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OFFSHORE CONTRACTS and THE SEARCH FOR “A MARE’S NEST”

by

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INTRODUCTION

Over the last few years there have been costly reminders of the need for the oil & gas industry to examine new contracting strategies and the way it documents E&P construction projects.

It is widely agreed that the balance of risk in projects reflects the balance of power and is too heavily weighed against the contractor. Both operators and contractors however acknowledge that more needs to be done to redress the imbalance. Successful projects must benefit the industry as a whole.

As a leading contractor said at an industry debate at OTC '04, *“Why is it that I have an understanding of what I have agreed when I sign, but when a problem arises and external lawyers look at the contract later I am told my understanding is no longer shared by the oil company and it means something different?”*

It is a well held view in the industry that you should only resort to a contract if things go wrong. Contracts are often based on precedents adapted from project to project, on each occasion fashioned into a workable document. Each E&P construction project, however, brings its own unique challenges. There is therefore some inevitability that, when the contract comes under intense scrutiny in the event of a dispute, it does not meet expectations nor does it appear to reflect the original intentions of the parties.

A number of high profile disputes in the industry have cost contractors (and operators) millions of dollars. Unforeseen costs have been caused by a range of issues, from risks inherent in the complex technical nature of the projects to the lack of any detailed design or planning and inadequate “up front” preparation generally. The absence of a clear, consistent and practical contractual regime for managing the issues has been a significant contributory factor to contentious issues escalating into disputes and views becoming polarised, with consequent lengthy, adversarial court or arbitration proceedings.

The starting point is that in the event of any dispute, where English law applies, the parties’ rights and remedies will be determined by reference to the written words of their agreement against the context in which the agreement was made. If their intentions are opaque from reading the document, the parties should not be surprised if the tribunal or court reaches an unexpected view. This is not rocket science, but time is often at such a premium during negotiations that there is no period for review before signing. Indeed, a lot of contractual documentation is simply too complicated and dense for a thorough review within these timescales. The manipulation of an old precedent from a previous project is not always an easy task.

This does not mean agreements should necessarily be shortened to fit the back of an envelope, but there is a fine balance to be achieved between ensuring that all of the risks are thoroughly provided for and ensuring that the key commercial issues remain transparent.



The contract terms will need to stand the test of time. The terms of any contract need to be capable of being clearly understood years after signing. Over the life of any substantial project, neither party can be assured that the relationship will be consistently amicable. A wide array of factors, many of which are unforeseen, contribute to test the resolve and longevity of relationships. Policies and personnel change. This is especially so in the case of any politically driven organisation. Those negotiating the contract may not be the same personnel as those conducting any dispute. Any dispute may not be determined until years after the project was completed and the contract will dictate the outcome.

The P-36 disputes illustrate a number of contracting issues. In that case, precedent documents were developed to suit the project and the parties all worked on the basis of trust in negotiating and progressing the project. The relationship between Petrobras and contractor deteriorated however for political reasons and the contracts have been the subject of several judgments to date in the High Court in London, which neither party would have anticipated when they were negotiating them. The dispute is part of a continuing saga.

Lord Justice Sedley of the Court of Appeal, in considering one aspect of the P-36 agreements, likened the task of trying to discern what the parties had intended as “a search for a mare’s nest”.

“...I take the liberty of adding a word about the construction of contracts like this one. We were told in the course of argument that a number of the most prestigious firms of solicitors in the City of London had had a hand in drafting this charterparty. That perhaps begins to explain why its parts do not fit together. It also explains why the court’s assumed task of identifying the parties’ true intentions has been, as so often, a search for a mare’s nest...”

Coupled with the political overtones (two changes in government and Petrobras board), the dispute between Petrobras and the contractor on P-36 has highlighted the need for clarity in drafting and the importance “the contract” plays in determining who wins and who loses ultimately.

Using the P-36 dispute as an example, this paper examines some of the issues from the case and outlines guidelines for preparing contracts in the future that can help to reduce costs in the long run. Whilst some of the points are obvious, time pressures often lead to a number of them being overlooked.

