ct. 2423 (2000). *Mobil* is a landmark case establishing the law applicable to federal offshore oil and gas lease contracts. The *Mobil* opinion, delivered by Mr. Justice Breyer, resulted from a breach of contract action by seventeen oil and gas lessees involving claims exceeding $700 million resulting from Acts of Congress that

restricted the rights of lessees to explore for and develop oil and gas resources on existing leases off Alaska, Florida, and North Carolina. Discovery exceeded several hundred thousand pages. I personally conducted depositions totaling more than 2,500 pages in length. All except two of the plaintiffs settled with the government prior to the case reaching the Supreme Court.

At issue in that Court was the passage of the Outer Banks Protection Act (OBPA) as a part of OPA 90 and whether the leases incorporated the OBPA into their terms and were "subject to" the OBPA. The OBPA established an Environmental Sciences Review Panel (ESRP) and prohibited the Secretary of the Interior from issuing any permit to drill on existing leases offshore North Carolina for at least thirteen months, but for a longer period if the ESRP had not completed its work of determining whether the Secretary possessed sufficient environmental information with which to make decisions on drilling permit requests for the affected leases. Among other things, the Department of the Interior had taken the position that the provisions of the leases incorporated the later-enacted OBPA into them and made them "subject to" it. This position was based on the terms of the leases which provided in relevant part that the leases are "subject to all other applicable laws and regulations." The Court addressed this issue by stating that "the lease contracts say that they are subject to then-existing regulations and to certain future regulations . . . This explicit reference to future regulations makes it clear that the catchall provision that references "all other applicable . . . regulations," . . . must include only statutes and regulations already existing at the time of the contract, see 35 Fed. Cl., at 322-323, a conclusion not questioned here by the Government. Hence, these provisions mean that the contracts are not subject to future regulations under other statutes, such as new statutes like OBPA. Without some such contractual provision limiting the Government's power to impose new and different requirements, the companies would have spent $158 million to buy next to nothing." The Court

found that when Congress enacted the OBPA and the Department of the Interior announced that it would apply its provisions to the leases offshore North Carolina, the government had repudiated the contracts and committed a material breach. In the Court's words,

> "As applied to this case, these principles amount to the following: If the Government said it would break, or did break, an important contractual promise, thereby "substantially impair[ing] the value of the contract[s]" to the companies, *ibid*., then (unless the companies waived their rights to restitution) the Government must give the companies their money back. And it must do so whether the contracts would, or would not, ultimately have proved financially beneficial to the companies."

The Court noted that the leases stated that they would be subject to "all regulations issued pursuant to" the Outer Continental Shelf Lands Act (OCSLA) "in the future which provide for the prevention of waste and the conservation" of outer Continental Shelf resources. Further, the Court found that federal mineral leases are governed by the commercial law of contracts. The Court further noted that "the Court of Claims concluded . . . that timely and fair consideration of a submitted Exploration Plan was a 'necessary reciprocal obligation,' indeed, that any 'contrary interpretation would render the bargain illusory.' We agree." Of note, but not decisive, is that the OCSLA required in 43 USC 1340(c)(1) that the government act within 30 calendar days to approve exploration requests. The government argued that the OBPA-required delays of at least thirteen months were not substantial and therefore did amount to a material breach of the leases. The Court rejected that argument by noting, "if the companies did not at least buy a promise that the Government would not deviate significantly from those procedures and standards, then what

did they buy? . . . The Government's modification of the contract-incorporated processes was not technical or insubstantial. It did not announce an (OBPA-required) approval delay of a few days or weeks, but of 13 months minimum, and likely much longer. And lengthy delays matter, particularly where several successive agency approvals are at stake." Finally, the Court wrote, "Contract law expresses no view about the wisdom of OBPA. We have examined only that statute's consistency with the promises that the earlier contracts contained. We find that the oil companies gave the United States $158 million in return for a contractual promise to follow the terms of pre-existing statutes and regulations. The new statute prevented the Government from keeping that promise. The breach "substantially impair[ed] the value of the contract[s]." And therefore the Government must give the companies their money back."

