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**ASSESSMENT OF THE NEED FOR MANDATORY
INSURANCE IN CONNECTION WITH THE GEORGIAN
LAW ON OBLIGATION TO COMPENSATE FOR
HARM CAUSED BY HAZARDOUS SUBSTANCES**

**Georgia Oil and Gas Sector Reform
Contract No. LAG-I-00-98-00005-00
Task Order No. 5**

Final Report

Prepared for:

U.S Agency for International Development
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**ASSESSMENT OF THE NEED FOR MANDATORY INSURANCE
IN CONNECTION WITH THE GEORGIAN LAW ON OBLIGATION TO
COMPENSATE FOR HARM CAUSED BY HAZARDOUS SUBSTANCES**

Background

Under Delivery Order 16, Hagler Bailly conducted a needs assessment and extensive training for counterparts on such topics as pipeline transportation economics, international contract negotiation skills, environmental impact assessments, the legal principles governing trans-country pipeline construction and operation, principles of oil and gas accounting, general accounting and auditing, project financing, and oil and gas administrative law. This training was designed to equip the Georgian counterparts with the skills and the knowledge to undertake the complex negotiations for the Main Export Pipeline (MEP), which will, if constructed, transport crude oil from the Caspian Basin through Georgia. That training was to have continued under Task Order 5.

In the Fall of 1998, however, Georgia International Oil Company (GIOC), the entity with principal responsibility for negotiating Caspian issues on behalf of GoG, advised USAID and Hagler Bailly that it is well-equipped by training and experience to undertake international negotiation without significant further training under USAID sponsorship. Moreover, other donor agencies, including Tacis and World Bank, advised us that they would be offering ample technical assistance to GIOC in connection with MEP negotiations. In lieu of the technical assistance envisioned in Task Order 5, therefore, GIOC requested help in meeting the World Bank board presentation conditions for an Energy Sector Adjustment Credit, including a requirement that Georgia enact strict liability legislation related to oil and gas transit. As consultation with counterparts on this legislative initiative commenced, however, GIOC indicated that broader legislation was appropriate to cover potential environmental liabilities arising from a multiplicity of potential sources. World Bank concurred with this broader approach. Accordingly, Hagler Bailly provided technical assistance in drafting, with full consultation with counterparts, USAID, and other donor agencies, a draft law on strict liability for hazardous materials.¹

¹ See Hagler Bailly, "Report on the Georgian Law on Obligation to Compensate for Harm Caused by Hazardous Substances," July 12, 1999.

At the time that Georgian counterparts proposed that Hagler Bailly provide technical assistance in preparing an environmental liability law, they also proposed, as part of that project, that Hagler Bailly prepare legislation requiring natural gas and oil pipelines to carry liability insurance to cover the risk of accident in the construction and operation of such facilities. Following consultation with USAID, Hagler Bailly added that item to the work plan under Subtask B of Task Order 5. Unlike the environmental liability task item, however, the mandatory insurance task first provided for an assessment of the need for mandatory insurance; only if the assessment showed that such a requirement is appropriate was Hagler Bailly to prepare legislation.²

As the environmental liability law expanded in scope from oil and gas to all hazardous materials, so did the mandatory insurance issue. Thus, the context for consideration of mandatory insurance under Task Order 5 has been whether the owners or possessors of hazardous materials should be required to carry insurance.

Mandatory Insurance Related to the Strict Liability Legislation

Proposals have been almost continuously discussed under which a section requiring mandatory environmental liability insurance would be incorporated in the proposed strict liability environmental law. After discussion with World Bank representatives, GIOC, and Ministry of the Environment and discussion at the workshop held on the strict liability law, it is apparent that the Georgian consensus is that such insurance coverage is desirable. A main point of concern, expressed by various Georgian parties and by World Bank environmental representatives, is that Georgia has no fund dedicated to paying the initial costs of response to and cleanup of oil or chemical spills or other incidents involving hazardous substances. Moreover, there does not seem to be a significant impetus toward establishing such a fund, which would require (particularly since the government is chronically short of funds) to impose a fee or some other form of taxation at some point in the chain of manufacture, transportation, or other handling of oil, gas, and chemicals.

² In the words of the work plan, Hagler Bailly is to provide

technical assistance to assess the need for a law requiring oil and natural gas pipeline licensees or owners to secure liability insurance to cover the risk of accident in the construction and operation of their facilities. If the assessment shows that such a law is necessary and appropriate, then technical assistance shall include the drafting of the law, in consultation with counterparts, USAID, and World Bank.

Hagler Bailly, "Work Plan – Subtask B: Legal/Regulatory Reform," March 19, 1999.

Early drafts of the broad hazardous substance strict liability law contained provisions for financial responsibility that would have required a person or firm subject to the law either to maintain insurance at or above a minimum amount or to obtain a certificate of financial responsibility from the Georgian government based on proof that the party held sufficient assets in Georgia or subject to Georgian jurisdiction in an amount at least equal to the minimum insurance requirement. Under the draft version proof of financial responsibility would be a prerequisite to licensing to engaging in a business involving hazardous substances.

