Offshore Energy

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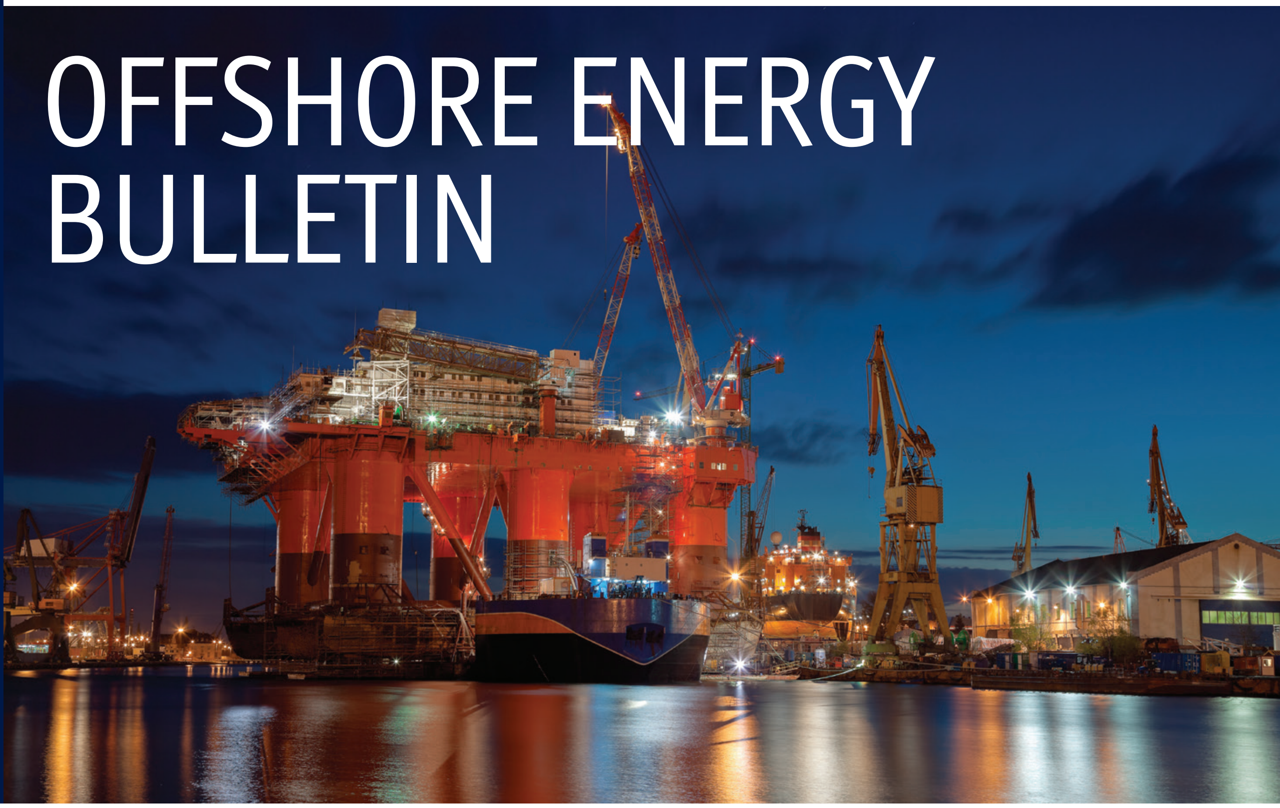
OFFSHORE ENERGY BULLETIN



Welcome to the December edition of our Offshore Energy Bulletin

In this edition we explore some of the international issues faced by participants in an increasingly global offshore energy sector.

The recent decision in the *Ocean Victory* has prompted offshore shipowners to question the role of safe port warranties in charterparties, and whether these will be overridden by the knock-for-knock regime of liabilities and indemnities. We examine the relationship between these two types of provisions in the standard form contracts. The tragic death of four offshore workers in the recent SuperPuma ditching in the North Sea is also a timely reminder of the considerable risks and liabilities facing all participants in the offshore sector, and the importance for participants continually to review and update the liability and indemnity terms of their offshore contracts. A recent English Court of Appeal decision may have a significant bearing on the scope of knock-for-knock terms, and a copy of our article co-authored with leading barrister Simon Rainey QC can be read here: http://www.lloydslist.com/ll/sector/Insurance/article426176.ece.

