Offshore Energy Insurance
Building a Program

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The offshore oil-and-gas industry has sustained significant and at times catastrophic losses that generated enormous and complex insurance claims. These claims are usually multi-faceted, involving property damage, well-control problems, loss of production, pollution, and injuries and death. Governmental and regulatory entities routinely become involved, criminal and civil proceedings are common, and an energy company may struggle to address the loss and carry on with business. The offshore-energy-insurance industry has embraced the sophisticated nature and technologically advanced practices of the offshore-energy industry, but the fast-paced industrial evolution creates challenges for the insurance markets that serve the industry.

Operational insurance for offshore energy companies is usually placed as a package or collection of policies that cover, on an occurrence basis, the owner's assets, well control, and liability exposures. The package is often supplemented by pollution, business-interruption and political-risk coverage. General conditions usually apply to all parts of the package and are supplemented with section-specific conditions, warranties and exclusions. Here, we offer a general overview of the coverages available for purchase in the offshore energy insurance market and highlight important facets of those coverages.

Additionally, we review the recent opinion, *Ranger Insurance, Ltd. v. BP, PLC,* which explores how the United States Court of Appeals for the Fifth Circuit applied Texas law to determine the level of interplay between indemnity and insurance provisions in a typical drilling contract and the additional-insured provision of a common umbrella liability policy. Note that on August 29, 2013, the Fifth Circuit withdrew its opinion and certified 2 questions to the Texas Supreme Court. On September 9, 2013, the Texas high court accepted the case.

A. Physical-Damage Coverage

The goal of this first-party, physical-damage section of energy package policies is to insure an operator's property, including the platform (at an agreed and scheduled value) and other property that would be considered permanently installed at an offshore-installation site: machinery, equipment, appurtenances, wellhead equipment, pipelines, risers, loading buoys, moorings, *etc*. Flowlines are frequently insured under a separate policy section. Temporary equipment may also qualify as insured property if, at the time of the loss, it was an integral part of the platform. Contractor's equipment is usually excluded, but coverage can be bought through endorsement. Insurers typically cover all risks of direct physical loss or damage to insured property, provided that the loss or damage does not result from a lack of due diligence on the part of the insured. Boilerplate exclusions are included in the policy.

Coverage is afforded for property listed on a "schedule" attached to the policy. The platform owner is best suited to determine what property should be included on the schedule and the insured value for its property. If the proposed value is accepted by the insurers, it becomes the "agreed value" and the basis for valuation of property coverage (although "increased values" can also apply). Disputes can arise when the platform value submitted by the insured and to which the insurer has agreed is ultimately found to be disproportionately low to the actual cost to rebuild the platform.

On occasion, an operator may inadvertently omit offshore properties from the schedule or make a mistake in the property description. Policies may include an errors & omissions clause, which provides a degree of protection to insureds when these mistakes are made. To avoid prejudice, the insured should discover and correct the mistake prior to a loss. If the mistake is discovered after or as a result of a loss, some policies provide a separate sub-limit for the loss of unintentionally omitted or misidentified property.

To the extent an insured is faced with a destroyed offshore platform, it may also incur significant expense related to hiring a heavy-lift vessel and barges to lift and move the platform debris to shore. Insurers typically indemnify the insured for costs and expenses of raising and removing the wreckage or debris of the insured property when that removal is compulsory by law, order or regulation, where the insured is obligated by contract, or even when the insured voluntarily removes the wreckage. Insurers normally impose a debris-removal limit of 25% of the agreed and scheduled value of the platform within the property-damage section. In the wake of several catastrophic storms in the Gulf of Mexico, many insureds have purchased additional debris-removal coverage in the event of toppled platforms or constructive total losses.

B. <u>Control of Well</u>

Even in today's technologically advanced and environmentally conscious world of offshore drilling, offshore well blowouts can occur and result in multi-million-dollar claims for energy insurers. Offshore drilling has been described as a series of various well-control events, but only a portion of these events are well-control risks covered by insurance. Well-control insurance is neither property-damage insurance nor a guarantee of oil/gas production; rather, it seeks to protect the integrity of the well from the development of certain hazardous conditions so that insureds can explore for and produce hydrocarbons.

