Institute for Policy Integrity
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REPORT: FAULTY ECONOMICS HELPED LEAD TO BP OIL SPILL

Government reform needed to avoid similar errors.

One year after crude oil began gushing into the Gulf of Mexico, little action has been taken to prevent a similar disaster. A report released today finds that overly simplistic economic analysis by the government may have helped lead to the accident.

Building on the theory of option value and adding original legal and economic analysis, the report concludes that America likely drills for oil too much too soon, taking on too much risk, and potentially missing out on higher pay-offs for taxpayers. The problem starts with the federal agency responsible for these natural resources using an out of date economic formula when deciding when to sell offshore drilling leases.

The current equation treats drilling like a now-or-never decision instead of taking into account more complex factors like uncertainty about prices and environmental risks. This blunt calculation can lead to the sale of leases for less than they are worth and to aggressive drilling without proper safety technology.

"Attempting to juice up the economy by over-exploiting U.S. oil reserves is like borrowing money from a loan shark—it might feel good today, but it can hurt you big time in the future," said Michael A. Livermore, one of the report authors. "With hundreds of billions of dollars at stake, we are not making the smartest financial choices possible."

As the BP spill demonstrated, deep water drilling involves the potential for catastrophic losses. The sale of America's offshore leases should reflect the risks taken when an oil rig goes up. But today's report finds that, until the government changes the economic rubric for selling natural resources, the public can be exposed to these risks without the proper compensation.

For decades, economists have recognized that when decisions are irreversible (like the removal of oil and gas from below the ocean floor) and conditions are uncertain (like the oft-fluctuating price of oil or environmental risks) an economic option value model is needed to determine the optimal time to drill.

With more finely-tuned economic models than the one in use today, the government would set a floor price that incorporates uncertainty about factors like the future value of the oil and the rate of technological development. If all the bids that come in are under the floor, then no sale would occur, protecting the American public from a bad deal. If some or all come in above that floor, then leasing could go forward.

Oil companies will not necessarily benefit from this change—they already profit from the government's current system. But the American public has much to gain in public revenue if the value of this shared resource is maximized.

The Institute for Policy Integrity at New York University School of Law is a non-partisan think-tank using economics and law to protect the environment, public health, and consumers.

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