LEGAL

Oil and gas disputes

Many legal disputes in Latin America are symptomatic of the bursting of the oil bubble
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Ted Rhodes, Office Managing Partner – CMS Rio de Janeiro and _Phillip Ashley_, Energy Disputes Partner – CMS London, look at the rise of oil and gas disputes in Latin America.

The dramatic fall in oil prices since the start of last year came at a time of rapidly rising production costs across Latin America, and has put oil companies and their suppliers under considerable financial stress. These conditions have strained relationships between operators and contractors, and between joint venture partners, often culminating in disputes or a forcible rebalancing of these relationships.

Shifting relationships

In Brazil and Mexico, Petrobras and Pemex have been vigorously renegotiating with their contractors, terminating vessel and drilling rig charters and slashing day rates. In many cases, these contractual adjustments have been made consensually, with contractors realising that the market dynamics have changed, and accepting lower rates in return for maintaining or extending contract terms.

These state-controlled oil companies have long taken advantage of their (quasi) monopoly positions to insist on flexible contracts in their favour. Contractors have often been reluctant to challenge them in court or arbitration, given their control of those markets. However, at least one arbitration has been commenced against Petrobras by Ensco, when the charter of its *DS-5* drilling rig was terminated for alleged kickbacks. While the Mexican market is opening up to international competition, Petrobras is currently selling off assets to shore up its financial position. As a result, we expect to see more standard international contracting practices and an increase in disputes as these markets diversify.

Other operators are increasingly insisting on their strict legal rights, enforcing liquidated damages clauses and scrutinising variation orders, to minimise value leakage through delays and cost overruns. In some cases, defaults are being used as leverage to renegotiate contract terms. Where contractual provisions are being adjusted, there is a tendency to align incentives between the contractors and their clients, linking remuneration more closely with performance and even, in some cases, with the oil price or the broader field economics.

In the wake of the *Transocean v Providence* case, operators are reconsidering what responsibility their contractors should assume in case of downtime of their drilling rigs or vessels. In this situation, the costs of lost production and unused spread can be very significant. But in tighter markets, contractors have sought to exclude any liability for these losses, and even to ensure their continued payment of so-called 'repair rates'. In the *Transocean v Providence* case, the court refused to apply the repair rate where the contractor was to blame for the downtime. It also left doubts as to whether standard consequential loss exclusion clauses effectively exclude claims for spread costs and other losses. The emerging consensus (amongst operators at least) seems to be that contractors should assume more risk in relation to their downtime, and a number of contract renegotiations are moving in this direction.

Burst bubble

Other disputes in Latin America are more symptomatic of the bursting of the oil bubble. In the depths of this downturn, the hype of just a few years ago seems like a distant memory. But in the wake of the 2008 financial crisis, emerging markets and commodities were billed as every investor's salvation, and as Chinese demand and instability in the Middle East drove Brent crude from \$40/b in 2009 to almost \$130/b in 2011, banks, private equity, hedge funds and retail investors were all desperate to cash in. Huge sums of money were flowing to finance projects that were little more than ambitious ideas.

Brazil was the poster child of this boom, and a prime example of the resulting bust. The high leverage of Eike Batista's oil company OGX and his oil services provider OSX ensured that when production levels disappointed, financing was pulled rapidly, cash flow dried up, and the group's lenders and bondholders stepped in to take-over assets. This has triggered a number of disputes between the two companies, with their suppliers and creditors, and has seen both companies enter bankruptcy protection proceedings.

Another example of this trend is the Sete Brasil debacle. Sete was created in 2010 to facilitate the financing of deepwater drilling rigs for Petrobras' ambitious pre-salt exploration programme (see p30). This audacious project attracted funding from Brazil's leading banks and pension funds, and investments from international shareholders, to build and operate 29 latest generation rigs, to be fabricated at five Brazilian shipyards. This was to be the biggest rig-construction project of all time, to be completed in shipyards that had never built any drilling rigs and, in some cases, were in the process of construction themselves. Inevitably, there would have been delays, but in the wake of the oil price collapse and allegations of corruption in the contracting of shipyards, long-term financing from the Brazilian Development Bank (BNDES) was withdrawn, funds dried up and Petrobras reconsidered whether it required these rigs at relatively high rates, when it was slashing capital expenditure and there was a surplus of rigs available internationally at knock-down prices.