Developed by the Lloyd's insurance market in the 1940s, well-control insurance changed significantly in 1986 when the London Rig Committee produced wording known as the EED (Energy Exploration and Development) 8/86 wording that offered clarity and definition to when a well was out of control and when a well was brought under control – events that trigger and terminate coverage, respectively. While that wording has been modified by various insurers over the last 27 years, it still provides a good template for what well-control insurance covers as expenses associated with control of well, restoration/redrill, pollution, and property in the

insured's care, custody and control. Under daywork contracts, the well operator normally provides well-control insurance for itself and its co-venturers. But in turnkey contracts, the drilling contractor likely bears responsibility for well-control expenses. The coverage is provided to the insured based on a schedule of wells and on an indemnity basis, requiring the insured to prove out-of-pocket expense.

1. Well Control (Section A)

An uncontrolled escape of hydrocarbons from a well can be an extremely dangerous situation and can require expensive emergency response efforts to control. Well-control insurance provides indemnity for those expenses a well operator incurs in bringing a well that is out of control back under control.

Offshore wells are insured through a rating system, in which they are identified by location, type (drilling, workover, producing, shut-in or abandoned), and depth of the well. Rating levels for offshore wells are higher than land wells – reflecting insurers' consideration of well accessibility, experience with formation pressure and availability of well-control resources – and vary depending upon the geographical zone in which the well is located. Offshore wells are generally rated in two areas: Area 3 (Gulf of Mexico, Venezuelan waters and Gulf of Paria) and Area 4 (all other offshore waters except north of the Arctic Circle and south of the Antarctic Circle). On a quarterly basis, the insured must submit a schedule of its wells to the insurer and identify the currents status of the wells as specifically as possible.

Generally, an insured well is a well out of control when there is an unintended flow of hydrocarbons that cannot promptly be stopped by 1) use of on-site equipment (blowout preventers, storm chokes, etc.); 2) increasing the weight of drilling mud or using conditioning materials in the well; or 3) safely diverting the flow into production. A well may also be considered out of control to the extent the flow is declared to be out of control by the appropriate regulatory authority. It is important to note that a well is not out of control simply because there is a flow of oil or gas that can be circulated out or bled off through surface controls within a reasonable period of time.

If a well is determined to be out of control, insurers will pay reasonable costs associated with bringing the well under control. A well is brought under control – and insurance coverage terminates – when the flow stops, is stopped or can be stopped; normal well operations resume or can be resumed; the well is returned to its condition prior to the event; or the flow is diverted to production, whichever occurs first.

2. Redrill/Restoration (Section B)

Redrill/restoration coverage seeks to reimburse the insured for costs and expenses reasonably incurred to restore or redrill a well insured that has been lost or damaged as a result of a covered claim under the well-control section. The triggering event is a covered well-control

event, and the insurers' indemnity obligation is typically limited to redrilling the well to the depth at which the well became out of control or in the case of a producing or shut-in well, to the geological zone(s) from which the well was producing. Many policies require spudding of the redrill well within 540 days of coverage termination. And some policies limit coverage afforded for redrill wells to a factor of the cost of the original well (typically 140% of the original well's AFE).

3. Seepage and Pollution, Clean-up and Contamination (Section C)

The Seepage and Pollution section of the package policy addresses pollution, clean-up and defense costs relating to accidental pollution that occurs as the result of a covered well-control event. Specifically, it pays costs that the insured is liable to pay by law or under the terms of a lease agreement for remedial measures, bodily injury, or damage or loss of use of property caused by seepage, pollution or contamination arising from wells insured (and resulting from a Section A occurrence). Costs include removing, nullifying and cleaning up polluting substances emanating from wells insured, including the cost to contain, divert or prevent the substances from reaching shore. In addition, the coverage may respond to expenses incurred in defending claims resulting from the pollution.

4. Care, Custody and Control Endorsement

An operator may have legal or contractual liabilities with respect to oilfield equipment that is leased to it or is in the care, custody or control. This endorsement applies when liability is incurred for physical loss/damage to third-party equipment, including drillstring components, or for salvage expenses. The endorsement may exclude certain equipment: diamond drill bits, drilling/workover rigs and components, mud, cement, chemicals, and the well itself and installed casing. Coverage for salvage expenses incurred to retrieve lost or damaged in-hole equipment may be limited to 25% of the equipment value. Losses resulting from delay, loss of use, wear and tear, gradual deterioration, or shortages in stock not tied to an accident are excluded. CCC coverage is not needed where an operator contracts on a turnkey or completed-well basis since the drilling contractor assumes responsibility for equipment up to a stated depth or completion.

