

## USA

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MICHAL MACHNOWSKI

JULY 2010

[www.kasusa.org](http://www.kasusa.org)[www.kas.de](http://www.kas.de)**BP: Barack's Problem**

With the BP Deepwater Horizon disaster moving into its third month and the public's sentiment becoming increasingly angry, it is increasingly apparent that the spill has now become the main focal point of President Obama's domestic policy front. Not only is the spill dictating the agenda for the Obama Administration, but the response to the spill is becoming ever more scrutinized.

On June 15 President Obama made his first speech from the Oval Office, addressing the BP oil spill crisis, saying, "This oil spill is the worst environmental disaster America has ever faced... Make no mistake: we will fight this spill with everything we've got for as long as it takes. We will make BP pay for the damage their company has caused. And we will do whatever's necessary to help the Gulf Coast and its people recover from this tragedy."

Prior to the speech, President Barack Obama ordered the federal government to hold issuing new offshore drilling leases until a thorough review determines whether more safety systems are needed and authorized teams to investigate 29 oil rigs in the Gulf in an effort to determine the cause of the disaster. But even with the moratorium, problems continue to multiply.

**Evolving Estimates**

Before the Deepwater Horizon tragedy, the greatest oil disaster in American history was the Exxon Valdez spill in 1989, which spewed 10.8 million gallons of crude into Prince William Sound in Alaska. Over the course of the last two months, the estimate for the amount of oil billowing from the BP spill in the Gulf of Mexico has gone from 1,000 barrels per day to

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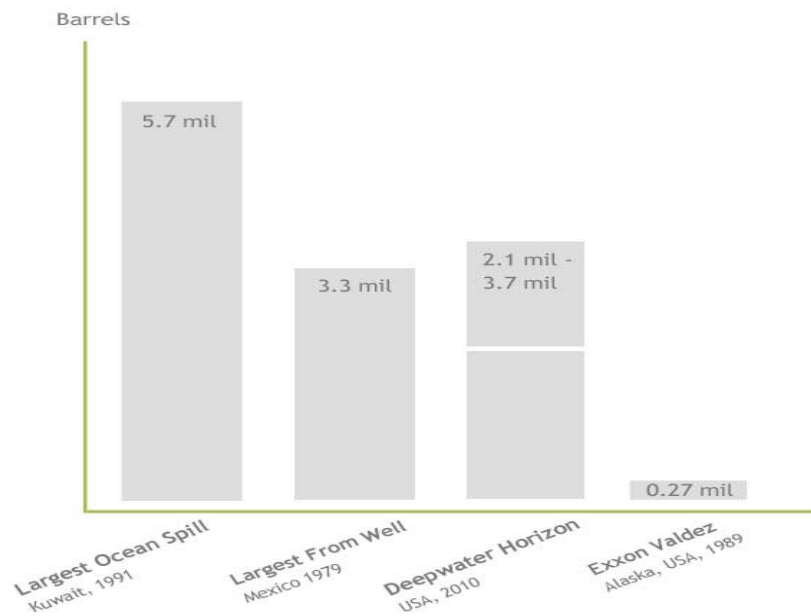
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60,000 barrels. That is roughly 2.5 million gallons of oil a day, and it means an amount equal to the Exxon Valdez spill could be gushing from the well about every four days.

The largest differentiating point is that the Valdez held a finite amount of oil, meaning that the range of possible cleanup costs was much tighter than the estimates for the Gulf spill. The worstcase scenario was that all 54 million gallons of oil gushed out of the tanker. This made it possible for analysts to do back-of-the-envelope calculations on a rough initial cost to get the spill cleaned up.

BP has yet to stem the flow of oil from the sea floor, and the current attempts may not be successful for many more weeks and months. Even the relief wells aren't guaranteed to work, and foreseeable events such as a hurricane could complicate matters even more. There is no way to accurately predict how much oil will eventually be spilled. And without that baseline, it is almost impossible to come up with an accurate estimate of the final spill.



