

Drilling Contracts

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Introduction

The leases have been taken, seismic analyzed, partners found.

Next is the process of drilling.

That involves another standard contract in the industry, the drilling contract.

The Independent Association of Drilling Contractors (IADC) has its own set of drilling contracts, and they are commonly used.

Most of the wells in the United States are drilled under one of the three major types of drilling contracts: the Turnkey, the Daywork, or the Footage contracts.

Examples of all three of these contracts are in the workbook.

Identity of the Parties

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The operator - the party who has the legal right to produce oil and gas from a given tract - may elect to drill a well.

A well is most often drilled by a drilling contractor, a entity engaged in the business of drilling oil and gas wells.

- Usually the job is bid out.

The operator and/or the drilling contractor will contract with various service companies and supply companies for the drilling project.

Negotiators

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- Large operators will employ a drilling manager or drilling engineer to solicit drilling contracts.
- Large drilling contractors will have a marketing or sales person to respond to solicitations/negotiate drilling contracts.
- The principal officers of smaller operators/drilling contractors often negotiate terms/execute the drilling contract.

Operator's Relationship with Other Working-Interest Owners

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Often the operator will be a farmee, a party to a letter agreement, or a designated operator under a JOA.

Other working-interest owners may have an interest in the proposed well and may be expected to pay a portion of the drilling/completion costs.

- The operator must consider any legal obligations owed to other WI owners.

The drilling contractor may inquire about WI owner credit/obligations in order to avoid a potential problems after execution of the drilling contract.

Formal Requirements Concerning Execution

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A pure drilling contract - drilling of a well in return for a money payment – is not an interest in real property.

- Outside the real property statute of frauds.
- A well drilled in return for an interest in real property (a farm-out agreement), then the parties must meet the real property statute of frauds.
- Since most wells are completed within one year, a drilling contract is generally not within the statute of frauds governing contracts which will not be performed within a year.

Parties to a drilling contract should have a written contract.

- Due to the detailed nature of drilling contracts and costly nature of drilling.

Model and Company Drilling Contract Forms

The American Petroleum Institute Model Form

- The API model form.
 - Contains a disclaimer - only a suggested guide.
 - This form may be either a daywork or a footage contract.

Model and Company Drilling Contract Forms

The International Association of Drilling Contractors Forms

- The IADC has daywork, footage, turnkey, offshore, and international model forms.
- The domestic onshore daywork and footage contract forms are similar to the API form.
- The IADC forms are more detailed.
- The IADC forms contain disclaimers.
- Major Company Forms - have operator-oriented contract forms.
 - Typically contain key provisions that significantly depart from related provisions found in model forms.
 - Some variations because major companies have bargaining power over drilling contractors.
 - Some variations in response to particular problems encountered by the company in drilling.

A few large drilling contractor companies have their own standard contract.

Types of Drilling Contracts

Types of Drilling Contracts in the drilling of domestic onshore wells: footage, daywork, and turnkey.

- The daywork contract historically has been the most commonly used form.

Daywork Contracts

- A daywork contract provides that the drilling contractor be paid a stipulated rate for work performed over a twenty-four-hour period.
- The amount of the daywork rate depends on a number of factors, including the type of rig, the size of the crew, et cetera.
- A daywork contract may provide for lump-sum payments for specialized work.

Types of Drilling Contracts (Continued)

Footage Contracts

- A "footage" contract provides that the drilling contractor be paid a stipulated price per foot of hole drilled from the surface to a total depth or some other specified depth.
- The IADC footage contract specifies that the operator is an independent contractor.
- The contractor more clearly assumes the risk associated with drilling under a footage contract rather than under a daywork contract.
- A footage contract may call for daywork compensation.
- Example, under a typical "standby" or "shutdown time" provision, daywork compensation is due with cessation of drilling operations.
- Because the contractor assumes more risk, the footage contract is more advantageous to the operator than the daywork contract.

Types of Drilling Contracts (Continued)

Turnkey Contracts

A "turnkey" contract provides for the drilling contractor to be paid a stipulated price for drilling a well to a specified depth or a targeted formation.

