Perception of contractual risk allocation in the oil and
gas contracts in Malaysia

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Abstract: Oil and gas projects are risky undertakings, which may cause severe
damages to property and the environment, not to mention, personal injury and
death to personnel. Contractual provision such as an indemnity and mutual
hold harmless clause is used as a tool in allocating the risks. However, as a
consequence of the private and government litigation arising from the Macondo
oil spill in the Gulf of Mexico in 2010, evidence suggests that operators
generally are seeking to modify the established approach to liability allocation
through individual contract negotiations with contractors. This scenario has
significant and potentially adverse financial implications for the contractors and
for the long-term sustainability of the industry. An empirical study was
conducted to investigate the issues and problems with regard to contractual risk
allocation in oilfield service contracts in Malaysia. The methodology employed
in this paper will essentially be a combination of literature review and
qualitative study.

Keywords: contract law; oil and gas law; oilfield service contracts; risk
allocation; empirical study; unfair contract terms; operator; contractor; standard
form contracts; Macondo case; Malaysia.

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1 Introduction

An empirical study was conducted in Malaysia during the period of February and April 2014. Seven case studies were taken and the purpose was to elicit the opinion of key players in the oil and gas industry on the issue of risk allocation. The empirical study also sought to ascertain their attitudes towards the current trends of indemnity clauses under oilfield service contracts in Malaysia as well as their perception of how to address this problem (Mohammad, 2008, p.29). The present empirical study was conducted to support a previous empirical study that was done in 2008. In the previous study, a total of three case studies were conducted in different companies in Malaysia in respect of their experiences and perceptions about specific issues on procurement in the oil and gas industry in general (Mohammad, 2008). The findings indicate that there is a strong objection in the Malaysian oil and gas industry to the one-way adversarial style of operator-contractor relationship and the way the contractor is being forced to be on the receiving end when it comes to price fluctuation, overall risks and increased workloads (Zulhafiz, 2017b). Even though the previous study is not designed specifically to deal with the issue of contractual risk allocation provision, there was a clear expression of dissatisfaction by the contractors pertaining to the unequal bargaining and the dominant position held by the operator in negotiating the contractual terms.

There are three main questions to be addressed in this study. The first question is that, considering the relationship between operators and contractors, to what extent do both parties exercise free will and have equality of bargaining power in negotiating the contractual terms (Panzera and Rossi, 2011). The second question is whether the risk allocation provisions and the indemnity clauses are fair to both parties? The third question is, to what extent does the insurer provide coverage in respect of the risks which have been indemnified by the parties? In addressing these questions, the discussion will be based on the legal theories, such as the concept of contractual risk allocation and indemnity, the theory of freedom of contract, the doctrine of inequality of bargaining power and fairness (Berends, 2007). These legal theories informed the construction of the interview questions. The author also used these theories as a tool for data analysis.

2 Research design

The research method chosen for this study was semi-structured interviews with oilfield contractors and operators. The semi-structured interviews were conducted with five companies representing the contractor, as well as, one company and one legal firm representing the operator. The respondents were

1 the heads or managers of the participating companies’ legal departments
2 contract managers
3 procurement managers
4 principal technical managers
5 head project managers of the companies and finally
6 a lawyer who used to litigate for operators in court.
The contractors were selected from three different ranges of size i.e., big, medium and small companies. The respondents were chosen due to their prominence and experience in contractual matters. The big companies are usually equipped with comprehensive legal and contract management departments. The medium size company might have a legal department, but not necessarily a contract management department since contractual matters are normally handled by the engineer who is also the principal technical manager. On the other hand, most of the small companies do not have a legal department or a contract department. Therefore, a procurement manager who comes from a technical background would handle contractual matters. Ten respondents were interviewed representing the operator and the contractor. The next section will present the findings on how operators and contractors perceive the distribution of contractual risk during contract formation.

2.1 Description of the case studies

In order to provide a better understanding with the number of respondents involved in this study, the summary of the respondents is tabulated as follows:

<table>
<thead>
<tr>
<th>Categories of units of analysis</th>
<th>No. Units of analysis</th>
<th>No. of respondents</th>
<th>Designation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contractor</td>
<td>1 Contractor A</td>
<td>2</td>
<td>Legal Head + Contract Manager</td>
</tr>
<tr>
<td></td>
<td>2 Contractor B</td>
<td>2</td>
<td>Legal Manager + Contract Manager</td>
</tr>
<tr>
<td></td>
<td>3 Contractor C</td>
<td>2</td>
<td>Legal Manager + Principal Technical</td>
</tr>
<tr>
<td></td>
<td>4 Contractor D</td>
<td>1</td>
<td>Procurement Manager</td>
</tr>
<tr>
<td></td>
<td>5 Contractor E</td>
<td>1</td>
<td>Procurement Manager</td>
</tr>
<tr>
<td>Operator</td>
<td>6 Operator A</td>
<td>1</td>
<td>Head Project</td>
</tr>
<tr>
<td></td>
<td>7 Operator B</td>
<td>0</td>
<td>–</td>
</tr>
<tr>
<td></td>
<td>8 Operator C</td>
<td>0</td>
<td>–</td>
</tr>
<tr>
<td></td>
<td>9 Legal firm Z</td>
<td>1</td>
<td>Legal Practitioner</td>
</tr>
<tr>
<td>Total number of respondents</td>
<td>10</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In this study, 10 respondents were interviewed representing the operator and the oilfield service contractors. Two respondents each from Contractors A, B, and C. One respondent each from Contractors D and E, Operator A, and Legal Firm Z. It is important to note that Operators B and C were reluctant and refused to be interviewed even though they have been personally invited by the researcher to participate in this research during the Offshore Technology Conference Asia held in Kuala Lumpur from 25th to 28th of March 2014. Although Operators B and C were not interviewed, the researcher was provided with the draft of their oilfield service contracts by the contractors.

2.2 Perception of the contractual formation process

This section presents the evidence on how the respondents perceive contractual negotiation during the contract formation process and also whether there is equal bargaining between operators and contractors. The case study was undertaken with the
aim of primarily investigating the extent of the contractual formation process that leads to
the distribution of risk allocation provision in oilfield service contracts (Pelster, 2013). Competitive tendering is a standard practice for operators to obtain information on the
optimal price in the contracting market (Robinson et al., 1988). Tendering is part of the
contract formation process. ‘Formation’ in this context means the process by which a
contract comes into being (Anderson et al., 1999). Usually, the operator would invite
several contractors to bid for the oilfield service job in accordance with detailed technical
specifications outlined in the bid invitation (Anderson et al., 1999), and subsequently will
issue a package of documentation including a blank form tender and the instruction to
tenderers. This package is called invitation to tender (ITT) or sometimes invitation to bid
(ITB). Negotiation of the contractual terms is crucial before the operator accepts one of
the bids and concludes the contract, as it enables the parties to identify one or more
incompatibilities between them and work to find a mutually acceptable solution (Hooker,
2010). Generally, standard forms of contract are not used for major oil and gas projects;
in almost all cases stand-alone bespoke contracts are used by the major oil companies
which bear little resemblance to the well-established standard forms except perhaps the
international FIDIC\(^1\) contract general conditions, from which a lot of bespoke
construction contracts are derived (Moomjian, 2012; Zulhafiz, 2015a). Most major oil
companies, large independents and national oil companies have developed their own suite
of contract forms (Moomjian, 2012; Zulhafiz, 2015a).

Most of the oilfield service contracts are based on one standard model form or
another and they tend to be similar in basic content with a few significant modifications
depending on the particular commercial activities involved (Hewitt, 2010). The operators
will often keep their own database of model form of contracts and use them as a
foundation in contract negotiations (Hewitt, 2010). This practice apparently saves the
parties time and transaction costs and is more convenient as they are working on the
model form of contracts with which they are already familiar (Edwards, 1995). The
contracts proposed by operators are subject to qualification by contractors that tender for
the work, resulting in negotiated contracts (Thorpe, 2008). The most important single
factor in any contract negotiation is the balance of bargaining power (Cameron, 2012).
The inequality of bargaining power during contractual negotiation can create contractual
unfairness between the parties. The dominant position of oil companies or the operators
relative to many contractors in the oil and gas industry is such that they may assume that
they can impose whatever conditions they wish (Kinsella, 1994). During the contract
negotiation process, there is a high possibility of inequality in bargaining power between
the operators and contractors, especially when there is ‘imposition of will by a dominant
party on a party with inferior economic bargaining power, who is being unfairly coerced
into indemnifying the dominant party, stating that the result will rest on the relative
bargaining power of the parties’ (Thorpe, 2008). Based on the findings of the case
studies, all respondents agreed that the operators hold a dominant position during the
contractual negotiation process. One of the respondents claimed that this scenario
occurred because of the contractors’ desperation for jobs.

