

## Offshore Energy Law

# Who bears the risk of shut-in?

One of the key features of a floating production project is the need for the facility to continue to operate without interruption to the flow of well fluids from the reservoir. In the event of interruption, it may be necessary for the reservoir to be "shut-in", thereby exposing the oil company to losses caused by lack of production and also incidental costs. FPSO operating agreements focus on avoiding circumstances whereby shut-in will occur, whilst legislating for the consequences if shut-in does occur. This is the first in a series of articles illustrating how liability for the consequences of shut-in is allocated between the oil company and the FPSO contractor.

The operation of the floating production facility may contribute to the risk of shut-in in a number of ways. The turret which receives oil or gas from the reservoir may be defective or unsafe, and therefore unable to receive hydrocarbons. The processing equipment, designed to remove water, gas and impurities from the oil may be defective. The availability of gas compression or water injection may affect oil production. Downtime caused by maintenance work may overrun. The storage tanks may become full, preventing any further production occurring until the tanks are discharged. The offloading facilities may be defective, preventing timely discharge. The scheduled offtake vessel may be delayed, or unable to connect due to bad weather. Some of these events may be due to the FPSO contractor's failure to perform its operation and maintenance obligations adequately, or may be due to design defects in the facility, or due to events entirely outside the FPSO contractor's control.

A number of questions arise which will be considered in this series of articles but the first is the fundamental nature of the legal obligations relevant to shut-in. In other words, is the allocation of risk of shut-in and its consequences determined by the type of contract that governs the provision and operation

of the facility? Such obligations are often contained in a form of operating agreement, which is analogous in shipping terms to the time charter of a conventional vessel. The contractor provides the facility, installs it, and, following acceptance by company, operates it, including processing, storage and offloading, in accordance with instructions given by company. In return, the contractor is compensated on a day-rate basis, with adjustment to day-rate according to performance, and deductions in the event of inadequate performance. In the event of downtime leading to shut-in, the day-rate payable may be reduced to zero. Contractor would normally accept no greater liability than cessation of day-rate payments, excluding in the contract terms all liability for the company's loss. However, zero day-rate itself may be painful to the contractor commercially, as in all probability the facility would have been procured or modified using third party financing that is repayable through the CAPEX element of day-rate.

For that reason, contractors would prefer the CAPEX element to be payable "hell or high water", i.e. continually throughout the charter period. That may, of course, lead to a difficult commercial negotiation of the contract terms.

That negotiation may be simpler, at least superficially, if the parties have chosen, as an alternative to a unified operating agreement, two separate contracts, one dealing with the provision of the facility, and the other dealing with production operations. This arrangement is common where there are tax or other commercial advantages in having this separation of legal obligations. The production contract is often described as an FPSO charter (and is in legal terms a form of lease or bareboat charter), its essential feature being the contractor's obligation to procure and provide the facility; but with the oil company taking over the responsibility to operate and maintain throughout the charter period. The expression "charter" is prone to cause confusion, as it may not be clear whether what is being described is a "time" charter as we describe above, or a lease – it is essential the contract makes this clear in its detailed terms.

The oil company would not in reality perform the operation and maintenance obligations, but would sub-contract these to an O&M contractor. This would normally be an associated company of the FPSO contractor. The key point here is that English law adheres strictly to privity of contracts, i.e.: obligations can apply only to the parties to that contract. Although the FPSO and O&M contractors may be related, English law does not assume that the performance by one party of its contractual obligations has any consequence for the other associated party. In short, if the O&M contractor fails to perform its obligations, causing shut-in, that event has no effect on the obligations under the FPSO charter, unless the charter itself expressly provides for those consequences.

For example, the day-rate payable under the FPSO charter may be adjusted to reflect the actual production of oil or gas. In effect, the FPSO contractor's profit margin is expressly subject to successful performance of the reservoir and of the associated O&M contractor's obligations. It is here that the use of a true lease or bareboat charter arrangement makes it clearer that, in the event of underperformance, the "lease" or "hire" element of the day-rate, i.e. the CAPEX element (or at least a substantial proportion of it), is payable hell or high water. That is the nature of a lease. Normally the

only exception to the payment of hire would be for latent defects. For example, shut in due to a failure of the turret bearing due to incorrect material supply or quality control.

Whether the remaining element of day-rate under the FPSO charter is payable during periods of shut-in depends entirely on how the commercial terms of the FPSO charter are drafted. It makes no difference whatsoever to the FPSO charter that the company may, due to O&M contractor's default, be entitled to withhold payment under that contract. The rights and obligation under either contract must be assessed by reference to that contract only, even though the same obligations in a unified operating agreement would give rise to a different commercial outcome.

We shall consider in more detail in the next edition of Well Connected the particular difficulties that arise when seeking to determine the cause of a shut-in event and its consequences.



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