An important issue for companies involved in projects in developing regions is the requirement for local content, and we explore the difficult balance between promoting local industry and fulfilling the service requirements of complex offshore projects. Another vital consideration is the management of political risk, which we examine in the context of recent developments in Latin America. We also consider the offshore construction market in the Asia-Pacific region, where the traditional powerhouses of Korea and Singapore are now experiencing considerable competition from Chinese yards.

If you require any further information or assistance on any of the issues dealt with here, please do not hesitate to contact any of the contributors to this bulletin or your usual contact at HFW.

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Safe port warranties and knock-for-knock

In the recent decision in the *Ocean Victory*[1], the English Commercial Court held charterers liable for US$138 million for breach of a safe port warranty in their charterparty. Offshore charterparties typically also include such warranties, but to what extent can shipowners rely on these where liabilities are allocated on a "knock-for-knock" basis?

The safe port warranties

The *Supplytime* forms provide: The vessel shall be employed *"between any good and safe port or place and any place or offshore unit where the Vessel can safely lie always afloat"*[2].

Towcon 2008[3] and *Towhire 2008*[4] provide: *"The place of connection and departure shall always be safe and accessible for the Tug to enter, to operate in and for the Tug and Tow to leave..."*

The knock-for-knock regime

Under *Supplytime*[5], charterers are not responsible for loss of or damage to the vessel, or other property of owners' group *"even if such loss [or] damage ... is caused wholly or partially by the act, neglect or default of the Charterers' Group"*.

Under *Towcon 2008*[6] and *Towhire 2008*[7], the tugowner is responsible for damage to its tug *"whether or not the same is due to any breach of contract..."*.

The responsible party also agrees to indemnify the other party against claims or liabilities arising out of the loss or damage for which the indemnifying party has agreed to be responsible.

Which clause prevails?

The knock-for-knock wording in *Towcon 2008* and *Towhire 2008* makes it clear that the arrangement applies irrespective of any breach of contract, which would include breach of the safe port warranty. The *Supplytime* terms do not refer expressly to breach of contract, but it is clear that the words *"act, neglect or default"* are intended to include breaches of contract.

So why go to the trouble of negotiating the parties' contractual obligations in the first place, if these are irrelevant when it comes to allocation of liabilities?

The Commercial Court does not consider the two types of clauses incompatible. In the *Super Scorpio II*[8], the company was held responsible for the cost of repairing an ROV, despite the contractor's breach of a contractual obligation to *"take all necessary care of Company's Items as required by good oil and gas industry practices and return them to the Company in their original condition..."* The Court explained that the knock-for-knock provision was concerned with damage or loss, whilst the safekeeping obligations were in force even though no loss or damage had actually occurred.

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EMILIE BOKOR-INGRAM

Owners beware

Unless the safe port warranties in *Supplytime, Towcon 2008* and *Towhire 2008* are excluded from the knock-for-knock regime, owners need to be aware that if their vessel is damaged due to charterers' breach, they will have no right of indemnity. With recoverable losses in the *Ocean Victory* of US$138 million, the comparison for owners is stark.

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1 Gard Marine & Energy Ltd v China National Chartering Co Ltd [2013] EWHC 2199 (Comm)
2 SUPPLYTIME 2005 Clause 6(a) / SUPPLYTIME 89 Clause 5(a)
3 Clause 13(b)
4 Clause 11(b)
5 SUPPLYTIME 2005 Clause 14(b)(i). SUPPLYTIME 89 Clause 2(a) is materially similar.
6 Clause 25(b)(i)
7 Clause 23(b)(i)
8 Smedvig Ltd v Elf Exploration UK PLC [1998] 2 Lloyd's Rep. 659

Offshore construction in Asia-Pacific

As the demand for energy continues to boom, bolstered by high crude oil prices, there is ever-increasing activity in offshore construction in the Asia-Pacific region.