C. <u>Offshore Liability Risks</u>

Numerous hazards exist in the offshore exploration, development and production industry, and oil companies work within an ever-tightening group of laws and regulations designed to protect workers, the public and the environment. Violation of these rules exposes insureds to potential damages, fines, penalties, and in some cases, punitive/exemplary damages. In addition, offshore energy companies have duties to the public generally, and third-party tort liability creates the need for insurance to protect against general liabilities: property damage, personal injury, products, professional indemnity, completed operations, advertising,

and directors and officers. For medium to large oil companies, the structure of their liability program may be the most complex of their entire insurance program.

The package policy can include a liability-coverage component for upstream oil companies and contractors, and there are various approaches for an insured to consider when purchasing liability insurance. As concerns oil companies and contractors, liability risk is often written on a claims-made basis. The coverage grant attempts to indemnify the insured, in relation to their operations, for loss/damages sustained by reason of liability imposed by law or assumed under a contract for claims for bodily injury, property damage, etc. Typical exclusions include property owned, leased or occupied by the insured; pollution caused by legitimate dumping of waste; punitive and exemplary damages; and war and nuclear damage. Specific to the offshore energy sector, insurers typically exclude loss of well or hole, in-hole equipment, well-control costs, removal of debris and underground resources.

Because offshore operators may incur liabilities to third-party contractors working on or around the offshore structure, the operator and contractors usually negotiate indemnity obligations between each other that may affect the indemnification of the party responsible for damage or injury. In the next section, we explore the Fifth Circuit's recent opinion in *Ranger Insurance, Ltd. v. BP PLC*, which has caused many insurers to examine their existing policy provisions in light of the contractual-indemnity relationships between an insured and a third party.

D. <u>Pollution – OPA</u>

Oil and toxic-substance pollution is an international concern. As a result of the Oil Pollution Act of 1990 (OPA), the lessee of an area, the entity with a right of use of an area in which a facility is located, pipeline operators, and a solely negligent third party are jointly and severally liability for pollution-removal costs and damages. Pollution coverage is normally purchased in conjunction with well-control policies (pollution emanating from a well out of control) and umbrella liability policies (pollution from facilities). Pollution cover relating to liabilities imposed by OPA, as well as the Offshore Pollution Liability Agreement (OPOL) and OCSLA Amendments, can be purchased in addition to main liability wording. With regard to OPA liability, coverage can be purchased for 1) injury to real or personal property, 2) loss of property use, 3) removal/clean-up costs, 4) injury to natural resources, 5) loss of use of natural resources, 6) loss of profits, 7) loss of tax revenue, and 8) interest and costs of advertising.

E. <u>Issues Presented by Insureds Under the Package Policy</u>

Because offshore insurance is multi-faceted, every new loss/claim presents facts that can challenge the understanding of the various offshore energy coverages. But there are a few issues that appear with some frequency and cause significant disputes between insureds and insurers.

1. **Inadequate policy limits encourage re-labeling of expenses.**

Even a prudent offshore operator may face the problem of inadequate insurance limits. Typically, issues arise in the property-damage or well-control setting. For example, an operator has scheduled an old platform with an agreed value of $10 million. The platform stands in the path of a hurricane and is toppled. The operator is entitled to $10 million for a total loss on that old platform but the regulatory authority issues an order that the company must remove the platform from the bottom of the ocean. It is likely that the operator has $2.5 million of debris-removal coverage (25% of the scheduled value of the platform) for that platform. The nature of the debris-removal process is complicated by the scarcity of lift vessels, weather-related delays, potential well-control issues and the inability to lift the platform as a unit from the ocean floor. As a result, the debris-removal expense increases to $25 million, and the insured faces a $22.5 million uninsured loss. Often times, the insured will attempt to re-categorize or re-label expenses to recover them under a different coverage (*e.g.*, well-control or pollution) with remaining limits.

