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Environmental Liability Insurance Requirements for Rail versus Pipeline

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The recent railway disaster in Lac-Mégantic, Quebec highlights the urgent need to review the current regulatory framework for third party liability insurance coverage for the transport of hydrocarbons.

On July 6, 2013, a 5-locomotive, 72-car train carrying crude oil and operated by Montreal Maine & Atlantic Railway (MM&A) was left unattended overnight. A series of events including an engine fire extinguished by fire crews who shut off the engine, and a subsequent suspected brake failure, resulted in the train rolling out of control into the town of Lac-Mégantic, Quebec. The train derailed, causing a series of explosions and fires, killing 47 people, and substantially destroying the small town. Nearly 6 million litres of oil spilled out of the cars, contaminating soil and making its way into Lake Mégantic and the Chaudiere River, which runs through town.

On August 6, 2013, MM&A filed a petition seeking relief under the *Companies' Creditors Arrangement Act* (*CCAA*) in the Superior Court of Quebec in Montreal. MM&A was unable to pay a demand letter from the Municipality of Lac-Mégantic for $7.8 million related to initial cleanup. The company noted its liabilities far outstripped its assets. MM&A also determined that its insurance policy of USD $25 million would be inadequate to cover the costs of the damage. The government of Quebec estimates that the total cleanup costs will be close to $200 million.

POLITICAL AND LEGAL CONTEXT

In North America generally, the focus of energy politics has shifted from production and consumption toward transportation. The use of rail for movement of oil has increased enormously in the past few years.[1] Rail infrastructure already exists, it is inherently flexible, and, at least initially, transportation of oil by rail drew little attention or political debate. Pipelines, on the other hand, require new investment and approvals, and have become a lightning rod for public debate and criticism of the energy industry.

In this context, it is useful to consider key differences in regulatory schemes and environmental liability for pipeline and rail operators.

On the surface, transportation companies are wholly liable for all environmental damage they cause. The "polluter pays" principles of the *Canadian Environmental Protection Act, 1999*[2] apply to environmental damage caused by any transporter of hydrocarbons. In practice, however, a company's net assets, corporate structure, and insurance policies limit the extent to which it can pay for its environmental liability. Any excess liability is passed on to other private parties or taxpayers if the company declares bankruptcy. This externalizes the cost of cleanup and can affect the underlying market structure by limiting the barriers to entry and operating costs.

RAILWAY REGULATION AND INSURANCE

Railway companies in Canada operate almost exclusively on privately owned tracks, although spills and accidents will almost always impact the public. Railways that cross provincial or national boundaries are federally regulated. The *Railway Safety Act* (*RSA*)[3] gives responsibility to Transport Canada (through the Minister of Transport)

for overseeing railway safety. *RSA* sets the parameters for regulations and rules pertaining to safety and environmental management. While regulations have broad application, rules are formulated by individual companies and filed for approval by the Minister of Transport. There are currently provisions in *RSA* allowing for the creation of regulations pertaining to the release of pollutants from railway equipment as well as for regulations requiring railways to file environmental management plans and compliance audits for environmental management.[4] To date, no such regulations have been created.

The transportation of some types of freight is governed by the *Transportation of Dangerous Goods Act, 1992*,[5] though not all substances capable of causing significant environmental damage fall within the scope of that act, and the *Canadian Transportation Accident Investigation and Safety Board Act*[6] governs the investigation of incidents. The *Canadian Environmental Assessment Act, 2012* (*CEAA, 2012*)[7] affects the development of new track infrastructure and facilities, but not the use of existing railways, even if the railway is being used in a new way, for instance, for transporting oil instead of grain.