Competition in the market is duly intensifying, as numerous major Chinese state-owned offshore construction firms make a serious play for projects historically dominated by Korean and Singaporean companies, which together account for the construction of a great majority of the world's jack-up rigs.

New players in the market bring new challenges, or accentuate pre-existing ones. Among these is the commonplace issue of what happens to owner-furnished equipment (OFE, sometimes referred to as the customer deliverables) if for whatever reason the construction process is not completed and the project is terminated. The value of such equipment cannot be ignored, as they are often sophisticated and expensive components imported into Asia at considerable expense.

Any buyer should give careful consideration to what will happen to OFE on termination. Does a buyer wish to have a right to elect between either demanding the return of the OFE, or requiring the builder to purchase it? There are various factors to consider depending on the specific piece of equipment involved, its suitability for further use, its post-termination value, storage costs and various other requirements which may influence the decision-making process at the time of termination. The answer to this question is likely to change depending on what stage of the project termination may occur.

The most prudent approach to avoiding disputes is to set out clearly in the contract provisions what will happen to the OFE upon termination. At the time the contract is being negotiated, this may seem cumbersome and pedantic, but the certainty it then provides during a termination is of immeasurable value to any buyer who is already dealing with other difficulties associated with termination. A contractual understanding, which expressly addresses which party takes what OFE upon termination, and on what terms, offers the most effective means of avoiding a dispute.

We also typically see buyers facing some of the following problems:

If the builder is to return any OFE to the buyer post-termination, issues such as exactly when it will be available for delivery, which party bears the cost of its storage until the redelivery date, who pays for its removal from the vessel, tax, customs clearance and other practical aspects should also be detailed in the contract so as to avoid costly and time-consuming disputes.

In cases where the builder wishes to purchase some or all of the OFE from the buyer upon termination, price differences are a regular source of dispute, and one which could easily be avoided by including in the contract provisions dealing with the calculation of the price payable to the buyer.

Issues concerning OFE are unlikely to disappear as the offshore construction market in the Asia-Pacific region sees ever-increasing competition from Chinese yards. Termination of a construction contract raises many important issues, including ensuring that the buyer has security for refunds that may be due on termination. But in any project where OFE forms a significant portion of the project budget, it is vital that matters relating to OFE are not ignored or dealt with lightly.

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Local content: changing rules but an ongoing priority

Local content has been making headlines in the industry press, and causing headaches for policy makers and oil company executives alike - for a number of years now. How should the need to promote local industry and employment in oil and gas producing countries be balanced by the need to recognise limitations in the local economy? How flexible should the rules be?

We have recently seen local content rules relaxed in Brazil, to allow the Petrobras-led pre-salt consortium to order two floating, production, storage and offloading (FPSO) vessels to be converted by non-Brazilian companies outside Brazil, apparently on the grounds that the Brazilian shipyards do not have the capability to produce the FPSOs required. Conversely, local content rules were tightened post contract award for the Total-operated Maharaja Lela Jamalulalam South gas development in Brunei, where the successful bidder was at a late stage expected to develop a new yard to fabricate jackets locally. We are told that this is likely to delay the project coming on-stream from 2015 to 2016.

In most oil and gas producing countries, governments take steps to try to ensure that the benefit of the opportunities thrown up by new exploration and production projects accrues to the local or national economy as far as possible. This may be done in the contract between the host government and the oil company or consortium which gives the latter the right to explore for and produce oil and gas in a specified area (production sharing agreement or equivalent), or through legislation and regulations. Wherever the rules appear, their impact flows from the oil company or consortium to its contractors and subcontractors.

A breach of these rules will often justify termination of contract. A perceived disregard of the needs of the local economy can also have an adverse public relations impact for those considered to be responsible.

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In many jurisdictions, the rules are becoming more and more detailed. An example is the *Nigerian Oil and Gas Industry Content Development Act 2010*, which requires a percentage of each category of equipment in a defined list to be manufactured locally and a percentage of employees holding specified roles to be nationals or residents of the host country. More recently, a Legislative Instrument was passed by the Ghanaian Cabinet on 6 June 2013 aimed at integrating every aspect of upstream activity into the main economy and targeting 90% domestic involvement within a decade. Such detailed rules present problems when the local market is unable to provide the technology and skills to meet the industry's needs.