After the Valdez spill, new legislation was passed, but the impact appears to have been minor. Even today, oil tankers in Prince William Sound are not required to be double-hulled. Energy policy continued essentially unchanged from before. It is of course possible that outrage over the current spill won't translate into new costs for energy companies, but it creates another layer of uncertainty in an already-uncertain environment.

One lesson that is transferable, however, is that the consequences could drag on for decades. It took five years after the Valdez spill until the initial \$5 billion-plus verdict was handed down against Exxon. The case has been working its way through the appeals process ever since and was even the subject of a 2008 Supreme Court decision. The complexity of litigation surrounding the BP spill could mean a process that drags on for years, and further pushes out the date when investors will know how much the entire crisis is going to cost them.

Both spills have also taken a reputational toll. Even today, many still associate Exxon with the Valdez spill, and chances are the Gulf spill will be forever linked to BP. Reputation is a flexible variable and one that is hard to factor into the investment case, but if a bad

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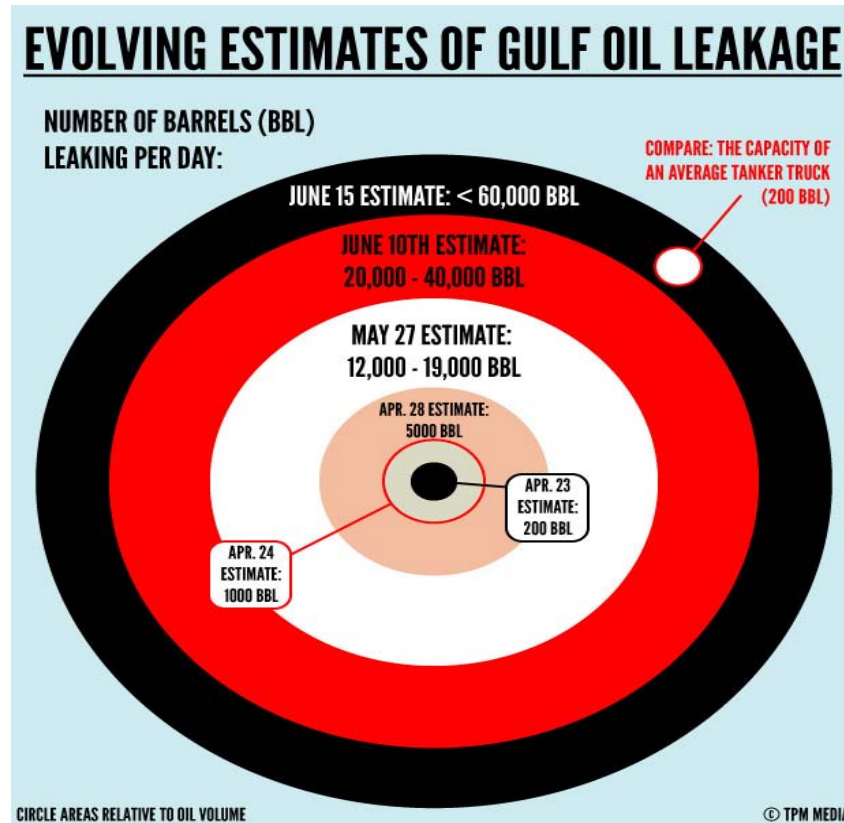
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reputation leads to extra oversight and nervous business partners, it can have a real long-term negative effect.

### By the Numbers

Just after the Deepwater Horizon rig exploded and sank, on April 20, BP claimed that a mere 1,000 barrels of oil, or 42,000 gallons, was leaking into the ocean.



On May 14 the government, over protests from BP, announced that 5,000 barrels of oil per day were leaking into the ocean. They were immediately criticized by experts, reported The New York Times, for making a hasty guess using "a method that is specifically not recommended for major oil spills." At about this time BP claimed that there was no reliable way to measure the spill. Experts then pointed out that there was a method, called "particle-image velocimetry," that would work.<sup>1</sup>

On May 27, three teams using three different methods announced that they estimated the leak was, in fact, more likely to be between 12,000 and 19,000 barrels per day. Many experts revealed that they had thought that all along. On June 10 that estimate was doubled to somewhere between 25,000 and 30,000 barrels a day by the same teams. On June 16, the team—this time bolstered by the personal involvement of Nobel Prize-winning Energy Secretary Steven Chu used pressure readings and high-resolution video to make a new estimate: 60,000 barrels a day. In a statement Chu said that "... it is important to realize that the numbers can change."