- A drilling contractor assumes more risk under the turnkey contract than under the other types of contracts
- Because the contractor has general control of all operations.
- Turnkey contracts are often tailor-made to particular drilling conditions which may be encountered.

Contents of the Drilling Contract

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Form of Contract

- The Bid Sheet and Drilling Order used to solicit bids, to delineate the well technical specifications, and to specify which party will furnish certain materials/services.
- The **Bid Sheet and Drilling Order** is incorporated into the Drilling Contract.
- Forms a master contract when the parties plan to drill additional wells,

Description of the Parties

- The parties to a drilling contract are referred to as either the "operator" and "drilling contractor," or "driller" and "contractor,"

Contents of the Drilling Contract (Continued)

Respective Obligations of the Parties

Well Location

- The operator usually has better access to relevant topographical, geological, and geophysical information
- The operator should designate the well location when soliciting a bid for the drilling of a specified well.
- The operator ordinarily provides a survey of the tract to be drilled
- Stakes the well location.

Contents of the Drilling Contract (Continued)

Well-Hole Specifications

- The operator should specify the anticipated depth of the well in the bid sheet/drilling order.
- The depth should be expressed as depth from the surface location.
- A well drafted drilling contract allows for the possibility of deeper drilling, but should specify a maximum depth.
- Important as the contractor must be certain that its rig is capable of drilling to that depth.

Contents of the Drilling Contract (Continued)

Time for Performance

- The operator will specify a commencement date in the drilling order.
 - The commencement date - vital to the operator who has an oil and gas lease which is about to expire or is approaching a delay-rental anniversary date.
- To be profitable, a drilling contractor must keep rigs and crews busy.
- The immediate risk of failing to commence a well on time is on the drilling contractor.

Contents of the Drilling Contract (Continued)

Permits Required for Drilling

- The operator has the obligation to secure the drilling permit from the state agency regulating drilling operations (RRC).
- The drilling contract should specify this.
- Access to the Drilling Location
 - Operator is responsible for securing the legal right of access to the well site.
 - Includes an access road to the well location and any necessary rights-of-way for power, fuel, or water lines.
 - The operator is responsible for construction/maintenance of the access road right-of-way,
 - Installation of power, fuel, and water lines should be specified in the contract.

Contents of the Drilling Contract (Continued)

Modification of Contract Terms in the Course of Performance

- The parties will sometimes modify the contract during the course of performance.
- If the initial or modified contract fails to address all of the ramifications of the drilling project, litigation can result.

Contents of the Drilling Contract (Continued)

Description of and Responsibility for Furnishing Equipment

A drilling contract should contain a description of all equipment to be used, such as the rig and power source.

The contractor furnishes the rig and a crew of sufficient size/experience to do proper drilling operations.

The operator furnishes the storage tanks, drilling mud, separator, coring equipment, testing and completion services, and equipment.

Contents of the Drilling Contract (Continued)

Consideration to be Paid - By Types of Drilling Contracts

- In a footage contract, except for specified daywork operations, the contractor is paid a stipulated price per foot of hole drilled from the surface through the total depth of the well.
 - The consideration is earned when the drilling has been completed in accordance with the contract terms
 - The API form requires "daywork" compensation for
 - (1) the drilling/setting of casing below the contract footage depth,
 - (2) efforts to restore a hole which has been lost/damaged as a result of operator's failure,
 - (3) work performed at the operator's request beyond the scope of the work.

Contents of the Drilling Contract (Continued)

Consideration to be Paid (Continued)

- A day-rate or daywork contract provides that the drilling contractor is to be paid a stipulated price for work performed under the direction of the operator over a twenty-four-hour period.
 - Daywork compensation is usually payable on a specified periodic basis.
- A turnkey contract provides that the drilling contractor is to be paid a stipulated price for the drilling of a well to a specified depth or to a targeted formation.
 - Payment is due upon completion of all work specified in the contract.
 - A turnkey contract will often provide for payment of a day rate in specified situations.