Countries which opt for a more fluid local content approach run the risk that opportunities may only be created for local drivers, receptionists and catering staff, with limited impact on the development of the country's economy.

Whichever way the contractual terms or laws and regulations are drawn up, it is important to understand them and the framework within which they work. A breach of these rules will often justify termination of contract. A perceived disregard of the needs of the local economy can also have an adverse public relations impact for those considered to be responsible. Above all, local content issues need to be carefully managed from an early stage in the contracting process.

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Political risk in offshore energy in Latin America

Political risk can loosely be defined as *"the risk of operating or investing in a country where political changes may have an adverse impact on earnings or returns"*. Political risk includes nationalisation, expropriation or confiscation of assets, currency convertibility and transfer restrictions, civil unrest and the non-honouring of sovereign financial obligations.

Companies operating in the offshore energy sector are especially vulnerable to political risk because of the exceptionally high capital intensity of the industry, the volatility of oil prices, the escalation of project costs and the irreversible nature of the sector's investments. In some countries in Latin America, new oil and gas supply

contracts are taking place in an environment where the rule of law and the sanctity of contracts are not fully respected and where the level of political risk is therefore particularly high.

The political risks involved must be measured against the potential for profit, which can in many cases be huge.

GEOFFREY CONLIN

The four countries showing the worst political risk profile in Latin America and, in particular where the risk of nationalisation or expropriation of assets is highest, are the far left-leaning countries of Venezuela, Bolivia and Ecuador, and Argentina where the government continues to pursue a strong nationalist agenda. Save for in Bolivia which is land-locked, offshore energy companies operating in each of these countries have not been untouched by political risk.

For example, during his presidency of Venezuela from 1999 until his death earlier this year, Hugo Chavez nationalised more than one thousand companies including, in 2010, 11 drilling rigs belonging to the US company Helmerich & Payne. The new president, Nicolas Maduro, has expressly stated that he intends to continue with the *"Chavismo"* agenda.

In the meantime, Argentina's President Cristina Fernández de Kirchner's on-going intervention in private businesses culminated in April 2012 with the high profile nationalisation of 51% of YPF, the former state oil company, belonging to Spanish-owned Repsol. Ms Fernández' justification for the nationalisation was Repsol's alleged failure to invest in Argentina's vast reserves of unconventional gas and oil. Whilst compensation discussions are now underway, Argentina has yet to pay Repsol a peso of the $10.5 billion it claims it is owed.

In deciding whether to participate in an offshore energy project, the political risks involved must be measured against the potential for profit, which can in many cases be huge. Offshore energy companies that do decide to take the plunge have ways to reduce and manage their political risk, usually via a combination of experience, project structure and project finance. Where the residual political risk is still perceived to be too high, companies should also consider the use of political risk insurance (PRI).

PRI is available for various different types of political risk, including expropriation or confiscation of assets, political violence, frustration or repudiation of contracts, inconvertibility of currency or the failure to repatriate funds. As with any insurance policy, the precise scope of coverage is governed by the terms of the policy, however the basic objective is to indemnify the insured for losses arising out of a trigger event such as nationalisation.

Given the enormous level of investment in offshore oil and gas projects in Latin America, it is vital that all participants in the sector carefully consider their political risk exposure and seek appropriate advice where necessary.

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Conferences and Events

Offshore Wind Power Seminar
HFW London
29 January 2014
Presenting: Max Wieliczko, Simon Blows, Robert Blundell and Emilie Bokor-Ingram. External speakers will include DONG Energy, Per Aarsleff, Visser & Smit Marine Contracting, AON and London Offshore Consultants.

OSV Chartering Contract Management North America
Houston
24–25 March 2014
Presenting: Paul Dean

For more information about either of these events, please contact events@hfw.com.

HFW extends Season's Greetings to all of our readers with our best wishes for 2014.

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