<sup>1</sup> <http://www.newsweek.com/2010/06/16/a-history-of-incorrect-oil-spill-estimates.html>

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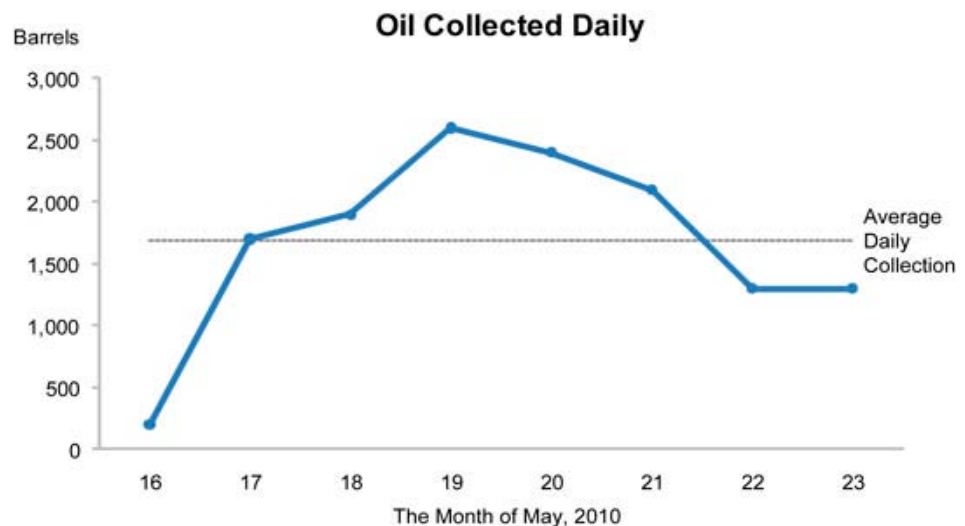
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The graph below was used in late May by BP senior vice president Kent Wells to show how the company's efforts to collect the oil that's spewing into the ocean at a rate of several thousands of barrels per day, is improving. He described adjustments that they've made to the siphon, then says "Here you can see how we've continued to ramp up." But does the graph display the reality of the situation?



Although the graph isn't outright dishonest, BP is relying on the viewer's assumption that a series of bars that increases in height represents an increase in performance. In this case it does not, however, because the bars display the cumulative amount of oil collected per day, not the daily amount. The graph below (created by Stephen Few of Visual Business Intelligence) shows the estimated daily oil collection by BP, and a story that is obviously quite different.<sup>2</sup>



<sup>2</sup> <http://www.perceptualedge.com/blog/?p=790>

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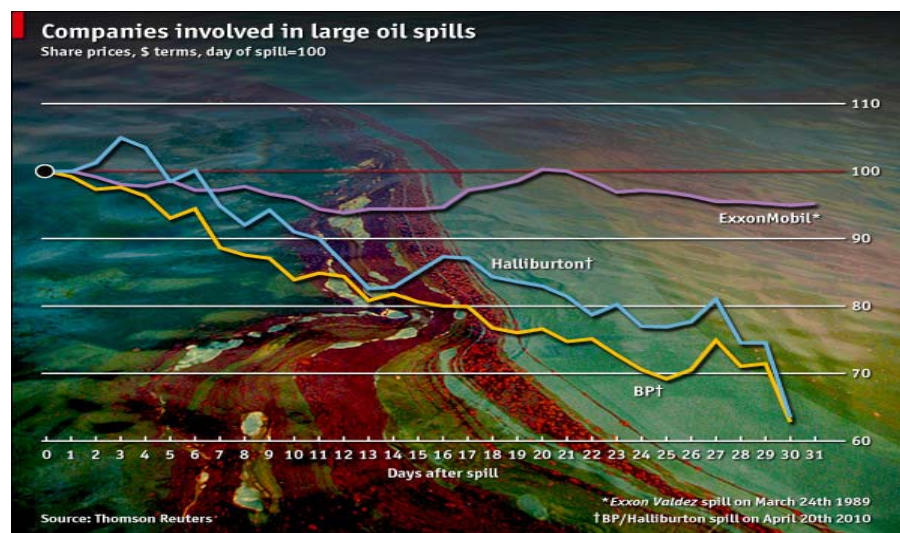
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While the amount of collection increased in the beginning, it has decreased or held steady for the last four days (as of May 26th) and is now well below the average amount of daily collection for this period as a whole.

