October 21, 2015

Upstream UK Oil and Gas Contract Case of Interest to the Energy Bar

By: Nigel Bankes

Case Commented On: *Scottish Power UL Plc v BP Exploration Operating Company Ltd et al*, [2015] EWHC 2658 (Comm)

This case involved a long term agreement for the sale and purchase of natural gas between BP and its fellow working interest owners in the offshore Andrew field (Andrew owners\vendors) and Scottish Power, the purchaser. The dispute arose because the Andrew owners decided to shut-in the Andrew field and platform in order to allow the processing and related facilities to be reconfigured so as to permit resources from the adjacent Kinnoull field to be tied into the Andrew facilities and platform, as well as production from a deeper pool in the Andrew field. The entire project was referred to as the Andrew Area Development (AAD). The Andrew field was ultimately shut-in from 9 May 2011 – 26 December 2014 with full production not being attained until March 2015. During that period there were no deliveries to Scottish Power under the contract. The shut-in continued for longer than originally anticipated by the Andrew partners but nothing seems to turn on that. There was considerable common ownership in the Andrew and Kinnoull fields such that at the time of the litigation two of the Andrew owners (BP and Eni between them held a 79% interest in the Andrew field) also owned a 93% interest in the Kinnoull field.

The matter came on for hearing as a trial of certain preliminary questions. A central issue in the case was whether (assuming liability on the part of the Andrew owners) Scottish Power should be confined to the specific "default gas" remedies provided by the contract for default delivery or whether it could sue for damages at common law and claim, *inter alia* for the difference between the price of gas under the contract and the price it had to pay for make-up gas. The decision also discusses contractual interpretation issues (see discussion of the factual matrix at paras 24 *et seq*), force majeure issues and the reasonable and prudent operator standard. The post begins with this last issue.

The Reasonable and Prudent Operator Issues

The Andrew owners sought to argue that they had failed to deliver gas because they were fulfilling their obligation to operate the Andrew facilities according to the Standard of a Reasonable and Prudent Operator. The obligation to provide and operate the necessary facilities and the definition of the Standard of a Reasonable and Prudent Operator (the RPO standard) were framed as follows:

> 7.1 Throughout the Contract Period the Seller will, in accordance with the Standard of a Reasonable and Prudent Operator, provide, install, repair, maintain and operate those Seller's Facilities which are (in the opinion of the Seller and the other Sellers) necessary to produce and deliver at the relevant times the quantities of Natural Gas from the Andrew Field which are required, in accordance with the terms of this Agreement, to be delivered to the Buyer at the Delivery Point.

> [Definition] A Reasonable and Prudent Operator: a Person seeking in good faith to perform its contractual obligations and, in so doing and in the general conduct of its undertaking, exercising that degree of skill, diligence, prudence and foresight which would reasonably and ordinarily be expected from a skilled and experienced operator engaged in the same type of undertaking under the same or similar circumstances and conditions, and the expression the 'Standard of a Reasonable and Prudent Operator' shall be construed accordingly.

It was the position of the Andrew owners that their operations were in accordance with the RPO standard because they were fulfilling third party access (TPA) obligations that they owed either pursuant to legislation or in accordance with industry standards, specifically an industry Code of Practice on Access to Upstream Oil and Gas Infrastructure on the UK Continental Shelf ("ICOP").

Justice Leggatt concluded that the Andrew owners could not rely on the RPO standard to excuse themselves from performance principally (at para 79) on the basis that the standard could only offer cover to the Andrew owners if they were, in the language of the definition, actually "seeking ... to perform their contractual obligations". That was not the case here since the Andrew owners had made a deliberate decision not to perform in order to complete the tie-in of the Kinnoull field. Justice Leggatt recognized that he was acceding to a fairly literal interpretation of the text of the definition but felt justified in doing so on the basis (at para 80) that the definition "is quite elaborate and gives the impression of having been carefully formulated. I see no reason to suppose that it was drafted by a Mrs Malaprop." Justice Leggatt did consider that there might be some situations in which the sellers could rely on the standard such as where they might shut-down the facility to undertake necessary repairs for safety reasons; but that was not this case (at paras 84 – 85):

> The basic obligations of the Seller under the contract are, as reflected in Article 5.1(1), to deliver the quantities of natural gas properly nominated by the Buyer. The obligations under Article 7.1 to provide, install, repair, maintain and operate the Seller's Facilities are expressly directed towards that aim. The Seller's obligations must, moreover, be performed not just from day to day but over the whole life of this long term contract. Thus, what is necessary in order to comply with the first limb of the RPO standard, as I see it, is that the Seller should be acting with the aim of performing its obligations to deliver natural gas to the Buyer over the remainder of the contract period through facilities fit for that purpose.
>
> On any fair reading of the requirement, however, it is plain that the Andrew owners were not complying with it when they decided to shut down production from the Andrew Field for what they knew would be a lengthy period for ulterior reasons which had nothing to do with enabling them to deliver natural gas to Scottish Power through facilities provided, repaired, maintained and operated for this purpose, and which were directly inconsistent with performance of their obligations to deliver natural gas