PETROBRAS-36 BACKGROUND

“Petrobras-36” was a semi-submersible production platform (formerly “Spirit of Columbus”) acquired, upgraded and installed for Petrobras’ operations at Roncador, offshore Brazil. It took a team of dedicated professionals many months to put in place a complicated contractual structure in 1997 for the transaction. The upgrade led to the common place dispute over payment for an increased scope of work beyond that originally agreed and, after a year of operations, the rig was lost in March 2001 following an explosion, which in turn has led to a number of consequential issues.

The dispute has highlighted the tension and practical difficulties associated with a project of its kind. On the one hand, the project was negotiated and run by Brazilian engineers in the main. On the other hand, the project agreements were prepared and negotiated by lawyers in London. Any formal dispute between the parties was agreed to be determined by a Judge sitting in London applying English law (being the law and jurisdiction chosen by the parties to govern their relationship). The project agreements were also heavily influenced by the interests of various banks.

Perhaps unsurprisingly the agreements were not used in conjunction with the operational aspects of the project, and were not read by many of those involved in implementing the project.

The courts in London were left having to pick up the pieces and make sense of it all.



MOA - interim agreement

The genesis of the P-36 project was a “Memorandum of Agreement”. There was no formal tender process. Petrobras urgently needed to secure production capacity in 1996/7. The parties negotiated terms and recorded what was agreed. The MOA set out the key commercial principles but included no price for the provision of the rig (which was still under final negotiation). The MOA was named ‘Memorandum of Agreement’ rather than “MOU” or “Letter of Intent” and contained a governing law clause. It also provided that the English courts would have jurisdiction to resolve any disputes. On the face of the document, it seemed the parties intended it to have some legal effect.

Significantly, the document contemplated that there would be a series of further agreements that would be negotiated to meet all of the various interested parties’ concerns. The issue that arose subsequently was whether Petrobras could sue the contractor for alleged breaches of the MOA (for around US\$365m for late completion of the upgraded rig), on an independent basis for liability outside the later detailed agreements that were concluded.

Unfortunately it was not only unclear on the face of the MOA itself but from the later detailed agreements what status, if any, the parties intended to afford the MOA and the terms recorded in it. The terms of the MOA were inconsistent with the later agreements. The Court, at first instance, dismissed Petrobras’ claims under the MOA because the parties must have intended the later agreements to supersede the MOA.

The parties should have put the position beyond doubt both in the body of the MOA and when preparing the later agreements by stating their intention clearly. A thorough review of the structure and project agreements as a whole would have identified the need to address the uncertainty. Offshore contracts occasionally seek to incorporate the terms of earlier interim agreements, indicating that the terms are to continue to take effect. In such cases, a thorough review will need to ensure there is no inconsistency that arises as a result between the interim arrangement and the later agreements.

Title and risk

When the detailed agreements were negotiated, covering the procurement, bareboat chartering and upgrading of the rig, no provision was made in relation to title to the “new” equipment to be procured by the contractor and installed by the shipyard on the rig. The rig was owned by a third party, an Italian company which had agreed to charter and sell the rig to the contractor for chartering to Petrobras, which would operate the rig. The issue of “title”, legal ownership, is a key consideration in conversion/upgrade projects, especially where the topsides equipment is being procured separately from the hull or bare deck and may indeed be financed independently.

Title and risk in such equipment will be a highly significant issue for the purposes of any third party taking security and for tax reasons. It will also be of some importance when insuring the rig and equipment, and in providing in the agreements for the consequences of any loss of that equipment. Petrobras, in the case of P-36, maintained that the contractor which had procured equipment for the upgrade was not insured by its rig fleet policy for the loss of that equipment in any event.

The agreements included provisions for title and risk in the original platform and yet it seems no consideration was given to the new equipment. It may have been assumed that the new equipment would in effect be transferred and become part of the original platform upon procurement or installation, but the Italian owner of the original platform had no interest in the new equipment. The parties needed to spell out in clear terms who was intended to acquire title (in the first instance the contractor responsible for procuring it) and in what circumstances it would be transferred and when. The question of risk in the equipment and insurance likewise should have been provided for.



Risks of construction

The construction risks were to be borne by Petrobras and controlled through the exercise of supervision and step-in rights. The agreements gave conflicting indications about the allocation of such risks. There was no express language about responsibility for shipyard or sub-contractor performance and no express “caps” or limitations on the contractor’s liability (because Petrobras agreed to bear such risks). On the other hand, the agreements did include provision for completion of the works by the contractor within a fixed calendar date. Basic operational issues that were likely to arise in the course of the upgrade were not provided for in any detail.