### Share Prices Tumble

In the financial sector, BP Plc's stock price tumbled in June as it faced more U.S. government and congressional scrutiny over its handling of the massive Gulf of Mexico oil spill. Much is being made of the decline in BP's stock price, which has lowered its market equity from around \$200 billion before the Gulf Oil disaster to around \$100 billion. Some pundits have wondered how the market value of its equity can be this low given that the book value of its assets is around \$235 billion while its stated liabilities are around \$135 billion. Of course, the book value of either can understate the true market value. The BP balance sheet implicitly assigns a zero book value for the contingent liabilities emanating from this Gulf Oil disaster. One pundit today claims that the maximum estimated amount for what BP will be held liable for is \$23 billion. Given all the underestimates of how much oil has been dumped into the Gulf of Mexico, one has to wonder about the accurateness of such an estimate.

Additionally, when asking what led to the Deepwater Horizon explosion, a prominent theory adds Halliburton to the mix. Workers had just finished cementing the well when the rig exploded leading experts to speculate that a flaw in this process could have caused the explosion. Halliburton, the largest company in the global cementing business, was in charge of cementing the well. Since the explosions, Halliburton has seen its shares fall 36.5%, as questions emerged about the role the company played in the nation's largest oil spill, now easily eclipsing the Exxon Valdez spill in 1989. But during a conference call with analysts, Mark McCollum, Halliburton's chief financial officer, said: "We believe we are fully indemnified for all potential claims and expenses, as it relates to bodily injury claims or damage to the environment." In addition, the company has a \$600 million general liability insurance program and \$1.3 billion in cash and short-term securities, he added. Apparently investors were pleased. Shares of Halliburton soared as high as \$23.84 during intraday trading in early June and closed at \$23.69, with double the 30-day average trading volume. Concerns about potential liability payouts apparently weigh greater on investors' minds than the loss of business Halliburton is currently facing and will face in the coming months in the Gulf of Mexico.





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Halliburton was also responsible for cementing a well off the coast of Australia that blew last August, leaking oil for ten weeks before it was plugged. Though the investigation continues, an official from the U.S. Minerals Management Service testified that a poor cement job probably caused the explosion.<sup>3</sup>

Regardless of whether Halliburton has a particular history of faulty cementing, the process is a risky endeavor. According to the Wall Street Journal, "a 2007 study by three U.S. Minerals Management Service officials found that cementing was a factor in 18 of 39 well blowouts in the Gulf of Mexico over a 14-year period. That was the single largest factor, ahead of equipment failure and pipe failure."

#### **Cost of Cleanup/Economic Impact**

BP said costs related to its oil-spill response had reached \$2 billion as it continues work to contain the leak and to pay claims for damages. To date, more than 65,000 claims have been submitted and more than 32,000 payments made, totaling about \$105 million, BP said. "It is too early to quantify other potential costs and liabilities associated with the incident," the company said in a statement.<sup>4</sup>

The Obama administration said it has billed BP and other, unnamed responsible parties \$51.4 million for oil clean-up efforts in the Gulf, raising the total to \$70.9 million. The amount includes expenses related to more than two dozen federal entities and agencies responding to the broken well, which is estimated to be leaking about 35,000 to 60,000 barrels of oil every day.

BP agreed to hand over \$20 billion—to cover spill victims such as fishermen and hotel workers who lost wages, and to pay for the cleanup costs—a move some politicians dubbed a "shake down" by the White House. Others have portrayed it as a capitulation by an oil giant responsible for one of the worst environmental disasters in history.

