

# **Service Contracts In the Oil and Gas Industry**

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## A. Issues in Service Contracting in the Oil and Gas Industry

The types of contracts most commonly used in the oil and gas service industry are generally described as drilling contracts, well services contracts and seismic acquisition agreements. Often oil and gas producers use master service agreements when they expect an ongoing relationship with a service company. These tend to be form agreements that the producers prepare for all their service agreements, and tend to be written favorably in favor of the producer, especially if the producer is big, and has considerable leverage. The reverse may be true, however, for national oil companies that conduct their own operations, who may be offered form master service agreements that favor the service company.

As with most contracts, the principal negotiation will be around costs. In the case of drilling contracts, it will be about day rates, standby rates, and commissioning and decommissioning rates, if applicable. Costs for well services contracts may be set by day rates, or they may be based upon a set price for the service provided. Frequently, well service contracts include elements of both services and equipment. These costs will be critical for the producer since they will be reflected in the producer's "authority for expenditure" – the principal document producers use to obtain internal permission and the permission of its joint working interest owners to undertake the operation. Of course it will also be critical to the service company, since it also determines the profitability of the services rendered.

After the cost of the service, the next major point of negotiation will be allocation of risk. When problems arise during drilling and other oil field operations, consequences can be substantial, both in damage to property and in personal injuries. What's more, because problems may arise thousands of feet down hole where direct observation is difficult, it is not always obvious what the problem is, or how it came to pass. As a result, companies who contract for high risk, high stake services like to eliminate uncertainty with regard to responsibility for consequences relating to problems that arise. A primary goal for companies entering into oil and gas contracts is to ensure that it is clear who is responsible for damages what various scenarios may come to pass, and to make sure that there are neither gaps in insurance coverage, nor double coverage. A secondary goal is to reduce the likelihood of protracted litigation resulting from disputes over fault.

The most common strategy used by producers and service companies to constrain costs associated with mechanical failure is the so-called "knock for knock" indemnification provision. Under this provision, each party assumes all risk associated with its own equipment and personal, regardless of fault, and agrees to indemnify the other party for claims arising out of injuries suffered to their own persons and property. For this reason, those with gallows humor also call this a "bury your own dead" provision. The thinking behind this provision is that parties who control their own equipment and personal are in the best position to reduce the risk of failure. But more importantly, by taking the element of fault out of risk allocation, it reduces the likelihood of protracted and costly disputes.

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Many legal jurisdictions, however, are uncomfortable with the idea of completely removing fault from allocation of risk. Further, they will not honor choice of law provisions for accidents that happen within their jurisdiction. In Louisiana, for instance, knock for knock provisions are unenforceable to the extent they apply to personal injuries that happen within the state. The Louisiana legislature determined that “no fault” provisions encouraged carelessness, and that this was against public policy when it came to personal injury. Maritime jurisdictions, on the other hand, have no such anti-indemnity statute. As a result, accidents that occur in offshore Louisiana have often resulted in jurisdiction jockeying by parties and their insurers to obtain favorable application of law.

In addition to anti-indemnity statutes, most jurisdictions also have public laws that require that parties not enter into no-fault contracts that seek to exculpate them from liability stemming from their grossly negligent or intentional acts. For the same reason, waivers of consequential damage provisions are often not applicable against grossly negligent acts. Of course the distinction between gross and normal negligence is in the eye of the beholder. Moreover, fact finders will often blur the distinction when damages are egregious, even if the negligence is not. As a result, in instances where the stakes are sufficiently high, one might expect allegations of gross negligence.

Perhaps the best example of how this loophole can play out has been in the litigation over the 2010 BP Macando blowout in the Gulf of Mexico – the ultimate of high stakes oil and gas litigation. In that case, a blowout killed 11 workers and resulted in 4.9 million barrels of oil being released into the waters off the coast of Louisiana. As is often the case in large-scale damage accidents, fingers were pointed at a number of different parties, in this case BP, Halliburton, Anadarko, Transocean, Cameron International, among others. In this case, the parties had knock for knock indemnity provisions.

