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A CRITICAL ANALYSIS OF THE CONCEPT OF CONTRACTUAL RISK IN THE UPSTREAM SECTOR, VIS A VIS AN APPRAISAL OF THE KEY FEATURES INCLUDING PROVISIONS ON INDEMNITIES AND LIABILITIES IN THE UPSTREAM OIL AND GAS CONTRACTS

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Abstracts

The work examines the notion of contractual risks in the oil and gas sector with particular reference to the key feature such as provisions on indemnities and liabilities in the upstream sector.

Introduction

Oil and Gas Contracts are the Legal Frameworks that underpin the operations of International Oil Companies (IOC) to explore, prospect and drill for hydrocarbons in a designated area where such agreement permits the company to operate. The Oil and Gas contracts are the foundations of the upstream sector, which carry out exploration and production of such hydrocarbon. Such agreements are typically consummated between the IOCs and National Oil Companies representing the State or between IOCs themselves and other service providers within the Exploration and Production stage of the oil industry which is highly technical and capital intensive. Indeed, the Oil Contract is the foundation of the Upstream Sector otherwise known as Exploration & Production (E & P).²

Reasons Why Contractual Risks Have Become a Priority in the International Upstream Sector

In agreeing with the statement pose above, it is quite clear from practical realities of the industry that the issue of contractual risk is one that is given priority by parties and their practitioners. The E & P Process in the Oil Industry is technical and capital intensive and IOCs or partners at times experience huge losses or in the alternative, vast oil reserves. Thus, risk is an integral issue of major concern to all stakeholders involved. The quantum of resources needed in the E&P in the upstream sector also necessitate the industry players to adopt various risk assessment measures that will minimise the risk on the investment made to the barest minimum in the event of any eventuality.³

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² P. Cameron, Liability for Catastrophic Risk in the Oil and Gas Industry, International Energy Law Review, 2012, pp. 207-219 — Discovery - the University of Dundee Research Portal

<https://discovery.dundee.ac.uk/en/publications/liability-for-catastrophic-risk-in-the-oil-and-gas-industry> Accessed on the 8th of April 2020.

³ Contract Risk Management: A High Priority in the Upstream Oil Industry | Oil & Gas IQ

<https://www.oilandgasiq.com/legal-and-regulatory/articles/contract-risk-management-a-high-priority-in-the-up> Accessed on the 8th Of April 2020.

This is because such risks include but are not limited to the following:

- I. Fluctuation of prices caused by wider economic or political considerations. An example of a global event which causes fluctuations was the 1973 Arab led Oil Embargo, which effectively stopped the exploration, production and export of Oil to some selected countries thereby affecting prices, investment by IOC's and many contractual and subcontracting interests.⁴ More recently, the uncertainty caused by the COVID 19 virus has occasioned price instability and heightened concerns for energy security around the world. Indeed, the COVID 19 pandemic resulted in reduced demand from larger consumers, corresponding overproduction and attendant losses suffered due to large unsold inventories and falling prices as a result of the effects of the pandemic which effectively shut down the global economy⁵.
- II. Increased risk of environmental accidents especially in deep water e.g. the Piper Alpha disaster which led to losses by the consortium of the Companies that owned the platform, loss of lives, reduced investments and a huge environmental disaster that increased legal and insurance claims⁶. The Macondo disaster is also another disaster that led to the loss of lives, investments, damage to the environment and a lot of claims and penalties imposed on the IOC's and other contractors operating. The risk involved is better not imagined.⁷ Thus, they must be provided for in the contract documentation between partner investors in any oil acreage.
- III. Political Instability i.e. change of Government Policies leading to expropriation and nationalisation as seen in the Venezuelan Government's peremptory nationalisation of assets of Oil Companies after the latter's large investments in the Oil fields of Venezuela and subsisting contracts with the Venezuelan Government. Their failure to pay Oil Companies compensation for their investments as agreed by the contracting parties has affected the oil industry therein.⁸ Though reduced in recent times, they remain an ever present risk.
- IV. Tax regimes: Despite Oil Companies' major risks in their E&P activities, Governments around the world often prescribe payment of signature bonuses and different types of taxes, urging companies to engage in Corporate Social Responsibility projects within the countries of operation. The Government could still impose more taxes any time it deems fit, as it did in Mexico⁹ even to the extent of scaring the oil companies that have taken the risk to invest their resources. In the UK, following the Sir Ian Wood Committee Report more taxes were introduced so much so that some Oil Companies sold their assets.¹⁰