Petrobras claimed in the ensuing litigation in London that it was entitled to recover its losses, on an unlimited basis, for delay in completion of the upgrade works beyond the contractual date. The claim was dismissed on the basis that the contractor was entitled to discharge its obligations under the agreements by sub-contracting the works with Petrobras’ consent and that in any event Petrobras was estopped from bringing such a claim now by reason of statements made in correspondence in the course of negotiations by its solicitors to the contractor’s representatives that Petrobras would bear the construction risks.

There needed to be a clearer statement in the contracts in practical language about the parties’ intentions with regard to the risks.

Implementation and administration

In implementing the engineering and construction works, the personnel who were responsible for managing the works were not familiar with the terms of the negotiated agreements. The teams were mainly Portuguese speakers and engineers by training. The agreements were in English, but more significantly written in legal ease by finance lawyers in London whose primary focus was security issues rather than providing for the kind of practical issues that arise in such projects. Many of the project personnel have since admitted they did not read the agreements and some who attempted to do so could not make any sense of them or fathom how they were meant to apply. This understandably led to difficulties, not in progressing the works at a practical level (where the Petrobras and contractor teams worked well together) but in applying the agreements to events later when the dispute arose. Inevitably there was considerable inconsistency between the agreements and events in practice.

Greater consideration needed to be given to ensuring that the agreements were easy to apply, codifying the practice for addressing issues such as modifications. The operational teams needed to have a far greater involvement in negotiating the terms and a thorough objective review prior to signing by someone with experience of such projects would have been of significant benefit.

Good faith and costs determination

The original scope of work was an upgraded rig for South Marlim, but Petrobras made a change to Roncador, which was newly discovered and for which only basic metocean and other data was available initially. The engineering had to be developed on the job as more data emerged. It was agreed that Petrobras would pay for the extra work of the change to Roncador. Its personnel were very closely involved in all aspects of the works. The agreements were silent with regard to any detailed regime for determining the impact of the extra work and the costs of it. The parties naively (trusting in their good relationship) provided in their agreements that Petrobras would act in good faith with regard to payment of the costs to be paid for the extra work.

The common goal was to ensure that the works were not delayed by a string of disputes over the impact of changes and that the contractor was compensated in time to meet obligations to suppliers and sub-contractors.



Notwithstanding the good co-operation that existed between the engineering teams as the works progressed and Petrobras' later audit of the costs incurred, Petrobras has since argued that its good faith obligation is of no effect under English law. The court at first instance has upheld this argument. It is a long standing maxim of English law that any contractual obligation to negotiate or agree in good faith is unenforceable, save in very exceptional circumstances. The absence of any agreed criteria by which the costs are to be determined now leaves the open ended question of how such costs are to be determined, giving rise to a myriad of technical issues and a large scale enquiry.

The parties negotiated the extent of the changes and their impact during the course of the project on a number of occasions, agreeing to a number of interim payment arrangements and a final settlement.

The parties negotiated an arrangement in 1999 prior to completion of the upgrade by which to determine the extra costs due to the contractor which averted the need for an expensive and lengthy technical analysis of each extra required by the change to Roncador. Whilst this was regarded to be fair and reasonable by those responsible within Petrobras for negotiating it direct with the contractor, the board of Petrobras did not approve it. Petrobras has maintained in the litigation that the settlement was not legally binding and can be disregarded for that reason.

The contractor has sought to enforce the settlement. Many of the negotiations were conducted at meetings face to face with little recorded contemporaneously. Neither party had a clear understanding of the agreements or the contractual regime that was to be adhered to. The contracts did not provide for a tailored regime for determining such costs and matters were left very much to the good relations that had previously existed and the belief that both parties would reach and honour a compromise short of litigation.

The parties merely put off the issue of determining cost increases by including provision for good faith negotiations. They needed to identify and make provision for the issues at the time of contract signing. A detailed regime was required for addressing the same on an ongoing basis, together with a well structured process for determining any dispute. The regime also needed to be one with which the project teams were familiar and comfortable.

