Contract exposures

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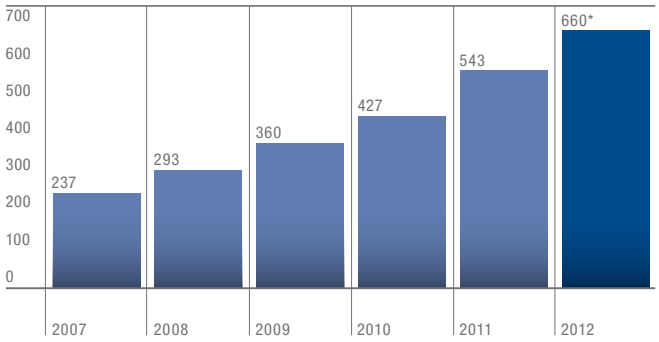
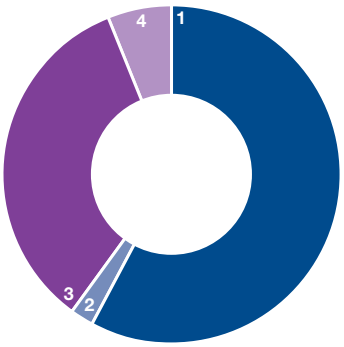
Each year, the club reviews a large number of contracts for its members. Last policy year the club reviewed 543 non-knock-for-knock contracts for its membership and new business enquiries. Through the contract review process, the club aims to proactively advise members of the effect of the contractual arrangements they have concluded in relation to their P&I cover. The purpose is to provide a level of comfort to members in respect of their P&I insurance cover before any potential liabilities arise. It is equally important in highlighting where club cover cannot respond so that members can arrange cover in alternative markets for such risks as they deem appropriate.



*2012 – 212 reviewed in first four months of the year
Projection for 2012 = 660

The contracts presented to the club for review range from unamended BIMCO approved forms that may apply to supply boat charterparties, through to drilling and production contracts and other complex and high-value Engineering, Procure, Install and Commission (EPIC) contracts for large offshore construction projects. Contract review is relevant both for members who have poolable cover and those who have non-poolable cover. The latter can be members either who have extended covers added to a poolable entry or those members entered in the club under the **Standard Offshore Rules**. The following chart shows the percentage of contracts reviewed in 2011 by business type/sector, which largely mirrors the spread of the club's offshore membership, with supply representing the largest proportion.

Contracts reviewed in 2011



1	Supply	58%
2	Drill	2%
3	Construction/ Installation	34%
4	Production	6%

Offshore ship types by number

Not only does our contract review process allow us to provide feedback to our members on a number of contractual pitfalls that we repeatedly see, but through the process of reviewing a large number of contracts, the club is able to identify how certain contractual trends develop. Although different sectors of the industry show certain contract trends (which will be discussed individually below) a common theme that we are seeing in many offshore contracts is the incorporation of exceptions for gross negligence and wilful misconduct. This can be problematic as the offshore industry has traditionally relied upon knock-for-knock contracts whereby the parties privy to the contract, take on responsibility for loss of, or damage to, their own property or injury or death of their personnel, regardless of fault, and receive a respective indemnity from the other party.

When risk is allocated in this way it provides the parties with legal certainty, promotes exchange of information, reflects contractual freedom, avoids costs of proving fault and minimises duplication of cover. Each party is best positioned to manage the risk of injury to its people and damage to its property as these are risks within their spheres of control. Knock-for-knock contracts allow operations that would appear to have disproportionate liabilities (for example towage of a drilling unit by a supply vessel) and which are commonplace in the offshore industry, to be undertaken.

Exceptions for gross negligence/wilful misconduct effectively erode the knock-for-knock regime and force the contractor out of its acceptable liability regime. It also introduces an element of subjectivity into what should be a completely objective knock-for-knock liability matrix. The determination whether a particular standard of behaviour is either grossly negligent or due to wilful misconduct will have to be made by a court or arbitration tribunal. Rather than cleanly delineating risks between the parties under a freely negotiated contract, the parties will have to rely upon a court or tribunal to interpret the contract. This introduces subjectivity and unpredictability; for example, there is no definition of gross negligence under English law. If the court is in the jurisdiction where an incident took place, particularly one that involves pollution or loss of life, there may be a perceived desire to see the party at fault held liable. If so, the owner may lose the benefit of the indemnity that they may have otherwise been expected to rely upon.