Liability Insurance for Railways

The *Canada Transportation Act* (*CTA*),[8] provides an overall regulatory and economic framework for the national transportation system. Before a railway can operate as a national, federally regulated railway, it must obtain a Certificate of Fitness from the Canadian Transportation Agency,[9] which is an independent, quasi-judicial tribunal and economic regulator. The agency must be satisfied that the railway holds enough insurance to cover, or has the assets to self-insure, the costs of any damage caused. The *Railway Third Party Liability Insurance Coverage Regulations*[10] state:

> Third party liability insurance coverage is adequate if there is
>
> (a) sufficient insurance, including self-insurance, to compensate for the following matters that may arise out of an applicant's proposed construction or operation of a railway, including a proposed temporary construction or operation of a railway resulting from unforeseen or exceptional circumstances:
>
> (i) third party bodily injury or death, including injury or death to passengers,
>
> (ii) third party property damage, excluding damage to cargo, and
>
> (iii) named perils pollution;

The Canadian Transportation Agency is required to consider factors set out in the regulations, such as volume of railway traffic, class and volume of dangerous goods transported by rail, and various other safety factors. In determining the adequacy of insurance coverage, the agency also considers the risk assessment carried out by the insurance company and the railway company, as well as comparisons with other railways and industry practices. However, assessments are done on a case by case basis, applications are not subject to public consultation or any public notification requirement, and the agency does not reveal how much insurance railways carry.

For some context on the costs of railway spills, in 2005, CN Rail stated that it spent $132 million to clean up and compensate third parties after a freight train derailed at Lake Wabamun in Alberta, spilling crude and pole oil.[11] For MM&A, however, the Canadian Transportation Agency found that $25 million of insurance was adequate.[12]

In August 2013, the agency announced that it would undertake a consultation and review of adequacy of third party liability insurance coverage requirements for federally regulated railways, while emphasizing that it is not aware of any federal railway incurring claims greater than their insurance capacity in the past 10 years.[13] Public consultation is ongoing, and the agency

will likely recommend improvements to the regulatory framework set out in the *Railway Third Party Liability Insurance Coverage Regulations* at some point in 2014.

INSURANCE REQUIREMENTS FOR OTHER "HIGH-RISK" INDUSTRIES

In other industries where there is a risk of significant damage, operators are generally required by legislation to carry insurance or have bonding.

For instance, the aviation industry is subject to requirements prescribing insurance on a sliding scale based on aircraft size and capacity.[14] These requirements are for insurance covering death and injury to passengers as well as third party liability.

In BC, mine operators are required to post security or bonds for harm to the environment and for reclamation costs before a project can go ahead.[15] A recent application for a mine in BC was denied its environmental certificate because of the concern that the project would create in-perpetuity financial obligations and liabilities that the company might not be able to adequately cover.[16]

PIPELINE REGULATION AND INSURANCE

Pipelines operate under a different regulatory scheme than railways. The *National Energy Board Act* (*NEBA*)[17] is the enabling legislation for the independent National Energy Board (NEB), which regulates the construction, operation, tolling, and abandonment of trans-provincial and trans-national pipelines. The NEB is responsible for environmental assessments of new trans-provincial and trans-national pipeline projects under *CEAA, 2012*.

Environmental assessments will impact pipelines significantly more than railways for two reasons. First, there is the historical fact that the railway system already exists across North America, whereas the pipeline system is still being developed. Second, pipelines are less versatile than railways, so a new product being shipped frequently requires the construction of a new pipeline. In contrast, the same railway can be used to transport corn, coal, or crude oil. As a result, the environmental assessment process is a significant tool in assessing pipeline operator's ability to pay for damage that it may cause.

Under section 54 of *NEBA*, the NEB must issue a certificate to a pipeline operator in order for it to proceed with the construction and operation of a pipeline. Part of the process for determining whether a certificate will be issued involves the NEB assessing the level of financial responsibility of the applicant as well as the public interest.[18] This entails determining whether the operator has both the operational and the financial ability to clean up a spill.

Liability Insurance for Pipelines

As noted above, during the NEB's environmental assessment for major pipelines, it may examine the pipeline operator's ability to pay for environmental harm from pipeline failure. While there is currently no prescribed amount, nor a specific process for assessing insurance and financial capacity, the environmental assessment process is more transparent than the process by which Certificates of Fitness are issued to railways by the Canadian Transportation Agency.