Authority

The consequence of the ad hoc cost arrangements that were adopted, which in the main fell outside the terms of what had been agreed, has been an expensive and lengthy investigation at trial into precisely what was said by whom and, as an incidental but crucial issue, with what authority. Petrobras succeeded in persuading the court at first instance that any binding settlement to pay the extra costs required the formal approval of the full board of Petrobras and that any agreement made by the individual officers of Petrobras who were negotiating with the contractor was not binding. This leads to a full and costly enquiry into the costs incurred by the contractor (which it sought to avoid), subject to appeal and further issues relating to the conduct of the Petrobras board in not approving the final settlement recommended to them, which are still to be determined.

There are various levels at which the parties and their representatives will communicate in the course of any dynamic project. The contract needs to spell out in clear terms who has what authority and provide for review meetings to ensure that issues are addressed promptly by those with authority to make decisions.

CONTRACTING GUIDELINES – POINTS TO REMEMBER

The P-36 case is a useful of how contracts, whilst seeking to protect parties from risks, can actually increase the risks and lead to considerable uncertainty, especially if they become divorced from events on the ground. Following some elementary guidelines can help to minimise the problems.



1. Be wary of precedents

No two offshore construction projects are the same.

Parties should be wary of negotiating and amending detailed agreements, which have been prepared in the first instance by reference to a precedent used in an earlier transaction. Industry agreements are, however, often prepared on the basis of a precedent that has been used and adapted over a number of disparate projects. An objective review should be undertaken on any precedents, both generally as part of the training within organisations and at the time of negotiating a project. Standardisation in the industry would assist if there was the will to endorse and adopt standard terms. CRINE and LOGIC have striven to encourage the use of standard contracts to reduce costs.

Agreements also suffer from being negotiated extensively over a period of time, running the risk of becoming the product of a drafting committee, such that the pieces do not all fit together. An “editor” should be responsible for overseeing the internal consistency of any agreement. It may be preferable if this is someone who has not been too deeply involved in the negotiations.

Make provision in any project schedule for a period of review before signing. This rarely done and yet, with experience, it is often the case that inconsistencies and mistakes have crept into documents and the clarity of key issues has become obscured because of the constant process of amendments made.

The same points apply to tender documents, which again with experience invariably include inconsistencies and provisions which have survived from earlier transactions but which make no sense in the current context.

2. Assess the key risks – plain sheet of paper approach

As an obvious starting point and acid test, it should be possible on a relatively quick review of any draft agreement to write down on a single sheet of paper what has been agreed about who bears which of the key risks (design, sub-contractor performance etc). If this is not possible, the draft contract may be unclear about such issues or it may not have addressed them at all. Avoid getting bogged down in the detailed wording of a draft in the first instance. Focus on the key issues and structure.

With experience, disputes do not arise because of the inclusion or failure to include “boilerplate” provisions. The priority has to be in ensuring that the risk/reward allocation is clearly and plainly spelt out and evident to any third party who has the task of determining from the words what was intended.

Someone should be given the brief to step back and review any draft contract with a view to determining if it is absolutely clear how the key risks have been agreed to be borne, by whom, on what basis and to what extent, and whether the contract is internally consistent.

Any lack of transparency on key issues of risk should be addressed before signing. Do not accept anything less.

Whilst it may seem obvious, the acid test of any agreement is whether it is possible for someone with no knowledge of the transaction to comprehend from simply reading the contract what the parties’ commercial intentions are.

3. Be clear and use plain language

The industry tolerates too often provisions that make little sense, because they are based on precedent or are being imposed by the operator. If the contract is unintelligible, it will make no sense to a third party adjudicator, arbitrator or Judge and the outcome of any issue will become a lottery to some extent. Parties need to know that the risks that have agreed to assume will be upheld. If any provision is uncertain, it



should be revised. Likewise, the contract should be internally consistent. Many contracts are far too dense and complicated, again based upon a history of precedents that have been adapted time and time again.

4. Ensure the contract terms are tailor made and practical

It is important the personnel responsible for managing the project on a day to day basis have read and understood the contractual terms that are being negotiated. Personnel change in the course of a project and it will be necessary to dedicate a team to a project of any size to ensure the contract is administered in keeping with what has been agreed. The nuance of points won or conceded in negotiations will otherwise be lost.

