K&L GATES

OnStream

Highlighting developments and issues in the international oil and gas industry

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Welcome to the first edition of "OnStream", K&L Gates' new publication for the international oil and gas industry, highlighting industry developments and issues touching on the development of projects around the world's major hydrocarbon basins.

In this issue we cover the following topics:

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The Arab Spring: Insurance Coverage For Losses Arising From Political Change In The Middle East And North Africa

The wave of popular uprisings across the Middle East and North Africa - the "Arab Spring"- has been a catalyst for political reform in several countries. These developments are causing Oil & Gas companies with operations and other interests in the region to take a fresh look at their exposure to business risks associated with political discontinuities in these markets.

There are likely to be several insurance policies which may respond to provide policyholders with financial support during this challenging time, but assessing how various exposures could fall for coverage under different policies may not be a straight-forward task. Undertaking this assessment, and taking action to access responsive cover, should be a priority in the overall risk management response to events in the region, particularly as most insurance policies require that insurers are given timely notice of actual or potential losses.

Risk exposures for Oil & Gas policyholders in the region

Key exposures are likely to include:

- Loss or damage to physical assets due to strikes, riots and civil unrest, looting, sabotage and terrorism as well as the consequences of civil war in some territories
- Business interruption losses including consequential losses following damage to assets, absence of employees expatriated to their home countries, strikes by local workers and unavailability of pipelines, ports and transportation routes
- Supply chain difficulties
- Contractual risk, including contract frustration, repudiation or renegotiation, particularly where major natural resource contracts have been placed with governments in countries subject to regime change
- Government expropriation of assets
- Currency incontrovertibility and transfer risk, in addition to late payments impairing cash-flow

Continued on page 5

Offshore Environmental Damage Insurance: Not Just Window Dressing Any More

Neal Brendel and Michael Miguel of K&L Gates discuss how recent high profile offshore energy disasters and judicial scrutiny have affected insurance coverage for offshore pollution claims

The offshore exploration and production energy sector is particularly susceptible to natural and operational losses that are catastrophic in nature. Since the mid-1980s, the standard "energy package" insurance policy has provided separate coverage for damages caused by pollution, but it was a windfall for the insurance industry in as much as premiums were paid, but claims generally were not. Now, recent attention brought on by significant weather events and high profile accidents, improvements in technology and judicial scrutiny has resulted in insurers acknowledging and indemnifying offshore environmental damages.

For decades, the insurance industry has required strict proof that the oil detected in the ocean or sub-sea soils, even after a blowout, emanated from an assureds' covered well. The existence of naturally occurring seeps, and the high cost of technology required to prove the source of the oil, historically resulted in insurers escaping responsibility for policy payments for pollution. New affordable technology means that now an assured is able to satisfy the insurers' strict burden of establishing the source of pollution. The effectiveness of this new technology was made evident to anyone with an Internet connection in 2010 who watched with fascination as the Deepwater Horizon well in the Gulf of Mexico discharged oil on a continuous live feed.

The Deepwater Horizon accident had the effect of heightening public sensitivities globally to offshore pollution damage. In the United States, the timing of the disaster coincided with the maturing of coverage suits over claims arising from Hurricanes Ivan and Katrina. Decisions were issued compelling the first publicly known payments of full limits of liability by insurers for offshore pollution, including regulatory liabilities arising from offshore pollution, such as the Oil Pollution Act of 1990 (OPA '90). Indeed, 2010 was a pivotal year for assureds, as courts found that certain routinely asserted defenses to coverage would no longer insulate insurers from coverage liability or bad-faith claims.

The policy language

Since the mid-1980s, energy package policies have included, as part of "control of well" coverage, separate grants protecting the assured from damages arising from "seepage and pollution, cleanup and contamination." These provisions provide broad coverage for legal liabilities (including lease obligations) for the cost of remedial measures undertaken to address pollution, and specifically include the cost of or "any attempt at" removing, nullifying or cleaning up the pollution. These provisions are found in the standard form Energy Exploration and Development (EED) form coverage, issued for use in the London market and now found in some form in energy package policies throughout the world.