Shortly after the *Mobil* decision, I became the lead Department of the Interior attorney in a breach of contract action filed by Chevron and its two co-lessees for 9 leases in the eastern Gulf of Mexico, *Chevron et al. v. United States*, 00-431 C (Fed. Cl. 2000), challenging actions, or lack thereof, by NOAA and the EPA related to the giant Destin Dome 56 dry natural gas development project located 25 miles south of Pensacola, Florida. The action stemmed from the failure of EPA to act to issue a required air permit for this proposed development to produce the estimated 1-2 trillion cubic feet of dry natural gas in 200 feet of water. Further, because the State of Florida had objected that the proposed project was not consistent with the enforceable policies of its state coastal zone management program, Chevron had filed an appeal requesting the Secretary of Commerce to overturn Florida's objection and allow the Department of the Interior to issue the required permits. The Secretary of Commerce failed to close the administrative record and make a decision on the appeal after a period of more than two years, and Chevron *et al* filed the subject breach of contract action alleging that both Commerce (NOAA) and EPA, citing *Mobil*,

had failed to provide the contractually-required timely and fair consideration of their permit requests, thereby materially breaching their leases and entitling them to restitution. After almost two years of discovery, briefs, and motions, I negotiated and signed on behalf of the United States, with the approval of the Department of Justice, an agreement in principle with the plaintiffs settling the litigation just after Memorial Day in 2002.

Prior to the resolution of *Chevron v. US*, I became the lead Interior attorney for another major offshore oil and gas breach of contract action, *Amber Resources Co. et al v. United States*, 538 F. 3d 1538 (Fed. Cir. 2008). This case was factually very similar to *Mobil* in that it involved a statute enacted after the issuance of the leases, the Coastal Zone Management Act Amendments Act of 1990, which was determined in other litigation for which I was the lead Interior attorney, *California et al. v. Norton*, 150 F. Supp. 2d 1046 (N.D. Cal. 2001), to apply to the operation of the leases. The lessees filed *Amber* citing *Mobil's* holding that the application of a later-enacted statute to the leases in such a way that materially changed the process through which the lessee must pass in order to explore and develop the oil and gas resources on the leased tracts amounted to a material breach of the leases entitling the lessees to compensation. The Court of Federal Claims granted judgment for the lessees and the Court of Appeals for the Federal Circuit affirmed the judgment but decreased the measure of compensation to restitution of the $1.1 billion paid to the federal government on the leases.

IV. Application of the *Mobil* and *Amber* Decisions to Current Issues

I will address the following in turn – legislative proposals to substantially increase, or eliminate, the OPA 90 $75 million damages limitation and apply this increase to existing leases; proposals to change the OCSLA statutory deadline to approve exploration plans from 30 to 90

days and apply this change to existing leases; and President Obama's current minimum seven month drilling moratoria on wells in more than 500 feet of water.

Proposals to substantially increase, or eliminate, the $75 million damages limitation (for natural resource damages, lost income, property damage/loss, lost tax revenues) in OPA90 and apply it to existing leases abound, even though the responsible party already has unlimited, strict liability for the entire response cost. One of the most widely cited solutions is the "Big Oil Bailout Prevention Act," introduced by Sen. Robert Menendez (D-NJ), that would raise the liability cap for damages under the Oil Pollution Act of 1990 ("OPA '90")from $75 million to $10 billion. The cap was put in place to limit the liability exposure of individual companies by sharing the risk so that companies would be able to continue to produce oil and gas offshore and tankers would be able to continue to bring oil into the United States. To raise the cap to $10 billion, or even some much lesser amount, would, at minimum, prevent U.S. small and mid-size oil and gas companies from participating in domestic offshore oil and gas development, and at worst, completely shut down almost one-third of our nation's domestic oil and gas supply. Either of these would destroy tens of thousands of high-paying American jobs.

While such an outcome would be harmful enough on its own, the consequences of such a policy could extend even further. The Menendez legislation would apply the liability cap retroactively to cover existing leases. Such a substantial change to the conditions under which companies have acquired their leases would likely be a material breach of contract, based on *Mobil*. As stated earlier, the Supreme Court held that companies that acquire leases do so in return for a contractual promise that the Government will follow the terms of pre-existing statutes and regulations. To apply substantial changes to those pre-existing statutes and regulations, except within narrow limits, in this case by materially changing the liability cap

under OPA '90 for existing leases, would likely be a repudiation of the contracts and entitle leaseholders to compensation for ALL existing federal offshore leases, including those already in production. In the Gulf of Mexico alone, there are currently over 6,600 oil and gas leases covering 35 million acres that were bought for an average of about $300 per acre in recent years. By committing a breach of contract on its Gulf of Mexico leases, the federal government would expose the American public to far more than $10 billion in claims from current leaseholders, not counting likely claims for lost profits. An additional $3 billion would be at risk for leases bought offshore Alaska.