If the company succeeds in stopping the flow of oil by August, when BP hopes to have relief wells operational, the company would be able to pay the majority of those costs by the end of this year. Costs arising from potential lawsuits and fines would be on top of that, BP CEO Tony Hayward said. He added that the moratorium on new drilling in the Gulf imposed by the U.S. government because of the spill could impact production by 50,000 barrels of oil per day in 2011 and up to 75,000 barrels per day in 2015. However, he highlighted BP's strong balance sheet, saying the company continued to generate strong cash flows from other operations.

BP earned more than \$16 billion last year. It has a generous annual dividend yield of 8.9 percent, compared with 2.8 percent for Exxon Mobil and 6.5 percent for Royal Dutch Shell. Executives disappointed investors who had hoped for an immediate commitment from the company to pay out planned dividends despite objections from some U.S. lawmakers who argue that it's not right for the company to hand out billions to shareholders at a time when the complete cost of the oil spill is unknown.

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<sup>3</sup> <http://www.theatlantic.com/science/archive/2010/05/halliburton-could-be-at-fault-for-oil-spill/56131/>

<sup>4</sup>

[http://online.wsj.com/article/SB10001424052748704895204575320064145090860.html?ru=yahoo&mod=yahoo\\_hs](http://online.wsj.com/article/SB10001424052748704895204575320064145090860.html?ru=yahoo&mod=yahoo_hs)

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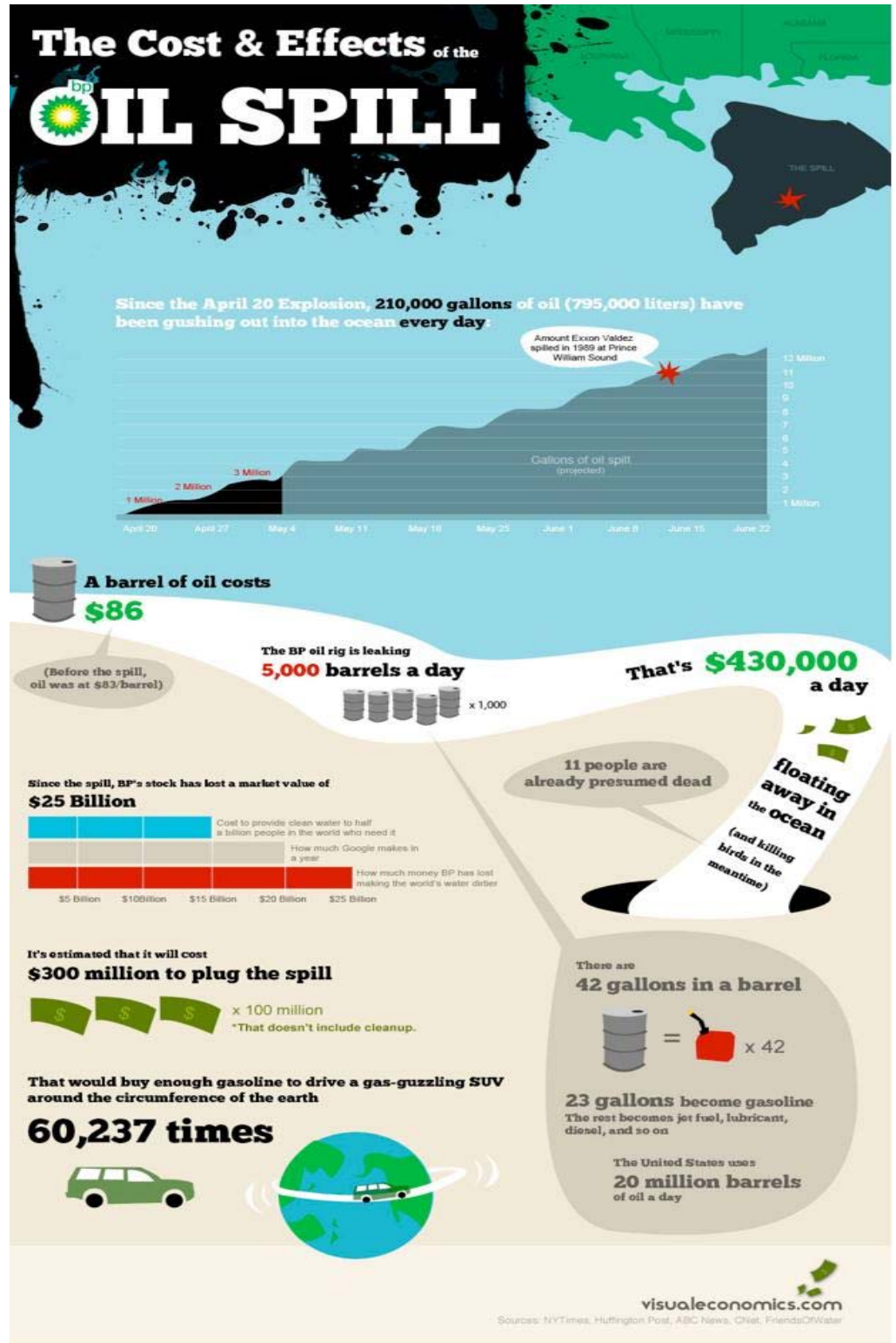
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Obama Response/ Obama's Katrina?