Many of the crucial terms in the seepage and pollution grants of coverage, such as what constitutes a "legal liability" or "remedial measure," or what constitutes an "attempt to nullify" pollution, are undefined. Under the usual rules of contract construction, these terms should be given their ordinary meaning or be construed in favor of the assured, since they are found in the insurer's standard-form agreement.

Historical insurer response

The traditional response from the insurance industry has been to deny coverage for offshore pollution claims, placing the onus on the assured to demonstrate that the offshore pollution originates from a covered well. The cost of proving the source of pollution, especially in a deepwater well, has historically been prohibitive. Recent technological innovations now make it easier, and less costly, to deploy remote operated vehicles that can identify the location of pollution and assist in tying it

Continued on page 6

EIA Study: Shale Gas Resources

Shale gas is being viewed as an increasingly important source of future energy, particularly in the US, and the Energy Information Agency ("EIA") sponsored study, 'World Shale Gas Resources: An Initial Assessment of 14 Regions Outside the United States', released on 5 April 2011, reported that the initial assessments of 48 shale gas basins in 32 countries suggested that, globally, there is an estimated 6,622 trillion cubic feet of shale gas available for use.

Shale gas, as the name suggests is natural gas produced from shale, as distinct from gas associated with oil, or gas captured in tight sands. Traditionally, shale has been seen as insufficiently permeable for commercial extraction however, recent technical advances have seen shale gas along with other unconventional plays such as coal seam methane become genuine commercial prospects.

The EIA study reports that it is expected that by 2035, 46 per cent of all natural gas production in the US will be shale gas. Other countries around the world are just beginning to discover their shale gas resources and the opportunities to use this relatively new source of energy.

Countries identified in the study as having significant shale gas resources included France, Poland, Turkey, Ukraine, South Africa, Morocco, Chile, Canada, Mexico, China, Australia, Libya, Algeria, Argentina and Brazil. The estimates given in the EIA study may be conservative, as the study did not include a number of countries which may have additional shale gas resources such as Russia and countries in the Middle East region. Neither did the study consider potential offshore resources.

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LSE-TMX Merger – A New Era In Fundraisings For Oil & Gas Companies?

In February 2011 London Stock Exchange Group plc (LSE) announced its proposed £4.3 billion merger with TMX Group Inc. (TMX), the operator of the Toronto Stock Exchange, in a deal that may have significant implications for the financing of natural resources companies in the years to come. The transaction remains subject to shareholder and regulatory approvals in both Canada and the UK and, assuming those approvals are forthcoming, is expected to close in the second half of 2011.

Commentators are divided on the reasons for and merits of the proposed merger, but there is overwhelming agreement that it is positive news for oil and gas and other natural resources companies. The merged group would constitute the world's largest exchange for natural resources and mining companies with more than 6,700 companies listed on its exchanges together having a combined market capital of £3.7 trillion.

The merged group would be joint-headquartered in London and Toronto and would operate six equities listing venues in Canada, the UK and Italy, catering to issuers of all types and sizes. TMX and LSE believe the merged group is well placed to become the primary listing venue for small and medium sized enterprises with LSE's AIM market and TMX's TSX Venture Exchange together comprising some 3,600 small to medium cap and early stage companies.

On announcing the merger Xavier Rolet, CEO of LSE and the intended CEO of the merged group said, *"We are creating the world's largest listings venue for the commodities, energy and natural resources sectors as well as a premium market for small, mid-sized and growth companies. This new international leader… will be strongly positioned to capitalise on growth opportunities in emerging markets and deliver them to our customers in North America, Europe and beyond."*

TMX, together with Canada's banking, legal and mining communities, have for years been promoting Toronto as a global centre for natural resources financing and LSE has itself long been recognised as a powerhouse in oil, gas and mining listings. The merged group is expected to offer unrivalled experience in dealing with natural resources companies and be the obvious place to look for investors interested in the sector.