Perhaps more surprising was Justice Leggatt's conclusion if the Andrew owners were able to bring themselves within the first branch of the RPO test. Here, Justice Leggatt went on to say that if that were the case the Andrew owners would have no need to rely upon a legislated or industry standard TPA obligations for it would be self-evident that any prudent operator would

follow the course of action taken by the Andrew owners. Justice Leggatt put the case this way (at paras 89 – 90):

> It is clear that the Andrew owners stood to gain substantial financial rewards from carrying out the AAD works and shutting in the Andrew Field for that purpose. The benefits to be gained from the agreement made with the Kinnoull owners for this purpose included: (i) the fees which the Kinnoull owners agreed to pay for the use of the Andrew facilities to handle oil and gas produced from the Kinnoull Field; (ii) cost savings from carrying out the works needed to develop the Lower Cretaceous reservoir in combination with the work involved in tying in the Kinnoull Field to the Andrew platform; and (iii) the fact that some two-thirds of the costs of carrying out the AAD works and the financial losses incurred as a result of shutting in the Andrew Field for that purpose were to be paid by the Kinnoull owners (subject to a cap). In addition, two of the Andrew owners (BP and Eni) who between them owned almost 79% of the whole interest in the Andrew Field also owned over 93% of the interest in the Kinnoull Field and hence also stood to gain the commercial benefits obtained by the Kinnoull owners from the tie-in.
>
> In these circumstances I have no doubt at all that a person exercising, in the conduct of its own business, that degree of skill, diligence, prudence and foresight which would reasonably and ordinarily be expected from a skilled and experienced operator engaged in the same type of undertaking under the same or similar circumstances and conditions as the Andrew owners would have taken the decision they did to shut in the Andrew Field to carry out the AAD works.

My instinctive reaction to these passages (and see also at para 118 where Justice Leggatt suggests that the failure to consider self (economic) interest in applying the RPO standard would "divorce [it] … from commercial reality and render it totally artificial.") is that they must be wrong largely for two reasons. First, Justice Leggatt has turned an objective standard into a subjective standard by taking into account the particular circumstances of these vendors. Second. Justice Leggatt has de-contextualized the RPO standard beyond the four corners of this contract by allowing/encouraging the operator to take into account its own interests and specifically its own interests in relation to another property. While I appreciate that we are working within a contractual paradigm and that the vendors owe no duty of loyalty to the purchasers, the obligation is still an obligation of these vendors to operate *this facility* in order to provide gas to the purchasers. The vendors might be able to make a decision about efficient breach (i.e. breach the contract, pay damages and still come out ahead) but the idea that the vendors could pursue their self-interest and rely upon the RPO standard to escape breach and liability seems misconceived.

Could the Andrew owners rely on statutory obligations or industry standards with respect to TPA to bring itself within the RPO standard?

Notwithstanding the above conclusions Justice Leggatt did go on to consider whether the owners could rely on their legislated TPA obligations or the standard within the industry to justify shutting-in the facility. TPA is certainly a significant issue on the North Sea continental shelf as governments and industry seek to ensure that assets are not stranded, that new fields can be tied-in and that maximum and efficient use is made of existing facilities. However, this decision

emphasizes that the obligations arising under the legislation (s. 17F of the *Petroleum Act 1998*) and industry standards are actually quite constrained.

Firstly, with respect to obligations arising under statute, Justice Leggatt emphasized that the powers of the Secretary of State were effectively limited to making an order with respect to the more efficient use of an existing pipeline. Justice Leggatt observed that the activities of the Andrew owners went far beyond this and included the construction of new processing facilities thus prompting the observation (at para 94) that "Section 17F of the Petroleum Act 1998 cannot reasonably be interpreted as giving the Secretary of State power to require the owner of a pipeline to provide such facilities or to carry out major construction works of this kind." Justice Leggatt also considered other possible statutory obligations that might apply but overall concluded that the Secretary's authority was limited to the use of existing facilities and did not extend to the construction of new facilities (at paras 95 – 100).

