Norwegian Continental Shelf – a new dawn for EPC alliance contracts?

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Introduction

Following the collapse of oil prices – from their peak of an average of $112 per barrel in 2012 to their lowest point of $28 per barrel in 2015/2016 – a significant number of developments became commercially unviable. During the lowest period, oil prices were substantially lower than the break-even price of most new developments. With the subsequent recovery and stabilisation of oil prices to above $50 per barrel, an increasing number of oil companies on the Norwegian Continental Shelf (NCS) are looking for new ways to advance these developments by cooperating with contractors.

Some oil companies have entered into agreements with contractors, under which alternative solutions to regulate the economic effects of oil projects have been introduced, such as:

- cash-flow management;
- open-book management;
- integrated project organisation; and
- target pricing.

Some oil companies are looking for a stronger commitment from their suppliers and have introduced a cooperation scheme whereby the parties share a greater portion of the risk for profit or loss under the contract.

This type of cooperation is not new. Over the years, various alternatives relating to such cooperation have arisen under different names – ranging from loose cooperation arrangements to fully-fledged alliance or partnering contracts.

An ‘alliance’ is understood to mean cooperation at any level, whereby the parties agree to share risk and reward without creating a joint venture or a single entity. This update will take a closer look at some of the challenges that may arise from such contractual structures with regard to NCS projects.

As a starting point, it is notable that the production licences awarded pursuant to the Petroleum Act 1996 require licensees to enter into a contract for goods and services subject to Norwegian law and contract traditions when such contracts or activities concern or arise from NCS licences. Licensees and their contractors may select a conflict resolution mechanism other than one recognised by the Norwegian courts under Norwegian law, including international expert determination or arbitration.

Standard agreement on NCS

NORSOK’s(1) work on developing a model project alliance agreement (the Norwegian Project Alliance Agreement 1996 (NPA 96)) for the NCS was concluded in 1997. The general objective of the NPA 96 was to lower project costs compared with what could be achieved by using more traditional
engineering, procurement and construction (EPC) contracts. The aim was to create contractual
terms that allowed a more open and transparent working environment and greater project
cooperation, while still maintaining a system for avoiding or efficiently solving controversies or
disputes.

The NPA 96 has not been widely used; however, the issues that it addressed are still relevant,
including with regard to contracts that are being negotiated at present. Negotiators still aim to
reduce costs and obtain more seamless integration and cooperation within a project organisation.

**Basic issues to resolve in NCS alliance contracts**

*Integrated organisation*

Most NCS alliance contracts aim to reduce the project organisation. Instead of spanning separate
organisations, the parties look to establish an integrated project team. Not only is this a cost-
reducing exercise, it also aims to enhance coordination and facilitate the exchange of information.
An integrated project organisation will face at least two substantial challenges with regard to:

- the decision-making process; and
- the liability for any changes to the project as decided by the integrated project organisation.

Most alliance agreements have implemented a system whereby a governing body (ie, a steering
committee) comprising members from both parties leads the project. Such steering committees do
not manage the day-to-day business of the project, but provide strategic guidance and leadership for
the alliance. The steering committee must normally resolve disagreements and disputes within the
project organisation and between the parties which cannot be resolved in practical day-to-day
operations. Various approaches to such a dispute resolution process have been observed. In the
most common approach, the parties endeavour to resolve disputes amicably, if possible. If a party
has a substantially stronger position than other parties in the alliance, there is a risk that it may
attempt to use its dominant position in the steering committee to ensure that it has the final say in
any dispute. In principle, this is a breach of the fundamental reasons for establishing an alliance.
Most alliance agreements therefore require the steering committee to reach a unanimous decision on
matters submitted thereto. If this is impossible, the agreement requires a system for advancing
disputes to the next level of dispute resolution. Most alliance agreements do not resolve disputes by
involving the ordinary courts; rather, they appoint an independent entity or person (ie, an expert or
arbitrator) to resolve the dispute.

The dispute resolution procedural rules may vary from a few provisions to comprehensive
attachments to the alliance agreement. For practical reasons, the procedures concerning an expert
decision must be robust. In general, procedural decisions cannot be appealed; hence, the parties
must be reassured that the provisions are sufficient to ensure the quality of the expert's decision.
However, the comprehensiveness of the procedural rules must be based on a case-by-case
assessment of the project’s complexity and the alliance agreement’s duration.

