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Loss of Production Income

Fines, penalties, liquidated damages & service level agreements

The market standard Loss of Production Income ("LOPI") insurance cover in respect of offshore Business Interruption risks requires careful consideration when policyholders are entering into oil & gas supply contracts.

Introduction

In 2005 London based underwriting body, the Joint Rig Committee, introduced a standard offshore Business Interruption policy form, the *Loss of Production Income Wording – Production Loss Sustained JR 2005/003A*. In 2020 the Joint Rig Committee released an amended version of the form, *JR2020-025*.

Both versions of the policy form expressly exclude cover for *"(f)ines, liquidated damages, penalties or damage for breach of contract or for late or non-completion of orders or for penalties of whatever nature."*

Force majeure provisions within oil & gas supply contracts will often provide protection to the supplier should a failure to supply be due to events outside of their control. Nonetheless, in view of the aforementioned exclusion in the LOPI policy wordings, such force majeure provisions require careful consideration in relation to the Business Interruption insurance contract. For example, in the absence of effective force majeure provisions the supplier could be faced with penalties in the event of a failure to supply due to damage to their infrastructure.

Furthermore, in relation to Business Interruption insurance and the LOPI policy wordings, careful consideration is also required in relation to any price adjustment mechanisms contained within oil & gas supply contracts.

Fines, penalties & liquidated damages

A distinction can be made between fines or damages for breach of contract (often referred to as fines and penalties) and liquidated damages. Liquidated damages differ from fines and penalties in that an amount is agreed upon beforehand, within the contract, as being a reasonable estimate of the loss, for example a loss caused by a delay in supply.

In respect of the LOPI policy wordings, it will be noted that fines, penalties and liquidated damages are all expressly excluded. Whilst such fines, penalties and liquidated damages may be a consequence of a fortuitous incident, same are

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not automatically covered under Business Interruption insurance contracts as they are *in addition to* the loss of profit and cannot be measured against a reduction in turnover.

Accordingly, if owners of offshore infrastructure are purchasing Business Interruption cover, it will be important to carefully assess their intended oil & gas supply contract terminology to establish if any exposures exist to fines, penalties and liquidated damages in the event of a failure to supply due to fortuitous physical damage or a well out of control. Insurance coverage for any such exposures would require an express amendment to the LOPI policy wording.

Service level agreements

Contracts for the regular and continued supply of a product throughout the duration of a long term contract can include provision for price adjustments to reflect performance against specified criteria, often referred to as service level agreements.

Accordingly, in relation to oil & gas supply contracts, the LOPI policyholder will need to be mindful of any exposure to negative price adjustments during the period of a shortfall in production and also any such exposure that may exist for a period of time beyond the resumption of full production.

A negative price adjustment, during the period of a shortfall in production, could take the form of a reduced sale price for the hydrocarbons there were supplied during the period production was interfered with. This represents a further exposure to the LOPI policyholder in addition to the loss associated with the reduction in volume experienced during the period of interference. If coverage is required for any such additional exposure, same could be achieved in the form of an upwards adjustment to the unit price declared to the LOPI underwriters at inception. Such uplifted unit price being applied to the shortfall in volume experienced during the policy recovery period. The rationale behind any such uplift in unit price being declared to underwriters prior to inception.

Any contractual exposure to a negative price adjustment, that affects turnover beyond the defined policy recovery period, would require express policy terminology to be negotiated with underwriters subscribing to the LOPI policy form. For example, in certain instances, the contractually imposed reduced hydrocarbon sale price may continue for a period after full production has been restored. In this respect, in accordance with the standard LOPI policy wordings, coverage remains in force until production is restored to the pre-incident condition. Therefore, any longer term negative contractual price adjustment, caused by an insured peril and continuing beyond restoration of full production, would require specific negotiations with underwriters.

Policyholders should remain mindful of the fact that service level agreements can also provide for favourable upwards adjustments in commodity prices. Accordingly, when arriving at unit prices to be declared to underwriters, prospective LOPI policyholders, considering coverage based upon gross profit for insurance purposes, may wish to take into account any mechanism within their hydrocarbon supply contracts that allows for a favourable upwards adjustment to the commodity price during the maximum policy recovery period. When considering the potential for a favourable upwards adjustment in the commodity price during the maximum policy recovery period, it will be important for the prospective policyholder to consider the fact that the accidental physical loss or physical damage (or well out of control), triggering the Business Interruption claim, may come into existence on the last day of the policy period.

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Customer Risk

With regards to oil & gas supply contracts, the LOPI policyholder may have a dependence on trading with certain key customers. Accordingly, a potential exposure exists if such customers sustain significant physical damage to their own infrastructure, especially as force majeure provisions within the supply contracts may afford the customer with protection in certain circumstances.

Subject to appropriate declarations, the LOPI policy forms provide “Dependency Premises” coverage should production at the “Insured’s Premises” be dependent upon another party’s property. However, very specific negotiations would no doubt be required with underwriters, should the policyholder wish to seek coverage in respect of any customer risk exposures.

Furthermore, should a major incident impact upon a customer, the LOPI policyholder may consider that they could readily address the risk by supplying to alternative markets rather than seeking an extension to their policy form.

August 2022

About Trident Oil & Gas Claims Consultants Limited

Trident specialise in providing insurance coverage advice to policyholders from within the oil & gas industry. In particular, we offer advice and representation during the preparation, negotiation and settlement of insurance claims. Our experience encompasses exploration, construction and operational risks. For full and further details please visit our website www.tridentclaims.co.uk or contact us directly.

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