The federal court (following Louisiana law pursuant to the federal offshore continental shelf act) applied the Louisiana Anti-indemnity statute in finding that in order to allocate liability for personal injury, fault must be determined. It also determined that knock for knock provisions did not apply to the application of civil or criminal penalties, insofar as the purpose of the penalties were to deter certain types of behavior, and not to compensate for damages.

In the BP Macando oil spill case, the Louisiana court, perhaps sensing the slippery slope that allegations of gross negligence can create, held that knock for knock provisions may be valid even when there are allegations of gross negligence. Interestingly, however, the court found that indemnification agreements might be found to be invalid not only for fraud, but even for breach of contract, if that breach is egregious enough. BP argued that Transocean had breached its contract in such a way so as to materially increase BP’s risk as an indemnitor. The court declined to rule on it for that case, but did find that it is possible that the breach of a “fundamental, core obligation” could invalidate the obligation to indemnify.

But knock for knock provisions are not just limited by public law. Such provisions do not apply to damages to third parties or their property. For those instances, the parties typically use indemnification language that is reciprocal and fault-based. Moreover, third party pollution is often the biggest potential liability for parties. Certainly this was the case for the BP Macando oil spill. This may lead to some additional negotiations over who might be responsible for what sorts of pollution, especially for that which occurs underground.

## B. Role of Subcontractors.

Subcontracting is becoming more and more common in the oil and gas industry, today comprising as much as 70% of services performed on a typical well. Meanwhile, oil and gas drilling operations are

becoming increasingly high-risk endeavors undertaken in difficult circumstances, such as in deep water, in high-pressure zones, or for horizontal drilling.

Subcontractors are not normally “third parties” for purposes of knock for knock provisions, but they may be third party beneficiaries of them, or may be part of a group that benefits from the provisions, such as officers, directors, employees, consultants and joint venturers. Otherwise, they are unaffected by the provisions unless they contractually agree to be bound by them.

Subcontractors are often required to be contractually bound by knock for knock or other provisions through what is known in the industry as a “pass through” provision. The producer’s goal with the pass through provision is for the subcontractor to provide language in his contract with the contractor that passes through to the operator. Accordingly, the contractor’s duty to indemnify the operator passes through to the subcontractor. The usual rule is that absent clear language in the subcontractor’s contract providing this result, indemnity obligations will not pass through.

The most troubling aspect of pass through provisions is that they may require subcontractors to take on risk that is disproportionate to the value of their contract. Is it fair to ask a small contractor to indemnify a major producing company for personal injury or property damage sustained by the small contractor that the small contractor had no fault in creating, and no control over? Perhaps not, but that small contractor can expect to be asked to bear that burden, even for small jobs. A subcontractor that seeks to break into the oil and gas business may be especially vulnerable to this problem. They are more likely to take on substantial risk in order to open doors into a potentially lucrative new market. This could also be a matter of considerable importance in acquiring insurance.

Finally, subcontractors and contractors alike should be cognizant of problems with pass through provisions arising when parties involved in these may be insolvent. When this happens, a small subcontractor might end up picking up liability for more than just its own property and personal. For this reason, it is important to ensure copies of insurance policies are provided yearly, and policies name the other parties as co-insured.

### C. Drilling Contracts

Drilling contracts can often determine the economics of an oil and gas deal. This is especially true for offshore, deep and horizontal wells, where drilling costs and risk of mechanical failure are high. Shale wells also have very high completion costs in addition to high drilling costs.

Generally, drilling contract work is undertaken either on a “turnkey” or a “daywork” basis. In the former case, the drilling contractor, for a set price, agrees to take some or all the risk associated with mechanical failure in drilling a well to a certain depth. This form of contract is popular with small producers, who are willing to pay the driller a premium to ensure that they won’t have to face huge cost overruns associated with delays or mechanical failures. The driller, on the other hand, will want to be sure that the costs are predictable before agreeing to a turnkey contract.