A recurring question is which party is liable for the decisions made by the integrated project
organisation (ie, the alliance management team and/or the alliance manager). Controversy typically
arises when a decision by the alliance management team or alliance manager leads to increased costs
without any prior discussion or decisions having been made by the steering committee. How the
parties resolve such matters normally depends on how integrated the alliance project team is. If the
parties have agreed that there can be no variations and that all costs must be measured against the
target sum, such a decision is consumed by the project and the parties will share the risk for any
overrun. However, most alliance agreements have provisions which allow variations in certain
predetermined situations and determine how such changes will affect target cost adjustments. As
such, alliance contracts may contain rules concerning changes or variations. Provisions
incorporated in the alliance agreement may follow the same procedures as for disputes which are not
resolved by the steering committee. However, some alliance contracts may contain more traditional
variation order provisions. The reasons for applying a formal variation order procedure will be the
same as a traditional contract. The parties must determine if the work is within the defined scope and
subsequently reach contractual clarification on payments to be made (ie, to change the target cost).

*Defects and delays*
Under NCS alliance contracts, issues concerning delays and defects are treated as a problem shared by the parties and must be jointly solved. In general, any delays or defects are considered a breach of contract and, in some cases, a material breach of contract. The alliance contract must address this in a way that supports and strengthens the alliance's objectives. The contract must determine the legal and commercial tools that the alliance has at its disposal in order to resolve issues concerning delays and defects.

The most obvious tools are introducing a target cost and maintaining a project account (ie, the total amounts to be distributed among the partners versus the actual project costs incurred). Any defects or delays will have an impact on the project account – the question is whether this will influence the target cost and what the knock on effect will be for one or all of the alliance partners.

Delays may be addressed separately to target cost deviations. Some contracts have provisions where delay-related costs are simply added to the target cost based on invoices at full-cost rates. However, this solution may not achieve the intended alliance objectives. Most alliances need provisions concerning whether delays will impact the target cost and, if so, how they will do so. In such cases, provisions under which defined permissible delays trigger an increase in the target cost by a certain percentage or a stipulated amount calculated for every day of the delay should be incorporated into the alliance agreement.

A true alliance is recognised through provisions pertaining to the rectification of defects by determining that such costs will be mutually shared between all alliance partners. However, some alliance agreements accept no changes to the target cost unless the situations in which it can be adjusted have been pre-agreed. Regardless of whether the target cost is adjusted in accordance with the alliance agreement, the cost will be allocated to the project account. This implies that, in most cases, the alliance risks an overrun if the target cost is not adjusted. Most agreements exercise great prudence in identifying what type of defect may cause a target cost adjustment. Hence, any additional cost incurred in connection with defect rectifications will, as a main rule, have an impact only on the project account, which may cause a cost overrun compared with the stipulated target cost.

**Risk and reward**

Most NCS alliance contracts have a system where any overrun or underrun is split between the alliance parties in a predetermined portion. Overruns or underruns are determined by balancing the final project account against the target cost. If the project account exceeds the target cost, the alliance will have an overrun which will be split between the parties in accordance with the provisions in the alliance contract (ie, the alliance parties will risk a loss on their work under the contract). The same will apply if there is an underrun, but the parties will share the cost savings incurred in accordance with the agreement.

Most alliance contracts have a starting point in accordance with the above principle (ie, splitting a possible overrun or underrun). However, many alliance parties consider that the party with the biggest stake in the project will assume a larger portion of the risk for overrun or underrun. How risk and reward are split between the parties is a commercial issue. This may lead to one of the alliance parties undertaking a higher portion of the risk and reward as a consequence of its dominant interest in the project. However, the aim to create a reasonable balance between the input and output for each individual alliance party remains.

Some contracts may include a provision which gives a stop-loss for one or more of the alliance parties if there is target cost overrun. In the oil and gas business, it is customary for a company to accept increased liability for any overrun exceeding a predetermined amount or percentage of the target cost. Such liability can be split into different levels and for different reasons to adapt to the special requirements of each project.

**Opportunities and constraints of an alliance contract**

The main risk from the perspective of an oil and gas company working on the NCS is the target cost being set unrealistically low because the scope of the work has not matured sufficiently. In oil and gas EPC contracts, commencement of the work will be based on a front-end engineering and design study or comparable limited engineering works. The fact that the engineering and procurement work are not separated from the construction work increases the margin of error when setting the target
This has prompted some companies to separate contracting work into engineering and procurement work and construction work in several of their model contracts in order to:

- obtain a higher degree of certainty for the target price stipulated for the construction part of the work; and
- allocate risk between the engineering contractor and the contractor performing the construction work.