2. **Property betterment may be necessary but not insured.**

To the extent an offshore property owner sustains damage to a facility that requires repair, refurbishment or replacement, insureds are often faced with business decisions relating to materials, building, and design improvements. Typically, the basis of recovery is contained within liability limits and makes insurers liable for the cost of repairing or replacing damaged property with materials of like kind and quality to a condition equal to that prior to the loss. But what if the insured has an ownership interest in the platform rebuild, but is not in a position to direct or approve the rebuilding project? And what if the project entails numerous design changes, upgrades in materials and improvements that the other interest owner has charged to the insured? What if industry standards have developed in such a way to require design or material improvements? As a rule, insurers will not pay for betterment (in whatever form), but in some cases, policy wordings allow betterment to the extent the improvements are required by government law or regulation. In these cases, the claim and adjustment process becomes belabored because the complexity of the rebuild requires engineering expertise to separate costs to rebuild "to a form equal" from costs incurred for betterment.

3. **Scheduled property and a combined single limit provoke questions regarding limits.**

When a piece of property is a total or constructive total loss, an insured can recover for the actual cost incurred up to the value in a schedule. And various other coverages (*e.g.*, sue and labor and debris removal) are calculated as percentages of the scheduled value. To the extent there is also a combined single limit in place and the total loss of any one scheduled item exceeds or is disproportionate to its corresponding scheduled value, an insured may present an

argument that the scheduled values become irrelevant in light of the overall combined single limit for the occurrence.

To the extent a policy is written on a combined-single-limit, each-occurrence basis, indemnity is available for the total sum insured. But when property has been scheduled and the schedule is made part of the policy, the values contained in that schedule may be applied as a series of sublimits to manage overall exposure.

RANGER INSURANCE, LTD. V. BP, PLC – A CHANGING LANDSCAPE?

After Transocean's semi-submersible, mobile offshore drilling unit *Deepwater Horizon* exploded and sank in April 2010, numerous contractual issues surfaced. Transocean's predecessor and BP America Production Company's predecessor had a drilling contract that governed the parties' exploratory drilling activities. Transocean also maintained a liability insurance program through Ranger Insurance Ltd. (primary) and London Market syndicates (excess). The policies defined "additional insured" and "Insured Contract." And the parties' drilling contract defined obligations to one another and identified liabilities each party assumed. The contract also required Transocean to maintain insurance covering the contract's operations and naming BP as an additional insured for liabilities assumed by Transocean under the contract's terms.

The principal legal issue in the *Ranger* case involved the alleged interplay between Transocean's liability policies and the drilling contract between BP and Transocean and the extent to which the policies provided additional-insured coverage to BP for pollution liabilities. The trial court and the Fifth Circuit applied Texas law to resolve the issue, but came up with different answers.

Transocean's insurers argued that BP was only afforded additional-insured coverage to the extent of the contractual liabilities Transocean assumed under the drilling contract. It encouraged the court to refer to the drilling contract for guidance in determining the scope of the insurers' coverage obligation to BP. But BP – which did not seek indemnity from Transocean but only coverage under the policies – argued that neither the policies nor the drilling contract placed limitations on the additional-insured coverage, and it was covered to the full extent of Transocean's policies. BP argued that a court should look only to the language of the insurance policy and not to the underlying services contract to determine the extent of additional-insured coverage.[1]

Neither party argued that the policy language alone provided anything other than broad additional-insured coverage for BP. And so long as the drilling contract's additional-insured

[1] BP argued the Texas Supreme Court's opinion in *Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660 (Tex. 2008) and the Fifth Circuit's opinion in *Aubris Resources LP v. St. Paul Fire & Marine Ins. Co.*, 566 F.3d 483 (5th Cir. 2009).

provision and the indemnities clause were separate and independent – which the Fifth Circuit concluded was "unmistakable" based upon its comparison to similar provisions in other reported opinions – there was no relevant drilling-contract limitation to BP's coverage under the policies.

The Fifth Circuit has now withdrawn its opinion and certified the following determinative questions of Texas law to the Supreme Court of Texas.

1. Whether *Evanston Ins. Co. v. ATONFINA Petrochems, Inc.*, 256 S.W.3d 600 (Tex. 2008), compels a finding that BP is covered for the damages at issue, because the language of the umbrella policies alone determines the extent of BP's coverage as an additional insured if, and so long as, the additional insured and indemnity provisions of the Drilling Contract are "separate and independent"?

2. Whether the doctrine of *contra proferentem* applies to the interpretation of the insurance coverage provision of the Drilling Contract under the *ATOFINA* case, 256 S.W.3d at 668, given the facts of this case?