Sete has since been forced into bankruptcy protection and has yet to agree a revised deal with Petrobras. There are potential claims between Sete and Petrobras, and with the various shipyards involved. Sete shareholder EIG has recently launched proceedings against both Petrobras and the shipyards, alleging that it was fraudulently induced to invest in the project. Sete's outright bankruptcy is still a distinct possibility, with debts of almost R$20bn (approx. $6bn).

Venezuela's nationalisation hangover

Venezuela's current difficulties are related to the commodities bubble in a different way. The sharp rise in oil prices from about 2007 encouraged resource nationalism amongst a number of leftist governments, including in Argentina, Bolivia, Ecuador and Brazil. Nowhere was this trend more pronounced than in Venezuela, which was in the grip of Hugo Chavez's Bolivarian revolution.

Venezuela sought to impose new terms upon the international oil companies operating in the country, which culminated in the nationalisation of assets held by ExxonMobil and ConocoPhillips. State oil company, PDVSA, was increasingly treated as a cash cow and used to manage the government's social programmes, while it delayed payments to international service providers. This eventually led to the nationalisation of drilling rigs, gas injection facilities and other assets of at least 60 contractors.

ExxonMobil has recently been awarded $1.6bn for the expropriation of its Cerro Negro and La Ceiba projects in an arbitration decision by the International Centre for Settlement of Investment Disputes (ICSID). ConocoPhillips brought the largest claim to date against Venezuela, seeking $30bn in compensation. It has received an initial decision in its favour, but its ICSID case is still ongoing, including in respect of quantum of damages.

The government's populist economic policies have starved the Venezuelan oil industry of the investment it needs. Despite boasting the world's largest reserves, this under-investment and mismanagement has resulted in rapidly decreasing production, from almost 2.5mn b/d in 2011 to less than 2.1mn b/d in mid-2016. In a country that is dependent on oil for 96% of its export revenues, this production decline and the steep drop in oil prices has brought Venezuela to the brink of economic collapse and triggered a political crisis (see p14). In this context, the flow of disputes is likely to continue and there is an increased risk of *force majeure* claims, particularly resulting from social unrest and strikes.

Fraught partnerships

Relationships between oil companies have also been put under strain by the recent volatility and sharp drop in oil prices. There has been a marked increase in joint venture disputes worldwide, accentuated by the entry of smaller and financially weaker independent oil companies. Latin America has not been immune from this trend. Since around 2009, Brazil's oil industry has gone from being dominated by a small number of oil majors, to counting on the participation of an increasing number of smaller Brazilian independents and Latin American-focused multinationals.

Karoon Gas has recently issued a default notice to its Canadian co-venturer, Pacific Exploration & Production, for delays in meeting cash calls. The problem is that partners who are under pressure to preserve cash may be tempted to delay payments and leave the operator with the burden of commitments undertaken on behalf of the joint venture. Where a partner has limited assets in a country, they may wait for drilling results and not pay if the well is unsuccessful. Joint operating agreements do not always provide sufficient protection against this risk, particularly if the default provisions require non-defaulting parties to buy-out at a specified discount. In a volatile market, the value of an interest can be hard to determine, and the non-defaulting parties may not be able to bear the additional costs attributable to the defaulting party.

Volatility can also be a source of disputes in mergers and acquisitions (M&A) transactions. That would seem to be the cause of a dispute between Interoil and Trayectoria in Colombia, which related to a sale of Interoil's licence interests for $2mn, plus the assumption of exploration commitments totalling $26mn. This was agreed in early 2013 when Brent crude prices were around $110/b, but Trayectoria settled an arbitration and bought itself out of this undertaking for $4mn in early 2015 when the oil price was around half that level.

A new normal?

Commercial disputes are inevitable in a complex, high-value and cyclical industry like oil and gas. The surprise is rather that they have been so rare for so long, but that is largely explained by the historical dominance of state-controlled quasi-monopolies and a relatively small number of multinational oil majors and prime contractors. These market participants had many interactions around the world and would often resolve conflicts commercially, to preserve these important global relationships.

Elements of this dynamic continue, but new market entrants have shaken up this cosy club and begun to change the culture. Even when contracting with more established players, agreements are often long-term and can be assigned or companies can be taken over. Oil prices can rise or fall, sometimes rapidly, and governments come and go. So now, more than ever, it is important to anticipate these variables and associated risks, and to conclude agreements that can flex for whatever the future may throw at them. That is the best way to mitigate the risk and potential cost of disputes. ●