The Administration has recently proposed to make other legislative changes, such as amending the Outer Continental Shelf Lands Act to substantially extend the statutory time allowed for the Department of the Interior to act on exploration plans (extending it from 30 days for existing leases to 90 days), that would materially impact existing leases and likely constitute a breach of contract of all non-producing offshore leases and thousands of onshore oil and gas leases, potentially costing taxpayers billions more. This exact provision was one of the issues in the *Mobil*. Regarding this, the Supreme Court stated, "The Government's modification of the contract-incorporated processes was not technical or insubstantial. It did not announce an (OBPA-required) approval delay of a few days or weeks. . . . The upshot is that, under the contracts, the incorporated procedures and standards amounted to a gateway in the companies' enjoyment of all other rights. To significantly narrow that gateway violated material conditions in the contracts. The breach was "substantial," depriving the companies of the benefit of their bargain."

Finally, in my opinion, President Obama's current minimum seven month drilling moratoria on wells in more than 500 feet of water is not well-supported by the law and is likely

to constitute a repudiation of all of the leases located in 500 feet of water and deeper. The OCSLA provides that the government must approve "submitted" exploration plans within 30 calendar days, as recounted in *Mobil*. By regulation, the government has 15 business days to review an exploration proposal to determine if it contains all of the required information and forms. Upon deeming an exploration plan "submitted" the government has a further 30 calendar days in which to review it and approve it or send it back for changes. In order to get around this statutory requirement which *Mobil* decided is part of the essence of the lease contracts, on May 30, 2010, the Minerals Management Service issued a Notice to Lessees (NTL) directing a suspension of operations, citing 30 CFR 250.172 (b) and 250.172 (c) as authority. The NTL states that it -

> "is based on a May 28, 2010, Memorandum from the Secretary of the Interior to the Director of the MMS finding that, under current conditions, deepwater drilling poses an unacceptable threat of serious and irreparable harm or damage to wildlife and the marine, coastal and human environment, as set forth in 30 C.F.R. 172(b). The Secretary also determined that the installation of additional safety or environmental protection equipment is necessary to prevent injury or loss of life and damage to property and the environment, as set forth in 30 C.F.R. 250.172(c)."

These are regulatory provisions taken from the OCSLA verbatim, so regulatory interpretation includes statutory interpretation. To my knowledge, never in the history of the OCS oil and gas program have either of these provisions been applied to hundreds or thousands of leases, and especially not for a significant period of time. There is really no justification given in the NTL

for taking these actions, but the NTL does state that "the causes [of the explosion] are still under investigation." So, if that is the case, what "additional safety or environmental protection equipment is *necessary*"? "Necessary" is a legal term that states within the context of the regulation that without the equipment to prevent it, the injury will take place. Where is the list of such "necessary" equipment? Why is it necessary to require drilling to stop for 6 months to wait on a report from a non-technical commission that is not expert in safety and environmental equipment? Wouldn't it be more reasonable to take immediate actions that are already recommended in the 30-day review safety report? Further, a blanket 6 month additional drilling moratorium because "under current conditions deepwater drilling poses an unacceptable threat of serious and irreparable harm or damage to wildlife and … the environment" is highly questionable. What "current conditions" are reference here that causes deepwater drilling to pose an unacceptable threat? What is an unacceptable threat? Is the fact that many thousands of deepwater wells have been drilled before having a sea-floor blowout an "unacceptable" threat? Can a 1 in 3,000 or 1 in 4,000 or 1 in 5,000 drilling history constitute an "unacceptable threat"? I do not believe that a court of competent jurisdiction would agree with the Administration's judgment on those questions.

V. Closing

It is clear that our nation benefits from developing oil and gas resources here at home. Domestic energy development reduces our reliance on imported oil, directly supports over 9 million jobs, creates billions in new wealth every year, and generates over $13 billion for the federal Treasury on an annual basis. I hope that our political leaders will not implement what I believe to be reckless policies that would imperil such an enormous source of jobs and revenue.

Finally, it is critical that cooler heads prevail so that rational policy changes can be developed. We clearly will need to closely examine the findings associated with the oil spill investigation and develop policies that address areas including: (1) the appropriate level of funding for oil spill prevention, response, and mitigation; (2) inspections and enforcement of offshore facilities; (3) emergency response protocols; and (4) the training and pre-positioning of equipment and personnel to facilitate faster incident response times. In sum, we need a carefully considered solution that will appropriately address pertinent issues without jeopardizing our economic, energy and national security.

Thank you for the opportunity to testify and I would be pleased to answer any questions.