The company may do this by allocating more risk associated with defects in the engineering work to the engineering contractor (ie, the engineering contractor will be responsible for the detailed engineering drawings and specifications used for the construction work). However, should the engineering work be performed in such a way that eventual defects or mistakes are not a result of the engineering, but solely a consequence of the construction, the company may hold the construction contractor liable. This may be perceived as the opposite effect of what is expected from an alliance contracting strategy, which in many ways is correct. However, such contracting strategies may also be applied in an NCS alliance contract context. The contract may be split into different parts, with one part of the work being included in an alliance and one part being contracted on more traditional terms. The contracting parties may create an alliance for parts of the work containing many interface issues. The reason for this is to achieve the benefit of having an integrated organisation to handle potential interface issues in the most efficient way. The detailed engineering in a complex project is crucial for enabling the construction phase to progress seamlessly. If the engineering phase is managed through an alliance, the construction phase does not necessarily need to be executed under the same alliance or through an alliance at all.

The dilemma for parties is that an alliance opens up a number of uncertainties compared with the traditional terms and conditions of a regular EPC contract, which parties may be less comfortable with. An alliance contract's terms and conditions must therefore be contractually robust. Any such contractual basis requires a significant understanding of the alliance concept and a will among the parties to solve contractual adversities. In certain circumstances, we see hesitancy among potential alliance participants to engage in difficult contractual negotiations before entering into an alliance. There appears at times to be a tendency among commercial decision makers to postpone difficult contractual issues. The consideration appears to rest on the hope that adversities may not arise or may be easier to solve once a specific situation arises or details become available. Often the argument is that time is of the essence and the contract must be negotiated and concluded quickly. This has proven to be, in several cases, an expensive approach. Even so, many companies want to enter into an alliance to split the risk and reward appropriately, with the main aim of reducing overall cost and risk, as well as the individual company's cost and risk.

As a solution to this reluctance to create necessary and robust contractual terms and conditions, some oil and gas companies have distanced themselves from a strict legal interpretation of a 'deal' and rely more on procurement power and commercial or financial strength. In these cases, there is a contractual set of terms and conditions in place, but it is structured in a way where the flexibility to terminate the alliance is distinctive. In such cases, oil and gas companies incorporate the alliance objectives into the terms and conditions, but assume strict control over alliance management and the involved parties' performance. Through this control structure, the company reserves its right to terminate the alliance at any time should it be dissatisfied with the alliance parties' cooperation. The aim is a seamless cooperation on company terms where the oil and gas company functions as an integrator for the performance of the suppliers and other contractors. The main focus for the company is to secure the necessary commitment from the contracting parties through the application of an open-book principle where the parties have:

- agreed on margins, incentives concerning overrun and underrun (risk sharing) and the target cost; and
- appointed an integrated management team.

Many legal issues will not be resolved in detail in the contract, but the company will secure a position where it can terminate any parties which are not acting in the general interest of the alliance or the project's execution. Such an arrangement gives the oil and gas company increased control over the
project execution and the key to its success seems to be a constant and open dialogue between all parties involved.

**Comment**

Information received from companies involved in hybrid alliances on the NCS, as described above, is fairly positive. However, no recent projects have encountered actual legal problems and it remains to be seen what happens when such alliances are put to the legal test.

The fact that there are no widely used standard NCS alliance agreements implies that parties have substantial autonomy in creating a bespoke agreement adjusted to their own requirements and objectives. Even if the objectives of an alliance are essentially the same for every project, the complexity and execution may vary in each project, which can create a number of opportunities. From a Norwegian legal perspective, such opportunities should be addressed as early as possible in order to develop an appropriate legal framework. The legal framework should be designed to meet the requirements and objectives of the parties. One opportunity for the parties is to find the right solution between a traditional EPC contract and a fully-fledged alliance agreement in order to secure the necessary flexibility, but also develop and describe the integration and cooperation between the alliance parties. However, this depends on the commitment of the involved parties. In order to ensure the right level of commitment, the parties must ensure that the dialogue follows a pattern which both parties find practical and reliable. In addition, they must have a clear understanding of their roles and responsibilities in the alliance. Such roles and responsibilities must be discussed and agreed early in the course of the project in order to establish the correct framework for the alliance.

*For further information on this topic please contact Trym Landa at Simonsen Vogt Wiig Advokatfirma by telephone (+47 21 95 55 00) or email (tla@svw.no). The Simonsen Vogt Wiig Advokatfirma website can be accessed at www.svw.no.*

**Endnotes**

(1) The acronym NORSOK stands for Norsk Sokkels Konkurranseposisjon (ie, the Norwegian Continental Shelf's Competitive Position) and was introduced in 1994 to cut costs and improve competitiveness on the Norwegian Continental Shelf.