State officials believe their federal counterparts don't have a handle on the resources being deployed and are constantly overestimating the amount of booms, containment equipment, and boats being used.

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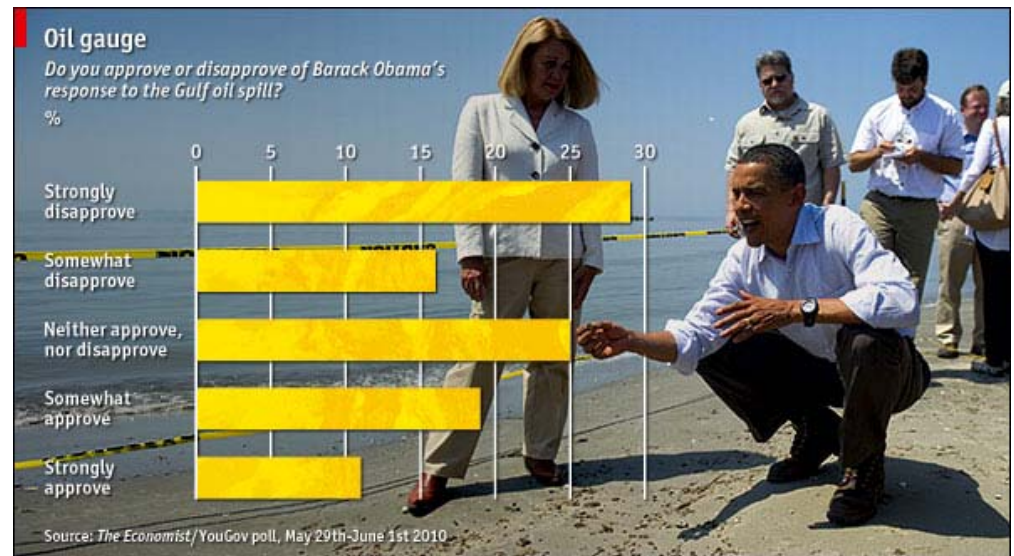
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Could this be President Obama's Katrina? It could be even worse. The federal response to Katrina was governed by the 1988 Stafford Act, which says that in natural disasters on-shore states are in charge, not Washington. The federal obligation is to "support . . . State and local assistance efforts" by providing whatever resources a governor requests and then writing big checks for the cleanup. President Bush had to deal with a Louisiana governor and a New Orleans mayor who were, by federal law, in charge.

But BP's well was drilled in federal waters. Washington, D.C., not Louisiana, is in charge. This would mean that it is President Obama's responsibility. He said his administration has been prepared for the worst from the start but President Obama's perceived failure to lead in cleaning up the spill could lead voters to echo his complaint in Katrina's aftermath: "I wish that the federal government had been up to the task."<sup>5</sup>



<sup>5</sup> <http://online.wsj.com/article/SB10001424052748704717004575268752362770856.html>