Contents of the Drilling Contract (Continued)

Drilling Methods and Practices

- The drilling of an oil and gas well is an expensive and hazardous endeavor requiring great expertise.
- A drilling contract should address the standard of performance expected of the drilling contractor.
 - The API drilling contract form requires the contractor perform "with due diligence and care, in a good workmanlike manner, and in accordance with good drilling practices."
 - The drilling contractor represents that it "is engaged in the business of drilling and completing ... wells"
 - The IADC footage and daywork forms do not include a general standard of performance; but a court might infer such a warranty.

Contents of the Drilling Contract (Continued)

Drilling Reports

- Most drilling contracts require the contractor to furnish the operator with daily or frequent drilling reports summarizing
- The current status of the well, including the current depth of the hole and the formations penetrated.

Contents of the Drilling Contract (Continued)

Reports (Continued)

- Accident Reports
- Because of tort claims and rising insurance rates.
 - In the event of an accident involving personal injury or equipment damage, the drilling contractor reports the accidents to the operator, by telephone with a follow-up written report.
 - Such reports include the nature of the accident, injuries, and damages.
 - Includes copies of any reports filed with insurers, government officials, or other parties.

Contents of the Drilling Contract (Continued)

Insurance Requirements

Introduction - Oil and gas well drilling business exposes operators and drilling contractors to risks.

- A drilling contract contains extensive provisions covering liabilities, indemnification, and insurance to guard against the potentially huge potential losses.
- These clauses attempt to allocate responsibility and liability for accidents resulting in property damage or loss, personal injury, or death.
- A major source of drilling contract litigation results from disputes over which party assumed responsibility for certain.
- Risk allocation is a most crucial issue in drilling contract negotiations.

Contents of the Drilling Contract (Continued)

Insurance Requirements (Continued)

Types of Insurance

- The majority of drilling contracts require the drilling contractor to procure/maintain adequate insurance covering the contractor for the duration of the drilling contract
- The parties must ensure that the minimum amounts are in compliance with all applicable state and federal laws and regulations.
- A drilling contract generally requires the drilling contractor to carry three or more categories of insurance coverage
 - Employee or personnel, including workers' compensation (WC) coverage.
 - Automobile liability insurance.
 - Comprehensive general liability insurance - covers the greatest potential exposure to liability.
 - Property insurance.

Contents of the Drilling Contract (Continued)

Insurance Requirements (Continued)

The drilling contract requires the drilling contractor to furnish the operator with certifications that insurance is in full force.

Operator may reserve final approval over which companies underwrite the drilling contractor's insurance.

Drilling contract provides that insurance may not be cancelled or materially changed without prior written notice.

Operator should examine all policies to determine whether each policy is an "occurrence" policy or a "claims made" policy.

- The "occurrence" policy coverage is extended for any property damage or bodily injury which "occurs" during the period the policy is in force, even if a claim for that damage or injury is not filed for years after the policy expires.
- Under a "claims made" policy, the time of the filing of the claim against the insured determines whether there is coverage.
- An "occurrence" policy is the standard form used in the drilling industry.

Risk Allocation and Indemnification

Risk Allocation and Indemnification

Public Policy

- Through the inclusion of indemnity provisions, the operator and drilling contractor allocate the risks of losses and damages between themselves.
 - Referred to as "hold harmless" clauses.
 - Indemnity agreements are generally enforced where the agreement to indemnify against negligence is clearly expressed.
 - Several oil and gas producing states have enacted anti-indemnity statutes that hold indemnity provisions void if they purport to indemnify the indemnitee against bodily injury, death, or property damage arising from the negligence of the indemnitee

Risk Allocation and Indemnification (Continued)

The Texas Statute - The Texas Act, initially enacted in 1973, amended in 1989.

- The Act nullifies "an agreement pertaining to a well for oil, gas, or water or to a mine for a mineral" which indemnifies against loss or liability resulting from personal injury, death, or property damage and caused by the negligence of the indemnitee.
- The Act does not apply to an indemnification against
 - Personal injury, death, or property damage resulting from radioactivity,
 - Property damage resulting from pollution or from reservoir or underground damage, or
 - Personal injury, death, or property damage resulting from the performance of services to control a wild well, including well-control costs.