⁴ Arab oil embargo | History, Cause, Impact, & Definition | Britannica <https://www.britannica.com/event/Arab-oil-embargo> Accessed on the 8th of April 2020.⁵ Covid-19 puts North Sea oil and gas in 'paper-thin' position - BBC News <https://www.bbc.co.uk/news/uk-scotland-51948269> Accessed on the 8th of April 2020

⁶ The Public Inquiry into the Piper Alpha Disaster: Volume 2 <https://www.hse.gov.uk/offshore/piper-alpha-public-inquiry-volume2.pdf> Accessed on the 8th of April 2020.

⁷ Macondo : the Gulf oil disaster : Chief Counsel's report / | Library of Congress <https://www.loc.gov/item/2011505289/> Accessed on the 8th of April 2020.

⁸ Exxon owed \$1.6bn by Venezuela for 2007 nationalisation - BBC News <https://www.bbc.co.uk/news/business-29561345> Accessed on the 8th of April 2020.⁹

Mexico's tax regime: scaring off oil company investors? | Financial Times <https://www.ft.com/content/9b99d0b1-efa4-3cf6-8d60-57cee472f446> Accessed on the 8th of April 2020.

¹⁰ Oil & Gas UK welcomes Sir Ian Wood's report - Offshore Energy <https://www.offshore-energy.biz/oil-gas-uk-welcomes-sir-ian-woods-report/> Accessed on the 8th of April 2020.

The situation is prevalent in many oil producing countries around the world, making the companies feel over taxed.

- V. Decommissioning: Many oil companies now engage in the decommissioning of Oil and Gas Installations due to environmental concerns and legislations by host Governments around the world. Indeed, a part of scarce resources needed for the new operations are taken up with decommissioning, thereby increasing the risk factor in putting up and removing Oil Rigs and other Installations, which is both a technical and financial risk that companies bear¹¹.
- VI. Piracy at sea is an emergent threat to Oil and Gas Companies as it increases the risk of delivering the products globally as a result of piracy around the world. The implication is that the cost of transportation and insurance invariably increase leading to concern about cargo deliverables.¹²
- VII. Government Policies, Local Content Laws and Legislation: The policies of Government are also an emerging issue and risk factor which oil companies have to contend with. Governments around the world in a bid to be patriotic enact policies compelling IOCs to engage more local Companies in the E&P process, thereby improving capacity and local expertise.¹³ However, it makes IOC's vulnerable due to inordinate pressure to consider Local Companies not necessarily on merit or cost benefit basis heightening the risk of accident that occurs particularly offshore.¹⁴
- VIII. Geo-Politics: Oil and Gas Companies are often caught up in geo-political considerations. Thus, Oil and Gas Companies undergo a lot of risks due to geo-politics.¹⁵ The Saudi Arabia/Russia price war for instance has affected global oil prices leading to losses and higher risks of default for Governments/IOCs¹⁶.

It is due to the aforementioned reasons that the issue of risk became a priority for IOC's and contractors in the International upstream Oil and Gas sector otherwise known as E&P.

¹¹ Oil and gas: decommissioning of offshore installations and pipelines - GOV.UK <https://www.gov.uk/guidance/oil-and-gas-decommissioning-of-offshore-installations-and-pipelines> Accessed on the 8th of April 2020.

¹² Pirates Threaten Oil And Gas Shipping In The Red Sea | OilPrice.com <https://oilprice.com/Energy/General/Pirates-Threaten-Oil-And-Gas-Shipping-In-The-Red-Sea.html> Accessed on the 8th of April 2020.

¹³ Local Content Policies in the Oil, Gas, and Mining Sector <https://www.worldbank.org/en/events/2013/10/01/local-content-policies-in-oil-gas-mining-sector> Accessed on the 8th of April 2020.

¹⁴ A Review of The Nigerian Local Content Act 2010 NCACT.pdf <https://www.ncdmb.gov.ng/images/GUIDELINES/NCACT.pdf> Accessed on the 8th of April 2020. ¹⁵Russia and the Geopolitics of Natural Gas: Leveraging or Succumbing to Revolution? | PONARS Eurasia <http://www.ponarseurasia.org/memo/russia-and-geopolitics-natural-gas-leveraging-or-succumbing-revolution> Accessed on the 6th of April 2020.