The proposed merger has attracted a lot of media attention against a back drop of soaring commodity prices. The surge in oil, metal and agricultural commodity prices has greatly increased the value of the natural resources sector on global exchanges in recent years, with oil, gas and mining companies now accounting for more than 12.5% of the FTSE All-World Index, up from less than 6% in 2000.

Companies listed on the merged group's exchanges are expected to benefit from improved access to a deeper and more flexible pool of international capital. Dual listings are expected to become easier and more commonplace with companies listed in London benefiting from improved access to European and the Middle Eastern capital and companies listed in Canada benefiting from improved access to capital from North America.

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continued from page 1

The Arab Spring: Insurance Coverage For Losses Arising From Political Change In The Middle East And North Africa

Which insurance policies may respond?

Most energy companies carry a portfolio of insurance policies which may cover financial losses arising from one or more of these risks. Potentially responsive policies include:

Onshore/offshore property policies: These principally cover damage to physical assets. Business interruption coverage is usually blended in to provide cover for loss of revenue and other costs consequent to property damage. These policies may state that they are written on an "All Risks" basis, however certain risks may be excluded from coverage (such as political unrest, terrorism and war).

Contingent business interruption insurance: This can be included as an extension to the main policy or coverage can be provided by a stand-alone policy, and applies where the ability of the policyholder to trade is impaired by external considerations such as damage to third party property, loss of utilities, denial of access and political acts of local governments and regulators.

Property terrorism: Where available, this stand-alone coverage may be appropriate where terrorism risks are excluded from the main property policy. The definition of terrorism varies for each policy and insurers are likely to debate whether particular events qualify as acts of terrorism, especially where damage was caused by insurgents who are now represented by new governments.

Political risks insurance: These policies potentially respond where there has been some form of interference with an asset or an investment which is politically motivated. Coverage can include most of the risk exposures identified above.

Supply chain disruption insurance: This cover is designed to protect companies whose operations rely on critical supplies of goods or raw materials. Coverage can include loss of supplier, stoppage of supply or delay in delivery due to political risks, terrorism, strikes and other forms of civil unrest as well as transport difficulties.

Accessing cover

Insurance policies usually contain a number of pre-conditions to recovery. Key considerations when accessing cover include:

- Notification: A common feature of insurance policies is a requirement to give notice of actual or potential losses within a certain period of time. Prompt notification of claims is essential as failure to comply with the notification provisions of relevant policies may enable insurers to restrict or deny cover.
- Proof of loss: First party loss policies typically require the policyholder to submit a formal presentation of the claim and relevant underlying documentation (known as a Proof of Loss) within a certain time period following notification. Care needs to be taken to preserve documents and to document losses so as to substantiate the insurance claim.
- 72 hour occurrence clauses: First party loss policies covering war, riots and other forms of civil unrest normally contain an aggregating provision by which all losses occurring from these perils within a certain period of time (usually 72 hours) are treated as one loss or occurrence in applying the policy limits and deductibles. The wording of such clauses may require careful consideration when presenting claims to insurers.
- Waiting periods: Many policies also incorporate language which provides that certain aspects of coverage only become available after a defined period of time (or waiting period) has elapsed. The period varies for each policy and can range from a few days for business interruption cover to as long as 180 days for some political risk policies. Policyholders must take care to ensure that they observe other terms of the policy during the waiting period, such as "due diligence" clauses which require the insured to take all reasonable precautions to minimize a potential loss and to keep insurers informed.

In conclusion, policyholders are well advised to review the terms of any potentially applicable insurance policies as soon as possible if business has been impeded by recent events. If a claimable loss event occurs, a policyholder should devote sufficient resources, both internally and externally, to preserve their ability to advance a claim against relevant insurers.