The gross negligence/wilful misconduct exceptions under a contract may be limited to the conduct of a defined figure or class of individuals (for example, the master or crew) rather than the controlling mind of the company. Therefore, the standard of behaviour triggering the gross negligence exception may be reduced. In these circumstances, the actions and decisions of the master or crew may obviate the entire contractual risk allocation balance. The desire for accountability for a party's actions is understandable. However, such exceptions act as a catalyst for litigation, increase insurance costs and firmly introduce uncertainty.

The inclusion of exceptions for gross negligence/wilful misconduct in indemnity provisions can prejudice club cover. Liabilities for gross negligence may be covered under a contractual cover. Under the **rules**, no claim is recoverable if incurred owing to the privity or wilful misconduct of an insured party (unless the board decides otherwise). This is in addition to the statutory exclusions under the **Marine Insurance Act 1906**.

We recommend that members avoid any reference to gross negligence/wilful misconduct when negotiating contracts and should, as far as possible, contract on knock-for-knock terms. The club works with our members to achieve this by reviewing contracts and providing advice and support during contractual negotiations. If a knock-for-knock allocation cannot be achieved the member and their advisers should bear in mind the additional insurance costs and consider whether there is an insurance appetite and capacity for the risk.

Drilling and Production

Post *Macondo* there has been a perception of an increase in efforts by operators to negate indemnity coverage in the event of a party's gross negligence or wilful misconduct. Drilling contracts for work in the US Gulf of Mexico have addressed new post *Macondo* regulatory requirements relating to blow-out-preventer certification and testing. However, the perception of significant changes to drilling contracts is perhaps unfounded outside of the US Gulf of Mexico. Industry standard terms are published by the International Association of Drilling Contractors.

The industry tends to use an unamended 'day rate' drilling contract, which contains knock-for-knock terms in respect of each party's people and property. We do see both 'fault based' and 'non-fault based' assumptions in respect of operators' property. These are onerous and need further consideration by underwriters to allow proper rating of the risk. Recently, we have also seen provisions that allow the company to step in to try and regain control following a blow-out, in which case the company becomes responsible for all risks, including the member's people and property. Such a provision improves the risks for members and demonstrates that the oil and gas industry is implementing improvements in contracts following recent events.

Normally pollution risks are allocated on a 'fault based' or a 'location of source' basis. In both drilling and production contracts, we have seen allocations for pollution risks which fall outside the scope of usual club cover. For example, a member may be contractually responsible for 'pollution above water'. This is unclear but it can be construed as a contractual assumption of pollution emanating either due to the other party's fault or from their equipment/property. Therefore, it is important to understand the definition of the unit under our rules. For drilling, the unit does not include anything below the rotary table.

The basic premise is that pollution from the unit is not covered from below the drill floor or rotary table. For production, the unit does not include anything on the well side of the well control equipment closest to the unit and means that pollution from the unit is not covered well-side of the pipeline end manifold (PLEM). Therefore, any pollution risks assumed under contract may not be covered by the club and may need to be insured elsewhere (for example under an operator's extra expense (OEE) cover). Again, the club will aid the member in identifying these potentially non-covered exposures through our contract review process.

Construction

Like production operations, the commercial reality of the offshore installation market is that there is no standard industry wording allocating the obligations of each party. Each contract is bespoke. Deviations from the knock-for-knock regime with the use of contractually assumed liabilities can often represent the exclusions or deductibles applicable to other insurances (for example, CAR/energy exploration and development). P&I insurance is a monoline insurance designed to provide cover for third-party liabilities arising out of the operation and management of the entered ship/unit.