¹⁶ How a Saudi-Russian Standoff Sent Oil Markets Into a Frenzy - The New York Times <https://www.nytimes.com/2020/03/09/business/energy-environment/oil-opeec-saudi-russia.html> Accessed on the 8th of April 2020.

Critical Analysis of the Contractual Risk in the Upstream Sector

In any business undertaking including the oil and gas sector, the possibility of loss of the investment is always a common denominator that the management of firms must always factor into decisions to engage in E&P in the upstream sector.¹⁷

Invariably, risks cannot be eliminated but managed through weighing of the options before investing and/or taking steps that are clearly set out in the clauses of the production contracts between parties so as to limit liabilities that will arise. Furthermore, steps like insurance, indemnities are all measures that business owners and managers take to reduce the impact of risks to companies and firms in the upstream sector.¹⁸

The first stage in the E&P process is the granting of license, which is usually given to a company as explained above. The license signifies the commencement of the contract between the IOC and NOC or Government. The IOCs are usually a consortium of companies with technical knowledge in different aspects of the E &P. The process involves a lot of contracting and subcontracting between parties in an effort to complement the process and move the crude oil out of the ground to the market. In the E&P process, costs are usually shared in the consortium as formulated in the contracts between parties as was decided in **Dresser Industry V Page Petroleum Inc**¹⁹ where the contractual terms between the parties were not clearly stated in terms of liabilities, thus impelling the court to divide the liabilities between the parties. Similarly, the capital intensive nature of the Oil and Gas sector compels industry players to clearly adumbrate limits to liability and risks in oil contracts in the upstream sector. This trend of sharing liabilities is judicially recognized by the courts.²⁰

Risks have evolved from the old trend of sole risk responsibility being borne completely by the company that is granted the licence²¹. The situation now is that the operator of the licence and all other companies and sub-contractors involved in any consortium also bear a part of the risk if it falls within the area of the work they are engaged to carry out. In the case of **BP V Trans-Ocean**,²² the Texas Supreme Court ruled on the issue of risk in relation to the famous Deep Water Horizon incident in the Gulf of

¹⁷ P. Saraceni & N. Summers, Reviewing Knock for Knock Indemnities: Risk Allocation in Maritime and Offshore Oil and Gas Contracts, Bluebook 20th ed 30 Austl. & N.Z. Mar. L.J. 28 (2016). <https://ivypana.com/referencing/bluebook-citation-style-guide/> Accessed on the 9th of April 2020.

¹⁸ Risk Allocation in Upstream Oil and Gas Contracts <https://www.kmd.law/articles/2018/january/risk-allocation-in-upstream-oil-and-gas-contract/> Accessed on the 9th of April 2020.

¹⁹ [1993]853SW2d 505

²⁰ Ibid Note 15

²¹ oga_guidance_disputes-over-third-party-access-to-upstream-infrastructure.pdf https://www.ogauthority.co.uk/media/2712/oga_guidance_disputes-over-third-party-access-to-upstream-infrastructure.pdf Accessed on the 9th of April 2020

²² 2015 Texas Supreme Court case No. 13-0670, RELATOR Supreme Court TX.pdf <http://phelpsdubar.com/webfiles/Supreme%20Court%20TX.pdf> Accessed on the 9th of April 2020

Mexico by preserving the right of parties to limit risk and liabilities on their part by properly capturing same in their contract clauses. It is notable that “... *The Supreme Court agreed with Transocean/its insurers’ position and decided against BP. The Drilling Contract terms had been “incorporated” into the insurance policy. BP’s status as an “additional insured” was found by the Court to be “inexorably linked ... to the extent of Transocean’s indemnity obligations”. The Court emphasised that BP, as a named additional insured, was only covered for “liabilities assumed by [Transocean] under the terms of this contract”. BP’s interpretation of the policy did not give any meaning to that underlined phrase, which proved its downfall.*”²³