Historically in the upstream industry, the party holding great bargaining power has
used their power to impose its preferred terms on the weaker party (Thorpe, 2008).
The party with a better bargaining position such as the operators will be able to use their
position to gain more favourable contract terms (Franklin, 2005). However, the
contractors might still sign an imbalanced agreement in order to secure a job even though
they will be subject to unacceptable risk. In fact, some of the contractors risk double
jeopardy as any extraordinary risks will not be accepted by subcontractors and will be passed down in the usual way from the operator to the contractor but not then passed on in the sub-contract (Franklin, 2005). In this situation, the contractor is exposed to both his own contractual risk and the subcontractor’s risk (Franklin, 2005). Generally, the operators’ statutory duties pertaining to the award of contracts give theoretical power to the contracting parties in order to ensure fair, open and competitive tendering practices; however, only a brave contractor would challenge an operator with whom he aspires to work in the future (Beale, 1978). Here, the inferior party may well find that he is given no opportunity to negotiate the one-sided terms prior to the conclusion of the contract, but that he should ‘take it or leave it’ (Beale, 1978). This is a problem “in so-called negotiated contracts if the stronger party chooses to dictate to the other” (Macaulay, 1974). The stronger party may use his power by declining to enter any contract at all (Gordon et al., 2011).

2.3 Perception of risk allocation and indemnity clauses

Semi-structured interviews were conducted to identify the perception of risk allocation from the people in the industry and to discover their views on its current practice in Malaysia. In general, ranges of risk allocation clauses are commonly seen in contracts used in the oil and gas industry including indemnity and hold harmless clauses, clauses excluding liability for ‘consequential losses’ and clauses limiting overall liability (Edwards, 1995). The actual sharing of risk, indemnities and provisions for supporting insurances will be determined by the wording of the relevant contract documents (Edwards, 1995). In fact, many contracts are non-standard or they are standard form contracts which are made non-standard by additional clauses. Non-standard contracts transfer more risk to the tenderer (Cameron, 2012). It is important to note that subsequent to the Macondo oil spill in the Gulf of Mexico in 2010, there was an attempt by operators to depart from the established standard form contracts and shift greater risk to the contractor in the event of a catastrophe (Moomjian, 2012). Post Macondo operators are now less willing to deviate from their pro forma contracts and this creates a ‘take it or leave it’ situation (Franklin, 2005). Even before the Macondo incident, some contractors claimed that they were ‘required to take on onerous responsibilities without appropriate margins to absorb the consequences of the associated risks’ (Franklin, 2005). Many contractors consider such non-negotiable contracts to be problematic, primarily because they often contain onerous provisions in important areas such as the allocation of risk and this can create significant risk exposure (Zulhafiz, 2017c). As a result, at the conclusion of the contracts, the contractors will end up swallowing greater risk and liabilities (Edwards, 1995).

In distributing the risk between the operator and contractor, one of the respondents claimed that contractors were usually at the losing end and expressed their dissatisfaction at being made to indemnify the operators’ negligence. The respondent also claimed that indemnity clauses were one-sided and that almost all of the liability in respect of indemnity clauses was placed on contractors. It could be argued that the best commercial policy would place responsibility for risk on the party best able to manage it e.g., the party with the relevant insurance coverage (Abrahamson, 1984). Insuring or contractually transferring risk to the insurer and allowing the premium to settle any charges to the other party could mitigate risk exposure and in fact, is the most economically beneficial as well as a practical way for risk to be dealt with BP Annual Report and Accounts (2007).
Insurance is used by the indemnitor as a risk cushion in a situation when he is responsible for his own employees and equipment. The insurance, in fact, is the underlying driver in this case rather than an ancillary tool for risk management. This is particularly natural for super-majors, who attempt to self-insure and minimise transaction costs (Edwards, 1995). But this reason is not applicable to some contractors, as they cannot afford self-insurance.

It is argued that the practicalities of risk allocation are limited by certain basic requirements for those to whom risk is being transferred such as ability to undertake a hazardous task, willingness to take the risk, financial capability if the risk event occurs, continued existence and adequate finance during the period of liability (Edwards, 1995; Wamboye, 2009). It is also argued that, ideally, the responsibility for indemnifying the consequences of a risk event resulting from the activities of one of the contracting parties should rest with the party who has control over that risk (Köksal, 2011). The operator is always in the best position to control the risk and this was confirmed by the respondent. The respondent also confirmed that both quantified risk and qualitative risk, including indemnity, would be transferred to contractors. He also contended that it is the responsibility of contractors to understand and convert the risk into a monetary value. Therefore, the contractor is inserted into a position where he has to absorb the risk and cost that risk into the price. However, it is difficult for contractors to calculate and set an ideal price for their services after absorbing the risk. Due to the highly competitive nature of the bidding process, the contractor faces a dilemma when setting the price. The contractor is either afraid of not getting the job if the price he sets is too high after converting the risk into a monetary value. Or he fears exposure to financial problems if the price he sets is too low.