As for the industry standards embedded in ICOP (above), Justice Leggatt accepted (at para 101) that "a reasonable operator of the Andrew facilities would have considered that ICOP applied to the negotiations with the Kinnoull owners regarding the tie-in of the Kinnoull Field" and furthermore that the ICOP had a broader scope than did the legislation and did extend to the construction of additional capacity. So far so good (at para 106): "I accordingly find that the Andrew owners did, as a reasonable operator in their position would have done, take account of and seek to comply with the provisions of ICOP in negotiating the contract made with the Kinnoull owners." But that evidently was not enough in Justice Leggatt's view to allow the Andrew owners to hide behind the RPO standard; they could only do so if they could point to statutory authority which would allow the Secretary to intervene to prescribe an agreement if the parties could not agree. Once again Justice Leggatt found against the vendors concluding (as above) that the Secretary could not intervene to require the construction of new facilities but also finding that there was little chance that BP (for the Andrew owners) would even avail itself of the opportunity to involve the Secretary of State and the Department for a number of reasons. First, BP and the Andrew owners would have wanted to maintain a good relations with the Department. Second, the results of any referral might be unpredictable, and third, BP and the other Andrew owners were on both sides of the negotiation (at para 110):

> I have no doubt that the representatives on each side sought to secure terms favourable to their interest, but it was clear from their evidence that they all regarded themselves as working towards a common goal. It was not of great overall significance to BP what balance was struck between the interests of the Andrew owners and the Kinnoull owners, since a disadvantage to them in one capacity constituted a benefit to them in the other. A key objective of the negotiators in these circumstances was to gain the support of the minority owners on each side for terms on which agreement could be reached so that the project which BP wanted to undertake could proceed. I find it difficult to contemplate in the circumstances that BP would ever have allowed a situation to arise in which [the Department] was asked to intervene.

Finally, all the evidence suggested that the negotiations between the two owners were based on mutual commercial advantage and had no reference to the ICOP or to the possibility of a referral to the Department.

In sum, even if the Andrew were entitled to invoke the RPO standard (they could not according to Justice Leggatt), and even if they needed to rely on TPA obligations whether based on statute

or industry practice (they need not according to Justice Leggatt) they could not do so because the limited nature of the TPA obligations meant that they did not extend to the construction of new facilities or the reconfiguration of existing facilities.

Is Scottish Power limited to the remedy of default gas or could it sue for common law damages?

The contract contemplated that Scottish Power would nominate certain volumes for delivery for each and every following week over the duration of the contract. In the event that the vendors failed to deliver the nominated amount the shortfall was denominated as default gas to be delivered the following month at 70% of contract price. Scottish Power continued to nominate delivery volumes throughout the period of default. The crucial provision in the contract was Article 16.6 which states:

> The delivery of Natural Gas at the Default Gas Price and the payment of the sums due in accordance with the provisions of Clause 16.4 shall be in full satisfaction and discharge of all rights, remedies and claims howsoever arising whether in contract or in tort or otherwise in law on the part of the Buyer against the Seller in respect of underdeliveries by the Seller under this Agreement, and save for the rights and remedies set out in Clauses 16.1 to 16.5 (inclusive) and any claims arising pursuant thereto, the Buyer shall have no right or remedy and shall not be entitled to make any claims in respect of any such underdelivery.

As one might anticipate, Scottish Power employed various strategies to argue that Article 16.6 did not preclude additional recovery. For example, Scottish Power attempted to argue that the real breach in question here was a breach of the Article 7 obligation to make available the necessary facilities to process and deliver gas. While Justice Leggatt seemed prepared to accept that there might be some cases that were not caught by the broad language of Article 16.6 (see at para 149), in general it was clear (at para 160) that the remedy of default gas was intended to be the exclusive remedy available to the purchaser for under delivery. Justice Leggatt concluded as follows (at para 175):

> In reaching my conclusions on this issue, I have not overlooked the presumption [and see also the references to the relevant authorities at para 23] that parties do not intend to abandon remedies that arise by operation of law. It seems to me that the presumption must be less strong where the common law remedy is not simply excluded but is replaced by a different (and valuable) contractual one. I am satisfied in any case that – to the extent I have indicated – the terms of the Agreements make it sufficiently clear that this was intended.

If Scottish Power does have additional common law remedies can the Andrew owners claim the benefit of an exclusion clause?

Justice Leggatt did not need to address this argument since he had already concluded that such additional remedies were not available to Scottish Power but he still decided the exclusion clause point in obiter. The Andrew owners claimed to rely on Article 4.6 which states:

> Save as expressly provided elsewhere in this Agreement, neither Party shall be liable to the other Party for any loss of use, profits, contracts, production or

> revenue or for business interruption howsoever caused and even where the same is caused by the negligence or breach of duty of the other Party.

Justice Leggatt made short work of this argument concluding that arguments to the effect that Scottish Power's claim was a claim for loss of use or loss of production were (at para 179) "untenable":

> It is clear that Article 4.6 is not intended to exclude liability for all losses caused by the other party's breach of duty – otherwise it would have said so. Rather, it excludes liability for certain specified types of loss. What these types of loss have in common is that they do not represent the basic or normal measure of loss caused by a breach of contract, but are all kinds of further loss that a party may suffer which go beyond that basic measure.