The environmental assessment for the Enbridge Northern Gateway Pipeline is an example of this transparency. During the Joint Review Panel process, the environmental assessment application was made publicly available online. Enbridge's application includes its risk assessment for spills and is based in part on NEB data on the frequency of pipe failure.[19] The hearing process for the application drew considerable attention to Enbridge's capacity to cover the costs of environmental damage. In issuing its final recommendation regarding the project, the Joint Review Panel recommended that approval of the pipeline be subject to a condition requiring Enbridge to have $950 million

available in cash and insurance to clean up any spills, of which at least $100 million must be ready cash to cover initial costs of a spill.[20]

Similarly, Kinder Morgan's proposal to expand its Trans Mountain Pipeline prompted a very public discourse about the environmental liability for a spill and Kinder Morgan's insurance coverage. The City of Vancouver chimed in on the debate, demanding that Kinder Morgan have more than $1.3 billion in coverage.[21] The debate on both of these pipelines straddles the risks of both marine and land spills, and in many respects, the risks are inherently different from those for rail operations. However, the analysis, disclosure, and assessment has been far more transparent for pipelines than for railways.

On June 26, 2013, the Honourable Joe Oliver, Canada's Minister of Natural Resources, announced that legislation will be introduced requiring pipeline operators to demonstrate the financial capacity to pay for any damage caused by spills or incidents. For major crude oil pipelines, the government will require a minimum financial capability of $1 billion. Companies will also be required to appoint a senior officer who will be responsible for compliance of management systems and programs, and for ensuring that emergency and environmental plans are transparent and available to the public.[22] It is not clear exactly when or how this law will be enacted, nor which pipelines it will apply to.

IMPLICATIONS AND CONSIDERATIONS

As details of the proposed financial capacity legislation for pipeline operators are revealed, the extent of the differences in requirements for crude oil shippers using pipelines versus railways will become clearer. In any event, both modes will likely play a role in the development of the North American energy industry, since each offers unique advantages.

At present, it seems that the regulatory requirements for financial security for pipeline operators are and will continue to be much greater, and more transparent. In light of the requirements that are currently in effect or proposed, the following points are worth considering.

- It is unclear whether financial capacity of $1 billion is an appropriate requirement for major pipeline operators shipping crude oil. The roundness of the figure suggests political rather than scientific risk management. But, with the benefit of hindsight, $1 billion seems more appropriate than MM&A's capacity of a $25 million insurance policy plus net assets.
- The costs associated with environmental contamination risk should be externalized to the same extent for both pipelines and railways. Environmental liability insurance requirements would not have to be nominally identical for rail and pipeline operators, but the amount should be based on the measured risk—the likelihood of harm and the expected severity of harm. Railways and pipelines have different risk profiles, and the costs of their respective spills are different as well. The risk assessment process should be the same for both pipelines and railways, such that the costs associated with environmental damage are externalized to the same extent for both modes.

  In other words, financial security regulation should be modally neutral. A drop of oil in a river causes the same damage whether it comes from a railcar or a pipe, and regulation should reflect this. Otherwise, market dynamics become skewed because regulators are effectively offering a discount to some forms of transport by passing more risk on to taxpayers.
- Regulatory schemes should be consistently transparent and stringent across modes. Otherwise, again, skewing of the transportation market will occur. For instance, if railways are less regulated and less politically contentious than pipelines, then there is an incentive for producers and marketers to use rail, regardless of environmental risks, even

if pipelines are cheaper and safer in the long run.[23] Such an outcome should be considered a regulatory failure.

- When it comes to liability insurance, more is not always better. Regulators should strive to find the "Goldilocks" amount. As with virtually all economic ventures, from banks to farming to fuel transportation, the tail-risks of catastrophic disaster at some point are carried by the taxpayer.

  Mandating higher financial capacity requirements raises barriers to entry for transporters and ultimately means higher costs and less competition. Lower financial capacity requirements mean the costs of disaster are unfairly passed on to taxpayers. Either way, there should be consistency across the board, and regulators should seek a universal balance between risk to the environment, risk to taxpayers, and industry cost.