It is true that a contract is an equilibrium between controllable and uncontrollable risks with the price deemed appropriate to undertake the work (Hartman, 1993; Jergeas and Hartman, 1996; Zack Jr., 1996). However, it is said that the main reason for the increase in overall costs is due to the usage of disclaimer clauses in allocating risk such as indemnity clauses (Jergeas and Hartman, 1994). This is because once the risk is transferred to the contractor and “the contractor has no means by which to control the occurrence or outcome of the risk, the contractor must either insure against it or add a contingency to the bid price” (Becker, 1993; Robert, 1997; Tenah, 2000). The cost of transferring risk to the contractor through such clauses presents a few hidden costs such as “restricted bid competition, increased potential for claims and disputes and above all, more adversarial owner–contractor relationships” (Cattelan, 2009). One of the respondents, who is a practising lawyer and used to litigate on behalf of an operator, shared her perspective on this issue. She claimed that when the contractors signed the contract, the contractors were fully aware of those liabilities that they will be carrying on. She said that it is the contractors’ obligation to get protection for those liabilities by way of insurance. Plus, the parties are able to practice contractual freedom. She also added that that matter should not be an issue unless it involves fairness in which such allegation may be proven by a separate cause of action and proper hearing in court.

It is true that as a matter of contractual freedom, the parties may freely decide the terms of the contract as they wish including the risk allocation provisions (Franklin, 2005). However, this particular respondent might not be aware of the actual situation in the industry during the contract formation process. For example, if there is inequality of bargaining power between the parties, then contractual freedom has not been exercised properly. As a result, the contract becomes one-sided and an unfair risk allocation has
taken place. The contractors are actually aware of the situation, but they are not in a position to change or qualify any of the terms. Nor are they given the opportunity to discuss or negotiate on the allocation of risk. There are circumstances, however – possibly owing to the self-insurance of certain risks – where one party will attempt to pass additional risks on to the other (Franklin, 2005). This may require the contractor to indemnify the operator for the operator’s negligence caused by the operator’s employees and damage to the operator’s property, or vice versa. This would represent an uninsurable risk to the contractor and the adjustment severely undermines the knock-for-knock indemnity regime and may also give rise to the possibility of increased costs as the contractor attempts to insure a risk in which it does not have a true insurable interest (Zulhafiz, 2017a).

Moreover, from the contractor’s point of view, the risk is not one which can be passed down to subcontractors. Again, parties who seek protection from the other party’s negligence in an adjusted knock-for-knock regime similarly undermine the benefits of the concept since they, the indemnifying party, will, in any event, be obligated to secure additional insurance to cover the consequences of their negligence to the other party’s employees or property. Moreover, it is likely that the existence of negligence may first have to be proved in the courts for an indemnity to operate, which defeats one of the primary objectives of the knock-for-knock regime (Franklin, 2005). In the same vein, a contractor will often seek to limit its liability for third party risks arising out of the agreement to the extent that this exceeds the limit of its third-party insurance (Zulhafiz, 2015b). This is consistent with an overall desire to cap risks over which it has little or no control, including the catastrophic risks associated with offshore exploitation. For example, fire, explosion, blowout (underground and surface) and pollution emanating from the reservoir. Without liability caps, the contractor will have to bear what are normally uninsured risks which may well be disproportionate to the size, nature and financial return of the contract. However, the *quid pro quo* for appropriate protection by the operator is that the contractor should be prepared to insure the operator. It is not reasonable to expect limitation of, and/or indemnity from, catastrophic and third party risks that the contractor’s own insurance covers. Contractors should be prepared to be open about the scope and terms of their insurance cover as well as other material information about the size and resources of the company and, where applicable, parent and group company structure (Sprcic et al., 2008).

