Operator vs. Non-Operator
Presented by: Bob Daniels

“Don’t Worry………….. Be Happy”
- Bobby McFerrin, circa 1988

“I don’t always buy blowout insurance, but when I do, I prefer that the Operator take care of it…..”

This is Mr. Carlos Johnson, the Most Interesting Man in the World and non-operating working interest owner, responding to a well control presentation seven weeks before a $99,000,000 Blowout / Well Control & Redrill loss in Vermilion Parish, Louisiana, circa 2007. He owns an 11% Non-operating working interest in the well.
INTRODUCTION:
Here’s a quick story to illustrate why this session of the Energy Symposium is important enough to be included, and why I have agreed to conduct this program.

To Mr. Johnson’s chagrin, he only first read the JOA (Joint Operating Agreement) insurance Exhibit D attached to the JOA for this particular venture after he heard about the loss, out of curiosity. This turned to a more morbid curiosity when he couldn’t find any reference in the exhibit D to ‘well control insurance’.

As it turns out, the Operator was a very large independent oil company which retained, or self insured, the well control risk up to $50MM any one occurrence, and didn’t offer even their own excess well control coverage to any partners in this particular well.

Mr. Johnson’s net loss, as a NON-OPERATING WORKING INTEREST OWNER, thus eventually totaled $99,000,000 * 11% = $10,890,000, a valid debt which the Operator is NOW seeking to recover from Mr. Johnson in the courtroom.

[Names have been changed to protect the stupid]

Now, where is Mr. Johnson looking to find $11MM?

Why, from the pocket of his insurance agent of course, who he says, didn’t tell him about this stuff.

Answer Ahead

...more on this all-too-common scenario later
Operator vs. Non-operator – who are the parties here?

Operator – the guy in charge, the ‘managing partner’, who often has ‘partners’...

Non-Operating Working Interest Owners – the well investors, ‘silent partners’ in some respects, who own...

Working Interests – each with proportional expenses, risks, and rewards.

Contractors – Hired by the Operator under Drilling Contracts and / or Master Service Agreements - Driller, Specialists, Suppliers, and all types of services to well, working under the terms of...

Who bears the risk of loss and liability?

Condex Resources has an opportunity to drill a well on a ranch in Brazoria County, Texas.

Condex offers participation to four of their usual investors, who each agree that the prospect looks good and signs on for 20% share of the costs in exchange for a 20% interest in the well.

These ‘partners’ then become the Working Interest Owners, including Condex the Operating partner, who retains an equal 20% working interest in the well.

Each Working Interest Owner is responsible to pay for 20% of all expenses related to the well, from lease acquisition through drilling, testing, completion, producing, and ultimately, plugging and abandonment.

This ‘partnership’ relationship is governed by a key document, the JOA (see hand-out).

Principle Insurable Risks of loss for the Working Interest Owners at, over, and in the hole.

A. General liability – third party exposures
B. Auto Liability
C. WC / EL – Whose employees?
D. Excess /Umbrella Liability
E. Well Control
F. Owned / rented / leased property
G. Vendor and Contractor equipment at the site
H. Specialty Contractor’s Equipment (Directional Tools)
I. Aviation
J. "Other" Items

There are wide disparities in the Joint Operating Agreements as they address a variety of these concerns, but seldom ALL of these concerns.
Understanding how the JOA addresses the ‘sharing’ of responsibility for insurable ‘risks’ among the partners / investors in the E&P industry.

JOA INSURANCE AND INDEMNITY EXPLANATION

At all times while operations are conducted under this Agreement with regard to subject properties, the working interest owners agree to protect, defend, indemnify, release from liability and hold the Operator, its officers, directors and employees harmless from and against all losses, liabilities, costs, claims, demands and causes of action of every kind and character, without regard to the cause or causes thereof, or the negligence of any party or parties, except for the gross negligence or willful misconduct of the Operator or the Operator’s officers or employees.

If the Operator is also a working interest owner, it shall bear its proportionate working interest share of such losses, liability, costs, claims, demands and causes of action. This indemnification is without limit; however, if it is judicially determined that monetary limits should apply in certain instances of the working interest owners’ voluntary assumption of such indemnities, the limit, or limits, shall automatically be amended to conform with the maximum limit permitted under law. It is understood by all parties that this indemnification is to clarify Operator’s and working interest owners’ obligations as stated in Article V of this Joint Operating agreement and does not place any additional liabilities on the working interest owners.

JOA INSURANCE AND INDEMNITY EXPLANATION

It is agreed that any future reference to the word “indemnify” shall also mean “protect, defend, hold harmless and release from liability” and shall only apply in the absence of gross negligence or willful misconduct on the part of the Operator or the Operator’s officers or employees.

Notwithstanding the previous indemnification, Operator shall maintain for the benefit of all parties hereto, insurance of the types and in the maximum amounts as listed below. Such insurance may carry reasonable deductibles. Premiums for such insurance shall be charged to the Joint Account and such premiums shall not exceed that which is normally available.

Non-operating working interest owners shall be named as Additional Insureds on the liability insurance policies, but only with respect to the performance of all work hereunder and only to the limits shown in this agreement. This insurance shall be primary to any insurance carried by non-operating working interest owners. The preceding indemnification shall not act to relieve the insurance carrier(s) of liability under the policies.
All such insurance shall be carried by an acceptable insurer or insurers; shall be maintained in full force and effect during the terms of this agreement; and shall not be cancelled, materially altered or amended without 30 days prior written notice having first been furnished non-operating working interest owners. If so required, Operator agrees to have its insurance carrier furnish certificates of insurance evidencing such insurance coverage's.