For more information on the issues covered in this article, please contact Frank Thompson in K&L Gates' London office (frank.thompson@klgates.com). ■

continued from page 2

Offshore Environmental Damage Insurance: Not Just Window Dressing Any More

back to a well (remember that the location where pollution is found is often nowhere near a wellhead, since the point source of the pollution may be hundreds of feet below the ocean floor and the migrating oil seeks the path of least resistance to the surface).

Even after the assured proves the pollution originates from a covered well, the insurers often seek to impose further impediments to coverage. Their arguments take three generic forms:

(i) *"Indemnity policies cover only 'damages' not investigation or preventative activities."* An indemnity insurance policy is meant to cover damage, not the prevention of damage. As a result, the assured is not covered for efforts undertaken to identify or prevent the pollution before it causes damage. Using this argument, an insurer would agree to pay, for example, for a containment dome to capture oil seeping into the ocean from a well, but would not pay for any effort to intervene in any effort to control or stop the source of the contamination. Seeking to control the source of pollution through an "intervention well" would be categorised as "relief well" technology, which is exclusively covered elsewhere and is not pollution control. In contrast, an assured would argue that the policy covers its legal obligations with respect to the identified pollution, in whatever form those obligations are manifest. In other words, the legal obligation is not limited to simply responding to the pollution once it occurs, but also includes identifying and controlling the source of such pollution. Regulators would demand that the assured both minimizes the ongoing damage, for example, with a containment dome, and that the assured locate and stop the source of the pollution. Further support for the assureds' point of view can be found in policy language that specifically covers "efforts … to nullify" the pollution. Certainly source identification and mitigation would appear to fall within the plain meaning of such terms, although historically the insurers have contested such interpretations.

(ii) *"All you really are doing is simple plug and abandon activities."* An operator has an obligation, at the end of a lease, to plug and abandon (P&A) its wells. Insurers would argue that any effort to stop pollution from a well by intervening and plugging it to prevent ongoing pollution is a mere discharge of the assureds' lease-end obligations to P&A, and not related to pollution control. In contrast, assureds argue that a policy covering "remedial measures" would include efforts to intervene in an out-of-control well. If the insurer wished to exclude such activities, it was free to do so by plain and unambiguous policy language in its standard form.

(iii) *"We never intended to cover such activities."* Probably the most surprising response from insurers and underwriters has been the assertion that the EED form was never intended to cover P&A activities, relief wells, or to cover preventative measures. A plain reading of the policy would not support this conclusion.

Court rulings favouring the assured

In 2010, the United States Federal Court for the Western District of Louisiana considered many of these arguments and ruled resoundingly for the assured and in favour of coverage in *Taylor Energy Company LLC. v. Underwriters at Lloyd's (2010 WL 4553482 (W.D. La.))*. In Taylor, an offshore production facility, with 28 operating wells, was toppled and destroyed by wind and a sub-sea mudslide caused by Hurricane Ivan. The facility was deemed a total loss. The U.S. government issued orders requiring that the assured investigate the extent of the damage, control the source, and remedy the pollution entering the Gulf of Mexico. In addition, the operator was required to post a bond of several hundred million dollars to ensure compliance with the government directives.

Underwriters (over a period of years) acknowledged coverage and paid limits under every grant of coverage in the EED package, save the seepage and pollution coverage, where they denied coverage and asserted each of the three arguments set out above. On the issue of coverage, the Louisiana federal court decided that the disputed terms in the insuring agreement "are unambiguous and provide coverage," further stating that the insurers' interpretation of its own policy language was "strained and unsupported by the plain language of the policy." Specifically, the Court focused on the legal obligations of the assured set forth in the various governmental directives, which required the assured to take all necessary actions to "remove the discharge or to mitigate or prevent the threat of such discharge." Also of importance to the Court was the plain meaning of "remedial measures," where the Court adopted a common sense approach stating that "[t]he primary remedial measure or corrective action for seepage is to stop the seepage." Lastly, the Court refused to accept any

argument that underwriters had a good-faith basis for denying coverage, finding that "coverage is clearly provided by the Policy" and consequently allowed the assured's bad faith claim to stand. A settlement was reported to the Court one day after the opinion on coverage was issued (terms confidential). Consideration of these issues by the Louisiana federal court marks the first known instance where a court has found coverage and required payment under both seepage and pollution and OPA '90 coverage parts.