Modern Contracts in the upstream sector reflects the global best practices which are aimed at reducing the risks to the barest minimum. Such risks are captured in the risk allocation clause, so as to ensure that loss incurred by each individual party is placed on the party that caused it. The “**Knock for Knock**” ensures that parties bear its own portion of the loss/risk. The Modern Contract departs from the old trend by clearly stating each party’s liabilities in a lucid, unambiguous way.²⁴

Despite the efforts of contracting parties in the up-stream sector to limit risk and liabilities in the contractual clauses that they sign, there are limits to such contractual terms largely due to public policy that protects the safety of the environment and the society at large from the excess profiteering by the industry, which may otherwise be more concerned with profits than safety of the environment and the society, a witnessed in the Niger Delta in Nigeria, which has weak environmental regulations and enforcement. In some cases, there may be a reason for a party to seek an indemnity for loss occasioned despite its best efforts. This may be achieved through exclusion of liability. Some instances when exclusion of liability clauses in the contract will not apply are as follows:

- a. Negligence: a failure to exercise due care, resulting in injury to another and for which an action for money damages may be brought. The failure to exercise due care may be the omission to perform an act that a reasonable person, guided by those circumstances that normally regulate the conduct of individuals, would perform, or it may be the commission of an act that a reasonable person would not commit, or would perform in a more careful manner with due regard for the safety of others²⁵. As can be seen in the Scottish case of **Caledonia North Sea Ltd V British Telecommunication Plc** were the Court held “.. *It is understandable that*

²³ BP v Transocean - UK P&I

<https://www.ukpandi.com/loss-prevention/article/bp-v-transocean-132010/> Accessed on the 9th of April 2020

²⁴ Ibid Note 15

²⁵ Negligence (law)." Microsoft® Encarta® 2009 [DVD]. Redmond, WA: Microsoft Corporation, 2008

*the right to indemnity should be excluded where the negligence or breach of statutory duty of the party seeking indemnity is evident*²⁶...

- b. Misconduct: Not carrying out the assigned act or responsibility diligently in line with the industry standards. In **Lewis V Great Western Railway Company**²⁷

Brett LJ stated that:

“...if it is brought to [a party's] notice that what he is doing, or omitting to do, may seriously endanger and he wilfully persists in doing that against which he is warned, careless whether he may be doing damage or not, then I think he is doing a wrong thing, and that that is misconduct, and that, as he does it intentionally, he is guilty of wilful misconduct; or if he does, or omits to do something which everybody must know to be a wrong thing to do. I think that those terms together import a knowledge of wrong on the part of the person who is supposed to be guilty of the act or omission”.

- c. Breach of Contract: Intentionally failing to comply with the terms of the contract agreed by the parties²⁸.
- d. Strict-liability: Where a manufacturer of a product or equipment holds out unsafe equipment, which when used causes injury, such manufacturer will be held to be strictly liable for the injury, damage or loss suffered as a result of the use of such equipment.²⁹

It is important to note that risk may be mitigated through Government Guarantees. These are globally recognized as needed to cushion the risk factors and growing uncertainties in the Up-stream sector through an assurance to Oil and Gas Companies of Government's resolve to guarantee Foreign Direct Investments as more oil fields are discovered.³⁰ The trend has no doubt boosted investor confidence in the Upstream Sector.³¹ These may also give companies the security to invest especially in countries with hitherto unfavourable policies like nationalisation, expropriation, over taxation and over regulation.

The emerging trends in Upstream Sector show that Governments around the world give incentives to Oil Companies including tax breaks so as to reassure investors and reduce their risks given the importance of the Oil and Gas Industry to global energy security.

²⁶[2002] UKHL 4, House of Lords -

<https://publications.parliament.uk/pa/ld200102/ldjudgmt/jd020207/caledo-1.htm> Accessed on the 10th of April 2020.

²⁷ (1877) 3 QBD 196, 206.

²⁸ Ibid Note 19

²⁹ Ibid Note 19

³⁰ bis-13-748-uk-oil-and-gas-industrial-strategy.pdf

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/175480/bis-13-748-uk-oil-and-gas-industrial-strategy.pdf Accessed on the 10th of April 2020.

³¹ Energy Act UK 2013

These are important contractual protections offered by Government and in the UK the Government has granted such tax breaks.³² In Mexico, companies like Exxon Mobil, Chevron and many others whose assets were once Nationalised by the Mexican Government have returned to Mexico³³ given better protection from such sovereign guarantees to investors in the upstream sector.