Justice Leggatt was of the view that Article 4.6 was directed not at the ordinary losses that would flow from breach of contract (here the cost of replacing the gas) but instead was directed at other consequential or secondary losses. Justice Leggatt out some flesh on what he meant by such a secondary loss in the context of loss of use or loss of production as follows (at para 181):

> In the present case, the damages claimed by Scottish Power represent only the normal loss which arose from the need for Scottish Power to buy alternative supplies of gas in the open market to replace the natural gas which the Andrew owners should have delivered under the Agreements. Had there been difficulty or delay in procuring replacement gas, various types of secondary loss might also naturally have been suffered. Such losses would potentially have included losses resulting from Scottish Power's inability to use the gas for the purposes of its own business. I think it clear that this is what is meant by "loss of use" in Article 4.6. The reference to "loss of profits" is directed at the possibility that, if Scottish Power was not able to buy gas to replace the gas which the Andrew owners should have delivered, it could lose profits which it would otherwise have made from selling the gas or using it in its business. ...I interpret "loss of production" as meaning loss resulting from inability to produce other products (for example, to generate electricity) because gas is not delivered under the Agreements. "Loss of revenue" covers similar ground to "loss of profits". The last item in the list, "business interruption", again overlaps with other items and further indicates the general type of loss which the clause is concerned to exclude.

To the extent that the Andrew owners could bring themselves within the subject matter of the force majeure clause of the contract, were they precluded from relying on this clause by reason of their failure to comply with certain of the notice requirements in the clause?

The Andrew owners originally had two force majeure arguments. The broad claim (referred to at para 44) was that the entire period of the shut-in was covered by the force majeure provisions of the contract. This defence was ultimately withdrawn. The narrower version of the force majeure argument (at para 44 and at paras 194 – 237) was confined to the initial period of the shut-in. The Andrew owners originally shut the Andrew platform down on 9 May 2011 because a leak had been detected and thus the platform was shut-in for safety reasons. By May 20 the Andrew

owners had decided to continue the shut-in and commence the AAD works rather than re-starting production and then shutting down again. The Andrew owners argued that they could rely on force majeure from 9 May to 20 May. The parties seemed to accept that the shut-in for safety reasons fell within the ambit of the definition of force majeure but Scottish Power argued that the Andrew owners were ultimately precluded from relying on force majeure because they had failed to follow some of the procedural steps outlined in the force majeure Article (Article 15). That Article required the party relying on force majeure to provide notice to the other party within 10 days of the event and then to provide an interim report within 5 days of the notification followed by a detailed report within 20 days. The Andrew owners complied with steps 1 and 2 but admitted that they had failed to provide the detailed report. Scottish Power argued that the requirement of a detailed report was either a condition precedent or a condition subsequent and that on either interpretation the Andrew owners were precluded from relying on force majeure since they had failed to fulfill the condition.

The principal objection to Scottish Power's argument was that the terms of the contract did not expressly refer to the reporting requirement as a condition of any sort. This led Justice Leggatt to make two further inquiries. The first inquiry was to examine whether it was possible to infer that the parties intended that filing a detailed report should be a condition precedent for making a force majeure claim. Perhaps the strongest argument for this was that the clause would confer no worthwhile protection if Scottish Power were confined to the remedy of damages. Justice Leggatt was not convinced and clearly believed that there were compelling arguments for both views: neither view (at para 223) was "inherently more sensible or commercially reasonable" than the other".

The second inquiry was whether the detailed report requirement should be viewed as an indeterminate (or innominate) term, breach of which was so serious that the Andrew owners should be precluded from taking the benefit of the force majeure characterization of the events. Readers will recognize (and see at para 233) that this argument is an attempt to apply the logic of *Hong Kong Fir* (*Hong Kong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd*, [1962] 2 QB 26) not to justify repudiation of the contract (clearly that was not possible in relation to this 11 day event, and nor presumably was it in Scottish Power's interest in doing so), but instead to preclude reliance on a particular clause or benefit contained in the contract. Justice Leggatt seemed to accept the principle underlying the argument (at para 230 but see *contra* at para 234) but ultimately concluded that the argument must fail partly at least on the grounds that this approach would hardly contribute to commercial certainty (at para 235).

In sum, the failure of the Andrew owners to fulfill the requirement of filing a detailed report did not preclude them from relying on force majeure. It was a breach of the contract for which they might be liable in damages, but Scottish Power would need to be able to prove that it suffered damage as a result of that breach.

Next Steps

As noted in the introductory paragraphs, this represents judgment on a number of preliminary issues. The matter will now proceed to trial (assuming that the parties cannot reach a settlement based upon the matters decided here).

To subscribe to ABlawg by email or RSS feed, please go to **http://ablawg.ca**
Follow us on Twitter **@ABlawg**