Risk Allocation and Indemnification (Continued)

The most common indemnity cases involve an employee of the indemnitor is injured on the job.

- Employer/indemnitor is negligent, the employee's claim against the employer is limited to the recovery permitted under the applicable WC act.
- The employee may sue the third-party indemnitee on a theory of negligence and recover damages in tort in excess of the available recovery under a WC act.
- If liable, the indemnitee may claim indemnity from the employer/indemnitor to the extent permitted by law.
- In the absence of lawful indemnity, WC law would shield the employer from tort liability, including contribution to the indemnitor.
- The employer/indemnitor may be contractually liable to the indemnitee by reason of the indemnity provision in the contract.

Risk Allocation and Indemnification (Continued)

- Indemnity (Continued)
 - Indemnification of and by Third Parties
 - The API and IADC forms provide that all indemnity obligations and liabilities assumed by the parties under the terms of the agreement "shall have no application to claims or causes of action asserted against Operator or Contractor by reason of any agreement of indemnity with a person or entity not a party hereto,"
 - Includes any third party contractors engaged by either party
 - This provision ensures that neither the operator nor the drilling contractor can attempt to enter into third-party contracts which may impair or defeat the indemnity.

Risk Allocation and Indemnification (Continued)

Special Provisions Concerning Allocation of Risk

- Blowouts (Pollution and Contamination)
- The sudden expulsion of oil, gas, drilling mud, and debris which may occur during a blowout may potentially result in exposure to liability for any resulting pollution, contamination, or other damages.
 - The API and IADC forms place the responsibility for pollution or contamination caused by blowouts on the operator, regardless of the negligence of any party.
 - In addition to pollution and contamination damages, a blowout may cause loss of/damage to the equipment of the operator, contractor, and third parties, or may result in loss/damage to the hole.
 - The responsibility for these latter types of losses is governed by other provisions of the drilling contract.

Special Provisions Concerning Allocation of Risk

Risk Allocation and Indemnification (Continued)

- Well Control and Lost Circulation - Examples of well control are shutting in a major blowout and extinguishing a well fire.
 - The drilling contract parties' potential liability for damages/costs resulting from loss/ restoration of well control under the API and IADC model form drilling contracts depends on whether the contract is of the daywork or the footage type.
 - Under the daywork contract, the operator is generally in charge of directing the drilling operations.
 - The operator assumes liability for any needed well control and attendant costs.
 - The responsibility for controlling a wild well is not clearly defined under the footage provisions of the API form; there is no express allocation of responsibility for well control to either the drilling contractor or the operator while on a footage basis.
 - Responsibility for well control/associated costs would be assumed by the operator under the daywork provisions of the footage contract.
 - If the loss of well control results from causes attributable to the drilling contractor's operations while on a footage basis, the contractor is responsible for regaining control of the well/associated costs.
 - Under a footage contract, the circumstances of switches from a footage to a daywork basis should be defined.
 - Under the API/IADC footage forms, the contractor is responsible for restoring lost circulation for a specified time period, after which efforts to restore circulation are to be on a daywork basis.

Risk Allocation and Indemnification (Continued)

Special Provisions Concerning Allocation of Risk (Continued)

■ Costs of Redrilling

- Redrilling insurance is available but because of its cost, many operators and contractors do not procure this coverage.
- Problems include excessive deviation from the straight hole specifications, special drilling problems, blowout, fire, and negligence.
- The model drilling contract forms place all liability for the costs of redrilling on the operator if operations on a daywork basis.
- If operations are on a footage basis, the drilling contractor is liable for the costs of redrilling if the existing well is lost or damaged by contractor negligence.
- If the hole is damaged/lost due to the failure of the operator's casing or equipment or to the failure of the cementing job, the operator must pay the contractor most of the costs for footage already drilled, and for redrilling a new hole.