- During its proposal for the Northern Gateway Project, Enbridge tabled the idea of a pooled insurance fund for Canadian pipelines, with a small levy being collected on each barrel of oil moved by pipeline, creating a massive fund available industry-wide. Such a fund would lower the costs of insurance and backstop an individual company without going to the taxpayer. This concept has been used in the marine transportation industry in Canada for some years, through the National Ship-source Oil Pollution Fund (SOPF), under the *Marine Liability Act*.[24] A similar scheme could play a role in the development of hydrocarbon transportation systems, and could provide a progressive solution to the problem of environmental liability.

CONCLUSION

The tragedy at Lac-Mégantic pushed transportation of oil by rail into the spotlight, but it is simplistic to suggest that there is a binary choice between rail and pipeline, or that one is better than another. Hydrocarbon transportation is a necessity, and both forms of transportation can play a role.

Ideally, the regulatory scheme will funnel decision makers and stakeholders into choices driven by the inherent risks, costs, and qualities of the transportation method. An asymmetrical regulatory scheme that creates differing degrees of cost externalization and barriers to entry leads to decisions being made for the wrong reasons, potentially harmful outcomes for the environment, and a less efficient energy industry.

ENDNOTES

1 The Railway Association of Canada estimates that, in 2013, 140,000 tanker cars of crude oil will have been moved on Canada's tracks. In 2009, 500 cars were moved. See note by Michael Bourque, President and CEO of the Railway Association of Canada, "Oil by Rail," at **www.railcan.ca/news/commentary**.

2 S.C. 1999, c. 33.

3 R.S.C. 1985, c. 32 (4th Supp.), as amended.

4 *RSA*, s. 47.1.

5 S.C. 1992, c. 34.

6 S.C. 1989, c. 3.

7 S.C. 2012, c. 19, s. 52.

8 S.C. 1996, c. 10, as amended.

9 *CTA*, ss 90 - 94.

10 SOR/96-337, s. 3.

11 Figure attributed to Jim Feeny, CN spokesman, in the *Spruce Grove Examiner,* May 29, 2009. See **www.sprucegroveexaminer.com/2009/05/29/cn-guilty-in-wabamun-spill**.

12 On August 13, 2013, the Certificate of Fitness was suspended. See Order No. 213-R-266, Canadian Transportation Agency.

13 See the Canadian Transportation Agency website, August 13, 2013, at **www.otc-cta.gc.ca/eng/backgrounder-certificate-fitness**.

14 See the *Air Transportation Regulations*, SOR/88-58, s. 7, and the *Canadian Aviation Regulations*, SOR/96-433, s. 606.02.

15 *Mines Act*, R.S.B.C. 1996, c. 293, s. 10.4 - 10.5.

[16] The Morrison Gold/Copper Mine Project had its certificate denied in October, 2012. See B.C. Ministry of Environment press release online at **www.newsroom.gov.bc.ca/2012/10/morrison-mine-project-denied-environmental-assessment-certificate.html**.

[17] R.S.C. 1985, c. N-7.

[18] *NEBA*, s. 52.

[19] See Enbridge: Northern Gateway Pipelines, *Section 52 Application, Volume 7B: Risk Assessment and Management of Spills—Pipelines*, Section 3: Probability of Hydrocarbon Spills, found online at **www.northerngateway.ca/assets/pdf/application/MASTER_Vol%207B_Final_14May10.pdf**.

[20] *Report of the Joint Review Panel for the Enbridge Northern Gateway Project*, Chapter 11, "Financial, tariff and tolling matters," found online at **http://gatewaypanel.review-examen.gc.ca/clf-nsi/dcmnt/rcmndtnsrprt/rcmndtnsrprtvlm2chp11-eng.html#s116**.

[21] As reported by Dene Moore, The Canadian Press, published online in *Huffpost British Columbia* on November 9, 2012.

[22] See Natural Resources Canada Press Release, June 26, 2013, online at **www.nrcan.gc.ca/pipeline/6698**.

[23] A recent report by the advisory firm Deloitte suggests that rail has the advantage of few regulatory barriers and shorter timeframes for startup. See Deloitte, *Gaining Ground in the Sands 2013*, page 16, viewed at **www.deloitte.com/view/en_CA/ca/industries/energyandresources/oilandgas/oil-sands-2013/index.htm**.

[24] S.C., 2009, c. 21.