What Does This Mean?

The combined influence of recent favourable decisions for assureds, and more affordable source detection technology now mean that claims for pollution coverage in energy package policies have become a more viable avenue for asset recoveries in the unfortunate event of catastrophic loss – whether induced by nature or human events.

Warning: political risks excluded from coverage

A significant percentage of the world's oil and gas reserves are located in regions that can be characterised as unstable political environments. This instability raises the prospect of interruption or damage to offshore operations, which may result in pollution. Unfortunately, the standard EED wordings specifically excludes coverage for loss, damage or expense resulting from "war terrorist" activities, which include (inter alia) insurrection, rebellion, revolution, civil war, usurped power, or action by governmental authority, seizure or confiscation.

However, almost every insurer servicing the exploration and production sector offers to "complement" its energy package policies with some form of political risk cover. Alternatively, political risk insurance may be available through Export Credit Agencies (or ECA's), multilateral organisations and other commercial insurers. For complete protection, an assured should consider purchasing political risk insurance to supplement the energy package policy in situations where the assured's operations are located in a politically unstable region.

Neal Brendel

"The combined influence of recent favourable decisions for assureds, and more affordable source detection technology now mean that claims for pollution coverage in energy package policies have become a more viable avenue for asset recoveries in the unfortunate event of catastrophic loss – whether induced by nature or human events"

Michael Miguel

"Indeed, 2010 was a pivotal year for assureds, as courts found that certain routinely asserted defenses to coverage would no longer insulate insurers from coverage liability or bad-faith claims"

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Recent Developments

Middle East Oil Crisis - Fears grow, at the time of going to press, that the price of oil may rise to the previous high of $147 a barrel unless oil production in Libya by the rebels can be stabilised shortly. Libya is estimated to have lost more than three-quarters of its oil output as a result of the fighting.

Global Economic Forecast Down - International ratings agency, Fitch, has cut its global economic growth forecast for this year. This was substantially due to the 32% increase in crude oil prices between October 2010 and March 2011.

Surge in Japan's LNG imports expected - As Japan continues to battle against nuclear disaster, there are expectations of an increased level of liquefied natural gas imports into the country to compensate for the longer term loss of nuclear power. In 2009, Japan's electricity supply was powered 26% by LNG but also 27% by nuclear.

Statoil suspend North Sea projects - Statoil, the Norwegian energy company, has said it will "pause and reflect" before deciding whether to continue developing two North Sea oil projects (on the Mariner and Bressay fields) due to come on-stream from 2016/17 in light of the UK's most recent budget announcement to impose a £2bn 'windfall tax' on oil companies. Other UK producers are also reviewing their investment plans, with Centrica for example warning that it may prune its planned investment in UK North Sea oil fields with the suggestion that it will not re-open its Morecambe Bay gas field after a recent 4 week closure for maintenance. Statoil is also in the news with the recent discovery of significant oil reserves on the North Sea Krafla prospect. Preliminary reports indicate the size of the discovery to be between 12.5 and 56.5 million barrels of recoverable oil equivalent.

BHP Bilton leave the Falklands - BHP Bilton is to transfer its interest in the northern licences in the Falklands to Falkland Oil & Gas. Increased activity is now expected in the region.

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New Professional

Welcome

Frank Thompson has recently joined the insurance coverage group at K&L Gates LLP in London from Herbert Smith LLP. His practice is focused on assisting policyholders in accessing the proceeds of their insurance policies. He regularly conducts policy wording reviews to assess scope of coverage and fitness for purpose, in addition to advising on notifications/claims submissions and disputed claims, in the context of various types of insurance, including Construction All Risks, Delay in Start Up and Operational Property policies in addition to Political Risks and Property Terrorism covers.

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