It is for this reason that normally turnkey contracts are restricted to onshore and shallow conventional wells. For the producer, the biggest issue to consider in entering into a turnkey contract, next to the price, will be the track record of the driller. Ambitious drilling engineers sometimes set up shop as a turnkey company with no resources whatsoever. These start-up companies can underbid other contractors because, notwithstanding what the contract says, they really intend to take no risk. They rent their equipment and subcontract the work, and this works fine if everything goes smoothly. But if there are delays or mechanical problems, the under-financed start-up will seek to renegotiate the deal, and failing this, will walk off the job, leaving the producer with environmental problems and a pack of unpaid and

unhappy subcontractors – many of whom may have access to self-help remedies that can attach to production from the well.

In daywork drilling contracts, the producer pays the drilling company a “day rate” for being on the job. Accordingly, should there be delays due to weather, mechanical problems, failed equipment and so forth, the drilling company continues to rack up significant charges. It is common for a drilling company to charge lower “standby” rates during delay periods, such as may occur during a “fishing” expedition when equipment gets stuck down hole. Long fishing expeditions are times of considerable angst for producers -- they face fees not only from the fishing tool company who tries to retrieve the stuck equipment, but they also incur fees for standby time from the driller. As each day passes, and costs increase, the stakes grow larger for the producer as it decides whether to abandon the well.

When problems arise, often times the most hotly disputed issue under the daywork drilling contract is the question of who was in charge. The issue of responsibility is exacerbated if the well is being drilled in some isolated location where access to management may not be casually obtained. By industry custom, producers usually have a “company man” on location during drilling – an experienced oil and gas drilling hand who has worked his way up the non-professional ranks, and is not a drilling engineer. The driller will contend that this person is ultimately responsible for all decisions on location. Producers, on the other hand, will argue that this person has limited knowledge, and that the driller not only provides the equipment and expertise, but also knows best how to resolve problems that arise during drilling.

Since only circumstantial evidence may be available to problem solve (it is impossible to see two miles down hole to know exactly why, for instance, a perforating gun is stuck), the result is that drillers and producers may find themselves in litigation later, each alleging that the other was at fault for the problems. During this process, multiple witnesses swear the other party was in charge when the problems arose, and that the damages resulted from the imprudent choices made by that party under the circumstances.

Among the more commonly used forms for drilling contracting are those produced by the International Association of Drilling Contractors (IADC). As one might expect, these forms generally favor the drillers. These are the forms that smaller producing companies generally execute when entering into drilling contracts. Major producers, on the other hand, have great leverage over drilling contractors, and typically prepare internal “master service” or other agreements with terms more favorable to the producer. Recently the AIPN has published a well services form (but not yet a drilling contract) that attempts to balance some of the competing interests. But even if you are a small producer with little leverage, you can still negotiate changes to the IADC form. Some key issues to watch for are:

1. *Indemnification.* Both parties will also try to avoid responsibility for the world of unforeseen events. Producers and drillers may agree to knock for knock provisions, only to have negotiations break down over allocating risk for potential third party pollution claims. Further, as discussed earlier, many jurisdictions require, as a matter of public policy, that each party be responsible for its own behavior, as least insofar as such behavior causes personal injury. *See e.g.* the Louisiana Anti-Indemnity Statute. On the other hand, some jurisdictions consider indemnification in drilling contracts to be a matter of risk allocation, and something to be negotiated as part of insurance coverage. Under general maritime law, for instance, the rule is that a contract requiring indemnification for a party’s own negligence is enforceable if appropriately worded. *See Corbette v. Diamond Drilling Co.*, 654 F.2d 329 (5<sup>th</sup> Cir. 1981). While parties are free to specify in the contract the jurisdiction purposes of choice of law, courts will ignore such provisions in favor of the public policy of the jurisdiction where the incident took place.

A common indemnification provision used by producers requires the contractor to indemnify the producer for “all loss, damage, injury, liability, and claims thereof for injuries or death of persons, and all loss of or damage to property of others, resulting directly or indirectly from contractor’s performance of this contract.” This is the sort of language that a producer might want to use to ensure that the contractor is responsible for damages caused by the contractor’s own negligence.