Key Features of Indemnities and Liabilities in an Oil and Gas Exploration Agreement

Indemnities in the Oil and Gas Exploration Agreements are provisions for undertakings to compensate a party for damage, loss, disputes, or inordinate expenses incurred by a party as a result of the act or omission of a party to the agreement between the indemnifier and indemnity holder.³⁴ As was stated in the Canadian case of *Lafrentz v. M & L Leasing*³⁵

The Indemnification Agreement is often part of the larger agreement between parties but may be a separate agreement entirely. Parties must be careful to read in between the lines in contracts so as to properly understand the scope and limits of liabilities that they pledge to cover in the contracts especially where the Oil Company engages an independent contractor.³⁶

The Key features of indemnity and liability in a contract are as follows:

- **Existence of a Valid Contract:** Contract, in law, is an agreement that creates an obligation binding upon the parties thereto. The essentials of a contract are as follows: (1) mutual assent; (2) a legal consideration, which in most instances need not be pecuniary; (3) parties who have legal capacity to make a contract; (2) absence of fraud or duress; and (5) a subject matter that is not illegal or against public policy³⁷.
- **Parties:** The Indemnifier and the Indemnity Holder must be clearly identified in the contract³⁸.
- **Scope:** The scope of the indemnity must be clearly stated to enable each party to know the limits of the application of the indemnity and liabilities that will accrue to the indemnifier.

³² £250bn: the cost of giving tax breaks to North Sea oil firms

<https://theferret.scot/north-sea-oil-250-billion-tax-break/> Accessed on the 10th of April 2020.

³³ Why Mexico's Oil Reform Is A Huge Opportunity For Investors | OilPrice.com <https://oilprice.com/Energy/Energy-General/Why-Mexicos-Oil-Reform-Is-A-Huge-Opportunity-For-Investors.html> Accessed on the 10th of April 2020.

³⁴ "Indemnity" Microsoft® Encarta® 2009 [DVD]. Redmond, WA: Microsoft Corporation, 2008.

³⁵ 2000 ABQB 714 (CanLII)

³⁶ Ibid Note 33

³⁷ G. Gordon et al (eds) *Oil and Gas law: Current Practice and Emerging Trends* (2nd Edn, Dundee University, 2011) ³⁸ A. Bodunde Badiru & S. Olusola Osisanya, *Project Management for the Oil and Gas Industry: A World System Approach* (CRC Press, 2013) e-book | London South Bank University <https://lsbu.rl.talis.com/items/29B48A85-1CAA-74DD-A3EB-17C31C96BB0.html> Accessed on the 11th of April 2020.

Liabilities: Parties in indemnity agreements have often devised ways to limit their liabilities. The frequent use of contractors in the oil and gas Agreements by the holders of licences and the risk involved led to the introduction of The **Hold Harmless Agreement**; which is a contract between parties that modifies the Legal Liabilities between them.³⁹

Contracting Parties in the Upstream sector will continue to identify ways to reduce the risk in the E&P process within the limits of the terms they agree on and as permitted by Law.

The Effectiveness Of Contractual Risk Provisions Relating To Indemnities And Liabilities In The Oil And Gas Upstream Sector.

The Contractual risk provisions relating to indemnities and liabilities in the upstream sector are clauses in the Agreement that specifies the damages that one party will pay the other party in case of breach of contract. Thus the effectiveness of a contract is determined by the consensus and mutual agreements of the parties involved. If the contract has been signed by the parties save for some exceptions, it will be binding on the parties.

All contracts in the up-stream sector as it is in other businesses have elements of risks. The amount of investment that is required in the upstream sector makes it a very risky venture and a lot of risk mitigation measures are taken to mitigate any likely risk and safeguard the capital of the investor by reducing the liabilities that will accrue in the event of any eventuality.