Extensions to cover can be given for members performing construction and installation through our specialist operations buyback extension. This cover is still subject to exclusions for loss of or damage to contract works and failure to perform. We have seen some construction/installation contracts whereby the member is assuming liabilities for cargos (such as topsides) without limit. This would bring the club closer to becoming a direct underwriter for loss of cargo/property and we are therefore unable to class some of these exposures as a marine liability risk. The provision of such cover may conflict with CAR/EED/cargo underwriters whose policies can respond to loss of or damage to contract works and removal of project property and debris, which are excluded under club cover.

Swire Blue Ocean *Pacific Orca*

Supply

Supply contracts represent the largest proportion (58%) of the club's 2011 contract reviews. We have seen a trend in these contracts becoming more onerous, with supply boat owners being required to purchase increased limits. We have had instances where the supply boat owner has felt it prudent to purchase $1bn contractual cover as a result of a complete waiver of the right to limit in respect of very high-value property. Clearly, it is not equitable to expect shipowners to bear expensive insurance costs for what can be excessively high exposures, especially since the owner's overall benefit from the project is typically below that which can be expected by the oil company field operator.

The club, through our reinsurers, has the capability of providing additional cover for such risks. However, the purchase of this insurance capacity will not be cheap, and the risk to the shipowner may be greatly in excess of the value of his contract. We recommend that these exposures should be passed up the contractual chain to the field operator in order to prevent a disproportionate risk allocation.

Supply boat

Conclusion

We expect to see typical contractual provisions to change and it is inevitable that contract drafters will respond and adapt to external events (for example, *Macondo* and the supply and demand for certain classes of tonnage). This is likely to continue as the offshore industry is complex and is extremely susceptible to changes in global financial and political conditions. Through technological innovation, the industry is also rapidly advancing, with increasingly complex projects and operations occurring in more hostile environments. By reviewing a high volume of contracts, the club gains a further insight into member's risk and risk allocation, and can pass on knowledge and recommendations to our membership to provide them with certainty of cover and aid them in their contractual negotiations. We believe that our contract review process reduces members' risk exposure and costs.

Suitability of CAR cover for offshore contractors

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Oil and gas companies (the 'principal') often maintain in contractual negotiations that any Construction All Risks ('CAR') cover provided will adequately protect the majority of contractors' or subcontractors' insurable risks based on the main policy form available, Welcar 2001. However, as most offshore contractors and service providers will have experienced, the coverage provided by the principal is often not able or adequate to protect those risks to the extent the contractor desires.

There is often a lack of empathy between the parties as to what constitutes a reasonable insurance product brought about by fundamental differences in the risk appetites of the principal and the contractor. The principal has a balance sheet that can exceed those of the international insurers, whereas the contractor's balance sheet, which does not benefit from the ultimate revenue stream of the field development, is not as well adapted to assume risks arising from less than clear indemnity regimes.

Oil and gas companies remain the main buyers of offshore CAR insurance and as such, the suitability of insurance products offered by the offshore energy insurance market is generally more focused on the principal's risks and retention appetite (and losses) rather than on those of a contractor in isolation.

As such, it is vital that contractors are aware of the scope of cover under the standard Welcar policy form. Whilst some exclusions of cover are absolute, some aspects of cover are voluntarily deleted or limited by the principal with the associated risks merely passed down through the contract to the contractor.

For example, contractor access to these policies is often limited. Often, 'Other Assured' status can be only implied or significantly qualified under the contract (i.e. valid only subject to certain onerous quality assurance/quality control restrictions). This presents an obvious issue for recovery of costs related to damage to contract works. However, even if unqualified 'Other Assured' status is available under the contract, the standard Welcar 2001 wording limits direct access to the policy to those with 'Principal Assured' status. In a difficult commercial relationship, the contractor may feel reticent about conducting the claims process via their customer.

What alternative does the contractor have if the principal is not willing to offer the equivalent of 'Principal Assured' status in this respect?

'Contingent' or 'contractor scope only' CAR cover is available from the offshore energy market to deal with most of the shortfalls in choice of cover (if not the absolute exclusions of cover, of course) albeit from a restricted market of interested underwriters. However, even if available, it is often not commercially viable for contractors as the aspects of cover that are being sought are those that attract the highest rating.