Risk Allocation and Indemnification (Continued)

Special Provisions Concerning Allocation of Risk (Continued)

- Waiver of Subrogation - Model drilling contract forms provide that both the operator and the contractor must secure special endorsements from their insurance underwriters which waive subrogation rights for the respective liabilities assumed.
- Operator as Named Co-Insured - In addition to requiring the drilling contractor to waive all rights of subrogation, the operator may require that the contractor's insurance policies name the operator as an additional, or co-insured.

Risk Allocation and Indemnification (Continued)

Special Provisions Concerning Allocation of Risk (Continued)

- Damage to Equipment – General Rules.
 - Operator’s Equipment - Most drilling contracts provide the operator bears liability for damage to/destruction of the operator’s equipment.
 - The drilling contractor is under no liability to reimburse the operator for loss/damage.
 - Under the API/IADC forms, the drilling contractor agrees "to visually inspect" all materials furnished by the operator and to notify the operator of any "apparent defects."
 - The forms also state the contractor "shall not be liable for any loss or damage resulting from the use of materials furnished by Operator or failure to notify Operator of defects."
 - Notwithstanding, a court might hold the contractor responsible for losses because of defective materials, when the contractor failed to inspect/discover visible defects or failed to warn the operator of observed defects.
 - Drilling Contractor’s Equipment – Destruction or damage to the drilling contractor’s surface equipment is borne by the contractor.
 - Third Party’s Equipment – Borne by the third party.

Risk Allocation and Indemnification (Continued)

Special Provisions Concerning Allocation of Risk (Continued)

■ Damage to Hole – General Rules.

- Damage to the hole or well bore may be minor - the hole can be cleaned out and redrilled.
- Or extensive - the well must be plugged and abandoned and a replacement well drilled.
- Under the model forms, liability for damage to the hole depends on the contract - daywork or footage.
- Under a daywork, the operator assumes liability for any damage to the hole.
- Under a footage, the drilling contractor normally assumes liability for any damage to the hole.

Risk Allocation and Indemnification (Continued)

Special Provisions Concerning Allocation of Risk (Continued)

- Force Majeure.

- The clause provides that the operator or the drilling contractor will be liable to the other for any delays/damages which arise as a result of "causes beyond the control of the parties affected hereby."
- Contract can call for payment of a "force majeure rate."
- Party claiming force majeure must give detailed notice of the force majeure to the other party.
- The force majeure clause is subject to a variety of interpretations and/or litigation.
- Force majeure clauses are strictly construed.
- Courts are hesitant to relieve a party of its obligations under a contract.

Confidentiality of Information

Confidentiality of Information - Operators spend large sums of money on exploration and development; therefore, they closely guard drilling information.

- Most drilling contracts contain a provision that upon the written request of the operator, the drilling contractor may not divulge drilling information to third parties.
 - The contractor also promises that its employees will not divulge any drilling information to third parties.
 - In reality, there is little a drilling contractor can do to stop loose conversation which may occur after working hours - in “watering holes” legendarily frequented by rig hands.
- In a famous oil and gas history book case, H. L. Hunt became one of the richest men in America in the 1930’s because the operator’s (“Dad” Joiner) drilling foreman was bribed by H. L. Hunt to furnish him (Hunt) with drilling data from the first East Texas gusher. Based on this data and right before the gusher came in, Hunt conned Joiner into selling him the lease. Hunt bought rights to all the surrounding leases. Thus, when the well formerly belonging to Joiner came in, Hunt became an instant oil magnate.

Choice of Law

Choice of Law - The API form does not include a choice of law provision; the IADC provisions do contain a statement of governing law.

- Likely because this matter is superseded by federal and state administrative law, no model forms specify a choice of forum which requires disputes to be resolved by the courts of a particular jurisdiction.
 - First, the courts must first decide which state's substantive contract law governs the contract.
 - In a diversity case a federal court applies the conflict-of-law rules of the state in which the court sits.
 - In most states, this is the "most significant relationship" test.
 - With regard to drilling contracts, both the validity of the contract and the rights created by the contract are governed by the law of the state where the well is drilled.

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