Non-operating working interest owners agree that the limits and coverage carried by Operator are adequate and shall indemnify the Operator if any claim exceeds such limit or is not covered by such policy. If the Operator is also a working interest owner, it shall bear its proportionate working interest share of such amount of claim which exceeds that limit or which is not covered by such policy. Such coverage's and limits may change or be unavailable from time to time and Operator does not guarantee their continuance but will use its best efforts to provide such coverage's and limits at reasonable costs.

JOA EXHIBIT D:
OPERATOR’S INSURANCE REQUIREMENTS:

a. Workers’ Compensation insurance in full compliance with all applicable state and federal laws and regulations.

b. Employer’s Liability insurance in the limits of $1,000,000 per accident covering injury or death to any employee who may be outside the scope of the Workers’ Compensation statute of the state in which the work is performed. (Non-operating working interest owners shall be named as additional insured’s only if permitted by the insurer.)

c. Commercial (or Comprehensive) General Liability insurance with combined single limits per occurrence (and any general aggregate if applicable) of $1,000,000 for Bodily Injury and Property Damage, including Property Damage due to Blowout and Cratering, Completed Operations, and Broad Form Contractual Liability as respects any contract into which the Operator may enter under the terms of this agreement.

d. Automobile Liability insurance covering owned, non-owned and hired automotive equipment with limits for Bodily Injury and Property Damage of $1,000,000.

e. Operator shall carry Control of Well Insurance covering the costs of controlling a Blowout, the expenses involved in re-drilling or restoring the well, certain other related costs and Seepage and Pollution Liability. (These are descriptive terms only and exact coverage can be found only in the policy.) The limit for this insurance and deductible shall be as judged appropriate by Operator. Non-Operating working interest owners not wishing to be covered under this policy must notify Operator prior to spud date and provide evidence of insurance equal to or greater than limits carried by Operator on a certificate furnished by the Operator; and by such refusal of coverage each non-operating working interest owner agrees to be responsible for his proportionate share of such loss and indemnify the Operator for any such loss that would have been covered under Operator’s coverage, regardless of the degree or type of negligence, either sole, joint, concurrent or gross, anything in this agreement to the contrary notwithstanding.

f. Umbrella Liability insurance excess of coverage’s b, c, and d above in the amount of $____________ combined single limit.
Non-operating working interest owner’s conundrum:
How in the world can he evaluate and measure his risk of financial loss among dozens of varied investment agreements?

The answer is:
he probably can’t.

Case in Point: BP Deepwater Horizon, Macondo Well
Next, after a break.................Well Control Insurance
Why is this coverage so important to the discussion of Operator vs. Non-operator?

Blowout!

A VIEW OF INDUSTRY TRENDS - 2010

Product prices remain mixed, but drilling costs have come down,
So many Operators continue to drill,
So they can sell more product,
So they can make more money,
So they can hire more rigs,
So they can drill more wells,
Which requires more rigs,
Which "thins out" crews, and
Wears out rigs...........

All of which leads to more losses –
and
they are more costly than ever!

COST OF CONTROL
How does it work?
Example Scenario: Expl. Well - Farmer Tom #1

TVD: 10,000 Feet

AFE: $1MM Dry Hole / $500k Completion

100% Working Interest

Policy Limit: $3MM / Retention $100k (Both for 100%)

Rate: $0.50 pfd = $5,000 Premium

$100,000 Retention (100%)

"Indemnification for Loss"

[Operator pays the vendors for costs related to Well Control.]

POLICY # 007-BR549

LIMIT: $3MM Each Occurrence

DEDUCTIBLE: $100,000

(For 100% Interest)

CCC Limit $500,000

WEEKS ONE and TWO: Early Expenses During and after the Blowout

Nubby’s Snubbing Crew arrives, then after three days, Operator hires Willie’s Well Control.

Total bills already $500,000 in the first two weeks.

Costs of Control Efforts: Fighting the Fire, Snubbing, Well Control

WEEKS THREE & FOUR: Expenses after the Blowout are curtailed.

Billy - Bob’s Soppin’ & Moppin’ Co. clean up Farmer Brown’s tanks, his honey-hole fish pond, and his Hog pens.

Billy-Bob’s hand written invoice totals $350,000.
WEEKS FIVE through TEN: Expenses after the Blowout

Well is under control. TX RRC leaves you alone, but your partners want you to replace the well to get whatever blew it out in the first place.

After fishing and sidetracking for ten days you give up, skid the rig over and start over – another $1,800,000 to reach T.D.

WEEK ELEVEN: Expenses after the Blowout

‘New’ Well achieves TD.

Rental tool companies and various vendors to the original well ask you to pay for their ‘stuff’ destroyed or which you never recovered.

Well Control “CCC” endorsement pays because the CGL won’t – $450,000.
COST / BENEFIT ANALYSIS –

What you paid versus What you got paid

COST:
- Premium Paid for this Well: $5,000
- Retention born by Insured: $100,000
- Total Costs: $105,000

RECOVERY:
- Costs of Well Control: $500,000
- Seepage and Pollution / Clean-up and Containment: $350,000
- Sidetrack, Restoration, Redrilling Expenses: $1,800,000
- Care, Custody, & Control (CCC): $450,000

TOTAL RECOVERY: $3,000,000

What can I do to prevent my clients, both Operator & Non-Operator, and potentially, my agency, from suffering catastrophic financial loss given the ramifications of Operator vs. Non-Operator in the JOA insurance clauses?