In order to combat this problem, some of the respondents suggested that fairness could be achieved by legal intervention where the legislator passes a law to protect contractors. Another respondent suggested that it should be an anti-indemnity law. One of the respondents shared his views and he said that the relevant authority should issue guidelines in order to address this problem. Therefore, based on the findings from the semi-structured interviews with the respondents, it could be argued that operators have a dominant position over contractors and are in a better position during a contractual negotiation in Malaysia. Due to the lesser bargaining power, contractors are given less opportunities to modify the terms and conditions in order to make them fairer. However, as discussed above, despite the unfair terms and conditions, contractors end up agreeing to them in order to secure present and future jobs. Moreover, contractors are exposed to the risk without being covered by insurance. This situation is regarded as a serious problem because it may lead to great financial losses to contractors.
3 Discussion and conclusion

It is important to note that there are some limitations in this study. When the empirical study was conducted as part of the research, the author encountered certain problems which could have negatively affected the outcome. The research required feedback from several parties, particularly from the oil companies (i.e., the operators) and the contractors. Feedback from various sources is important because it helps the research to avoid reaching a conclusion based on bias. However, some operators were quite reluctant to cooperate due to several factors, for example, time constraints or for confidentiality reasons. Despite the operators’ reluctance, the researcher managed to interview a professional from other relevant departments in the oil company, as well as legal counsel who held litigation experience acting for operators. The researcher also managed to obtain three samples of oilfield service contracts drafted by three operators. These samples were used in the study. Therefore, the analysis was based on 10 completed interview responses and the three samples of oilfield service contracts. However, it is important to note that the analysis of the contracts is not discussed in this paper.

Based on the empirical study conducted, this research argues that there is unequal bargaining power between operators and contractors in the Malaysian oil and gas industry. This inequality of bargaining power leads to imbalanced risk allocation and unfair indemnity hold harmless clauses in oilfield service contracts. In Malaysia, the absence of a law to regulate imbalanced risk allocation and unfair indemnity and hold harmless clauses in oilfield service contracts should be perceived as a serious problem because it leads to the problem of inequality of bargaining power resulting from the dominant position of the operators over the contractors. To date, there is no statutory restriction on contractual provisions purporting to exclude, limit or indemnify one or both of the parties in relation to liability and indemnity. Generally, contract law in Malaysia is governed by the Contract Act 1950. However, section 77 of the Contract Act 1950 merely discusses the meaning of ‘contract of indemnity’. Meanwhile, section 78 of the Contract Act 1950 merely talks about “right of indemnity holder when sued”. Based on the case analysis in Malaysia, the courts have not addressed this problem. Furthermore, the judicial position on the doctrine of unconscionability and inequality of bargaining power remains unclear in Malaysia since the Court of Appeal has taken inconsistent views in the cases of Saad Marwi, and American International Assurance Co Ltd. As a result of this gap in the law, the result is a lack of legal protection for the contractor, and the operator might use his dominant position and continuously shift greater risk over the contractor.

This uneven and unfair risk allocation may cause significant financial setbacks to the contractor. This problem deserves attention from the Malaysian government. The problem must be resolved. If left unresolved, it presents a threat to the commercial development of the Malaysian oil and gas industry. Even though insurance provisions are sometimes provided in the contract, there are no guidelines available to govern the conduct of the parties. Additionally, the insurance requirements are not mandatory for the parties. Some operators opt to take out self-insurance rather than to buy a premium that will extend its coverage to cover the operators and sub-contractors, for example in respect of construction all risk. This scenario can cause the contractor to assume uninsured risks, which could lead to detrimental financial exposure on the occasion of a catastrophic incident. The situation might get worse for contractors in the event that contractors have to assume double jeopardy contractual risk, whereby the contractors not only need to
assume operators’ risk but also sub-contractors’ risk. In order to resolve this problem, it is argued that a specific legal mechanism should be adopted in Malaysia to protect and limit the liability of the contractors under oilfield service contracts. As discussed above, Sections 3 and 5 of the Civil Law Act 1956 provide for the application of English law in Malaysia unless another provision has been or shall be written into law. The English legal principles are therefore applicable and ought to be applied in order to cover the gap in Malaysian law. However, it is important to note that the applicability of the English legal principles will be subject to the circumstances in the Malaysian oil and gas industry.

References


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Notes

1FIDIC stands for Federation International Des Ingenieurs-Conseils.

2Caledonia North Sea Ltd. v British Telecommunications Plc same v Kelvin International Services Ltd. same v London Bridge Engineering Ltd. same v Norton (No. 2) Ltd. (In Liquidation) same v Pickup No. 7 Ltd. same v Stena Offshore Ltd. same v Wood Group Engineering Contractors Ltd. – [2002] 1 Lloyd’s Rep 553.

3Saad Marwi v Chan Hwan Hua & Anor [2001] 3 CLJ 98.

4American International Assurance Co Ltd v Koh Yen Bee (f) [2002] 4 MLJ 301.