2. *Day rate.* This is usually the first topic to be negotiated. Day rates are generally set by market conditions, and the producer can get the best day rates by seeking multiple bids. Drilling companies have payroll and other expenses that continue unabated during down time, so they work hard to keep the rigs in constant use. However the producer should be careful to not get overcharged for down or stand-by time. Standby rates and commissioning and decommissioning rates can also be separately negotiated on the IADC contracts.
3. *Waiver or Consequential Damages.* The driller will insist on this provision being included, and well he should. A driller who is making, say, a \$200,000 profit on a project should avoid facing \$20 million in consequential damages because a well blows out. The producer, on the other hand, would like to have full and complete recourse if the drilling company damages its reservoir somehow. But the waiver of consequential damages is another area affected by public policy. For instance Louisiana law requires that waivers be brought to the attention of the producing company, not merely buried in fine print in a contract. Hence, you will see waiver language usually in either boldface or capital letters. Some jurisdictions will honor these provisions if the waiving party was deemed to be “sophisticated.” Even if the provision is clear and unambiguous, however, public policy may prevent waivers of consequential damages where the damages were caused by “gross negligence” on the part of the actor. The thinking behind this policy is that no one should be able to insulate oneself from the consequences of intentional or reckless behavior. Unfortunately, the concept of “gross negligence” is usually left to the fact finder, and this may render a waiver of consequential damages meaningless, especially if the damages are egregious.

#### D. Seismic Licensing Agreements

Purchasing seismic data does not have all the complex indemnity and consequential damage issues that are associated with drilling contracts, but it can nonetheless impact greatly the economics of a deal. This is especially true for small independents, who more and more rely on 3-D seismic to raise money for projects. Indeed, the reliance on 3-D data has rendered the independent geophysical prospect generator an endangered species: the acquisition of 3-D data is cost prohibitive to most independent geophysicists.

As with drilling contracts, the company that purchases large amounts of data has leverage with the seismic companies that the smaller producers do not. A big company may purchase exclusive rights to the data, and may even sell or license the data itself after it has used it. The smaller producer, on the other hand, will acquire seismic data rights by licensing the data directly from a geophysical company or indirectly from a brokerage company. In either case, the license agreement will be very restrictive. Before prospects can be shown, the producer needs to know whether it has the rights to show the seismic to third parties. Does the license extend to contract geophysicists? If you are a contract geophysicist, and you are reviewing geophysical data for a small producer, could you have liability to the seismic company for having done so? The producer should seek as broad as possible rights to use and show the data acquired through its seismic license agreements. The seismic company, on the other hand, will seek to require limited disclosure of the data to third parties, and that those who do see the data execute non-disclosure and non-use agreements.

Another key point of negotiation for seismic agreements will relate to processing. Some producing companies will want to do some or all of their own data processing, others will want the seismic company to do at least the basic processing, such as for normal move out correction or deconvolution, and often times much more. But if the producer wants to refine the seismic data, say, to filter frequency content or to examine amplitude anomalies, it may need unprocessed data. The parties will need a clear understanding of the producers' rights to this data, and to where and the manner in which it can be stored. In any event, the seismic company will usually want a provision in the agreement whereby it represents that it does not warrant the accuracy of the data, but rather only that it was acquired and processed within industry (or specified) standards and in a workman like manner.

#### E. Conclusions.

Contracting in the oil and gas business is affected greatly by both "industry custom" and by the advent of form contracts. These contracts and customs serve both as a framework for contract negotiations and a barometer for "fairness." If a producer or contractor has been used to certain ways of conducting business for a long period of time – i.e. industry custom -- there develops a sense that this way is the only fair way to do business. In other words, it becomes an entitlement.

We know how difficult it is for the oil and gas industry to change its ways of thinking when it is used to doing business in a certain way. It took over 20 years for producers to accept production sharing agreements, when the industry had used lease agreements to acquire mineral rights for some 70 years. The lesson for those trying to break into the oil and gas business as contractors is, then, to get up to speed quickly on oil and gas customs, form agreements, and applicable laws. But unconventional oil and gas recovery may also lead to unconventional agreements, so there is reason to be optimistic that oil and gas companies might change their thinking.

Finally, when looking at form agreements, it is important to check who the authors are. If the agreement has been generated by a trade association that represents the industry you are negotiating against, be careful. The forms are likely slanted against you.