The purpose of limitation of liability clauses and the effectiveness thereof are expressed in the following types of clauses:

- Amount Cap: this seeks to reduce risk by limiting the liability to a certain amount that will be awarded to the party in that is indemnified. It is usually stated expressly by the parties to the agreement.⁴⁰
- Exclusions: certain items of loss are usually excluded by the parties such as indirect damages, loss of profit, which are not foreseeable, breach of confidentiality, breach of intellectual property and breach of data privacy among others. As was stated in the case of *Investors Compensation Scheme Ltd v West Bromwich Building Society* “... while the old rule of ‘objective bystander’ still applied in interpretation of contracts, such a bystander should be assumed to be informed of most of the background facts to the disputing parties’ contract...”⁴¹

³⁹ Allocation of liability in the UKCS: the Industry Mutual Hold Harmless Scheme (IMHH) | Legal Guidance | LexisNexis <https://www.lexisnexis.co.uk/legal/guidance/allocation-of-liability-in-the-ukcs-the-industry-mutual-hold-harmless-scheme-imhh> Accessed on the 11th of April 2020.

⁴⁰ G. D. Well et al, ‘Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the “Entire” Deal?’ (2007) <http://www.weil.com/files/Publication/563ccf98-648d-4e5b-b3e5129805230615/Presentation/PublicationAttachment/fb77618a-f943-4797-98a12a69d92a4522/Extra-Contractual%20Liability%20Article.pdf> Accessed on the 11th of April 2020.

⁴¹ [1998] 1WLR 896

Thus, the effectiveness of contractual agreements relating to the indemnities and limitation of liabilities agreed by parties end up being effective with further agreements to evaluate already agreed terms, which become effective as captured in the clauses agreed by parties. The success of contractually agreed terms in the upstream sector is subject to the following:

- The Clarity of the limitation Clauses agreed by parties in the contract. The parties must note that Courts can intervene to invalidate or weaken exclusion clauses, especially where they are ambiguous. As was decided in *Transocean Drilling UK V Providence Resources Plc* “...***The recoverability of “spread costs” and “consequential loss” provisions must be clearly stated by parties for its full enforcement.***”⁴²
- Statutes that mitigate the effects of exclusion clauses seeking to limit the liability of parties. The court in the case of *Farstad Supply AS V Enviroco* opined that “... ***the operation of the Clause would in fact determine its true nature i.e. if it serves to create responsibility for the exposure of ‘a third party’ it would be an indemnity Clause; whereas if it operates only to create responsibility for the exposure of a party in the contract then it would be ‘an exclusion’ clause...***”⁴³

Findings and Recommendations.

The issue of contractual risks in the upstream Oil and Gas sector has continued to be an issue of major concern. Doubtless, this issue will continue to be relevant as long as fossil fuel is used as a source of energy. As such, one may opine, from surrounding laws and commercial realities that draftsmen and lawyers that draft and review clauses in contractual agreements in the upstream sector must take cognisance of the following:

- i. The nature of the contractual relations that the client wishes to enter into, as this determines the types of risk that must be mitigated (e.g. whether sovereign risk or otherwise),
- ii. The weighty adverse implications for the Company from not mitigating such risk,
- iii. The regulatory provisions relating to that subsector bearing in mind that most climes hold the Major contractor liable for breaches by independent contractors,
- iv. Long term effect of risk reduction clauses to the business,
- v. The need to ensure the client’s Competitiveness
- vi. Sustainability of the Industry

Recommendations

It is not enough to record one’s observational findings but also proffer solutions thereto.

These are as follows:

- i. Parties should consider the classic methods of risk allocation in the contract
- ii. Parties should pay attention to the issue of pollution and the cap of liability, as it is a major risk issue that drains resources.

⁴² [2016]EWCA Civ 372

⁴³ [2010] UKSC 18

- iii. Parties should review the performance of independent contractors from time to time within the duration of the contract.
- iv. Parties should create a contract implementation interface committee that will meet from time to time to review performance.
- v. Parties should review and or have a clause on approval of key clauses in the contract term.

Conclusion

The upstream sector is the most risky of all the Oil and Gas Industry. The global incidents ranging from accidents, Political matters, pandemics, conflicts, over regulation by Governments, makes the issue of risk and liabilities in the sector more challenging for the operators. The sector has continued to evolve by becoming more dynamic. The issue of Energy security in the 21st century is everybody's business, as human civilisation has become more and more dependent on Energy for its existence and Oil and Gas Industry remains a key source of energy. Consequently, all stakeholders must come together to identify ways that will reduce the risks and make energy available for our socio-economic development, taking cognisance of environmental concerns.

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