In talks with counterparts, the World Bank, and Hagler Bailly consultants familiar with the energy industry, no satisfactory resolution of the question of the minimum level of required coverage could be reached. Premium levels and even the availability of coverage are established through insurance companies' experience with a particular activity and loss history and exposure. There is little such experience base in Georgia, and few insurers have come into the Georgia market as yet. Moreover, there was concern that because the number of businesses subject to the law was quite large and included many small and medium sized businesses, financial impact would be significant, particularly for small and medium size concerns. In the absence of sufficient data and in a new insurance market, premiums might be prohibitive for domestic concerns, if coverage were even available, causing them either to cease business or operate illegally.

Both in individual conversations and in comments at the strict liability workshop, there appears to be a misconception on the part of many Georgian counterparts (and on the part of some World Bank staff) about the effect of insurance coverage. Statements made on several occasions indicate a belief that, in the event of an incident involving a hazardous substance release, insurance carriers would immediately begin to pay for the response and cleanup and to pay compensation for harm caused. Some expressed concern that enforcement of the strict liability law would depend on the courts. Issues of judicial system competence and integrity aside, western experience is that responsible business and responsible insurance carriers will respond promptly to incidents, as prompt response to and containment of spills will generally serve to reduce the ultimate liability exposure. In addition, offers of prompt payment of damages to parties affected by spills can serve to reduce exposure to liability by foreclosing claims prior to the time that damage can be assessed and evaluated fully and by discouraging injured parties from obtaining competent advice on their rights. However, both insurance carriers and businesses with adequate funds to use for defence purposes will resist payment if they perceive that they can either block or reduce the amount of a claim by doing so.

On the basis of the foregoing, Hagler Bailly concluded that the law imposing strict liability for damage caused by hazardous materials should not include a provision requiring the owners or possessors of such materials to carry insurance covering the risk of damage from such materials. (For the same reasons, Hagler Bailly concluded that no stand-alone law should, at this time, require such coverage.) We simply do not have adequate information on the possible financial

impact of such a requirement on the numerous businesses, large and small, that such a requirement would affect. We have no idea, and will not have until the insurance industry becomes more developed in Georgia, what the cost of such insurance would be. And, due to the wide coverage of the law, we lack the data on risk factors on the basis of which rationally to calculate decisions on minimum coverage amounts for different classes of materials and/or owners. Hagler Bailly communicated its conclusion to counterparts and donor agencies, including USAID, in the final stages of revisions to the strict liability law, and believes that it reached consensus with all relevant groups on the issue. We note that the issue may be raised again at such time as more data are available, and as experience with the hazardous materials legislation (when and if it passes) suggests that mandatory insurance might be desirable and appropriate.

Mandatory Insurance for Oil and Gas Products

After consensus had been reached on omitting a mandatory insurance requirement from the strict liability law, GIOC raised the issue of mandatory insurance in connection with the transportation of oil, gas, and refined products. These products will, of course, be subject to the new strict liability law (assuming that Parliament passes the law). GIOC, however, requested that Hagler Bailly revisit the original concept of drafting a specific provision requiring insurance for petroleum and natural gas transport operations, including marine terminal facilities and shipping in Georgian waters. GIOC expressed concern that GPC tanker loading practices at the Supsa terminal may not comply with international standards. GIOC cited, for example, the absence of standby tugs and booming during loading operations at Supsa as possible deficiencies.

Different factors enter into consideration when assessing this need from those connected with the broader issue of hazardous materials liability coverage. International standards for minimum levels of financial responsibility for damages resulting from oil spills already exist for vessels transporting oil over international waters. These minimum coverages are based on the amount of oil carried. The concept of per unit coverage could easily be adapted for onshore transportation and storage and for storage and handling at terminal facilities. Moreover, oil and gas transportation is similar in most circumstances worldwide and the nature of the risk is reasonably well known and related to volumes of oil and gas transported. Insurance coverage or self-insurance is common throughout the international petroleum industry, and its impact on operational costs should be determinable. In addition, all of the current non-governmental owners and operators of pipelines and terminal facilities in Georgia appear to be firms of a sufficient size that they should be able to meet minimum financial responsibility requirements (either through third party insurance or through proof of financial soundness). The same may not, however, be true of local contractors or sub-contractors.

Although GIOC's recommendation regarding mandatory insurance for oil and natural gas transportation may have merit, the issue re-emerged too late in the contract for Hagler Bailly properly to assess the issue. We recommend that USAID consider conducting such an assessment in the near future.

Conclusion

A requirement for mandatory insurance coverage in connection with the ownership or possession of hazardous materials is not appropriate at this time. A requirement for insurance in connection with oil and gas transportation may be appropriate, and deserves further study.