The contract should be developed as a practical document to be considered part of the working life of a project. Too often, problems arise because at an operational level the project management team adopt their own practices based on previous experiences. If some of the plain talking language used by the industry was to find its way into the contract, this would undoubtedly assist in removing the stigma attaching to “the contract”.

Likewise, be careful not to allow the tax and financing requirements obscure the core commercial and operational terms.

As all too often, unless the contract spells out in easy, practical terms regimes for handling the day to day issues that will arise (eg. changes to the technical requirements etc), there is a significant risk that the project teams may conduct their activities in a fashion that is inconsistent with the allocation of risks agreed between the parties commercially. Ultimately, this will expose one or either party which seeks to enforce the contract terms later facing the claim that it has either waived its rights or that the parties have adopted some other convention between them such that they are estopped, ie. prevented as a matter of law, from relying upon the regime which they at first carefully negotiated in their contract. If the parties have adopted an alternative convention in practice that is inconsistent with the contract, they may be unable to revert to the contract terms. This is always a risk but it is particularly prevalent where the agreements do not address operational issues clearly (or at all). This is a critical issue early in the project, and it can be overlooked.

If there is an open acceptance on the lawyer’s part in drafting or amending the agreements that they will be implemented at a day to day level by engineers in the project team and not lawyers, this would help ensure clarity on operational issues. The more complicated and elaborately drafted the agreement the far greater the likelihood that it will obscure the key commercial terms and intentions of the parties from an operational standpoint. The tax and financial issues are obviously important pieces of the jigsaw but it is problems that arise in the course of the physical works that lead to disputes costing millions of dollars because the agreements do not adequately cater for their consequences.

5. Ensure the terms are fully communicated

As the detailed engineering and drawings are developed and the approval process takes place, decisions are often taken pragmatically without a full appreciation of the impact at that point and the impact of deficiencies arising out of the specifications are not always traced. The use of informal or unofficial communications within the industry is prevalent in construction projects. Problems are solved and issues diffused as a result of such communications. The project team responsible for administering the works may not be familiar with the ramifications of the applicable law chosen to govern the risks. The “trap” for the unwary will be ever greater if the management teams for both operator and contractor are already accustomed on previous projects to working according to their own conventions and practices.



Time spent up front in briefing the project team on the agreements and in ensuring they are administered consistently will be time spent well and it may avert the substantial costs of a major dispute.

The problems can be compounded if the project team is not fully briefed on the terms that have been negotiated or do not fully appreciate the nuances of the small print hidden away in obscure parts of the agreements. There is often a tension between the commercial objective to complete the works on time and the contractual framework by which the risks and the parties' rights will be judged. The contrasting views between engineer and lawyer illustrate the point.

6. Ensure there is a clear and efficient process of review and dispute resolution

The benefits of any contract will be at risk unless the contractual terms are adhered to and implemented consistently. Points won in negotiations can be lost. The margin on "turnkey" projects in particular is often tight and unbudgeted costs will quickly erode that margin, with the contractor looking to its customer for additional compensation. Offshore construction projects are by their nature dynamic and the risks are inherent, but the role of the carefully negotiated agreement is to impose an agreed allocation of those risks. When faced with the realisation of any risk or a potential dispute, the emphasis should be on resolution.

When issues arise, decisions do need to be taken quickly and pragmatically. This does not always have to be at the expense of surrendering rights or compromising safeguards that were carefully negotiated when the contracts were signed. The attraction of ignoring problems or "parking" them until another day can be strong when there is pressure to keep the works going. With effective management of the project from the outset and an astute use of dispute resolution procedures "tailor made" for the project, the risks and consequent disruption can be minimised and the competing interests of getting the job finished and preserving the agreed allocation of risks can both be achieved.

Representatives of each party should be clearly identified in the contract as authorised to make binding decisions. Any limitations should also be identified to ensure that each party is aware of the proper channel for discussion.

Finally, dispute resolution procedures are often overlooked or treated as a poor relation of the other substantive clauses in a contract. The focus of any negotiation are the key commercial and financial terms, which is of course entirely appropriate. Having negotiated those terms, it is imperative to ensure that they are preserved through effective project management. This is the purpose and benefit of carefully considered dispute resolution procedures available in the event that there is a dispute at any stage of the project.