Drilling contracts are at the core of upstream operational agreements. They come in many forms and are negotiated to varying degrees depending on the value of the contract, level of risk involved, and existence of regional forms that may dictate terms. This article focuses primarily on general terms of a typical long term, high-dollar, day-rate, offshore contract; however, many terms discussed apply to the entire spectrum of drilling agreements. The terms selected for discussion are not intended to be exhaustive; they should be considered illustrative, and are intended to highlight the care that should be given to contract terms often unique to a drilling contract.

With $100+ oil over the last few years it has been a drilling company friendly market: high rig rates and driller favorable contract terms; however, as oil prices have fallen to below $50 and the budgets for oil company expenditures have been consequently slashed, there will be a drive, from the oil company perspective, to reduce the costs on their existing drilling contacts and to get better terms (including lower rig rates) on their new drilling contracts. This is likely to have two principal effects:

i. in many cases, oil companies are tied in to long term, multi-well drilling contracts that they will no longer have the revenue to fund – they will be forced to cancel or renegotiate terms for these contracts. This will inevitably lead to an increase in drilling contract disputes.

ii. for new drilling contracts the oil companies, beyond their obvious desire to want lower rig rates, will want increasing flexibility in the contract terms, a re-balancing of the risk/reward profile, and reductions in the fixed cost elements of the contract.

Awareness of critical terms which may be integral to a particular contract is important during the negotiation process to minimize the incidence of misunderstandings and conflict after execution. It is primarily in these areas that the scope for dispute lies for an existing contract, and where the focus of negotiation will lie for new drilling contracts.

Mobilization and Demobilization

It is in the best interest of the rig owner and the operator to be certain that there is a clear and definable point in time and space for both mobilization and demobilization. Depending on the terms of an agreement, day-rates may begin and end at mobilization and demobilization. This is often achieved by designating a location within a specified proximity to the project area. There are often other terms surrounding mobilization which may include place or port of origination (which may impact customs at the destination) and other applicable and appropriate conditions and/or covenants that apply to a specific transaction. Another important factor relating to mobilization is the pre-mobilization or pre-commencement inspection by the operator. Where and when will the inspection(s) take place and what are the consequences if the rig does not meet the technical requirements of the contract?

The parties should consider how demobilization is effected, particularly if the end of demobilization triggers
the cessation of payment of day-rates. How is demobilization determined? What are the criteria for establishing demobilization and are these criteria within the drilling company's control; if so what incentive has the drilling company to achieve demobilization quickly? Are there any government approvals that are needed that could cause delay? Is there any oil company equipment that must be offloaded from the rig and how will this be handled?

The parties will also need agreement as to the demobilization location and the terms either party may require in connection with flexibility of the demobilization location.

**Commencement Date**

Commencement is often viewed as a benign term; however parties should pay attention to subtleties that could impact the transaction. In some contracts, commencement triggers the beginning of the day-rate payment structure, while in others, mobilization is also paid as a day-rate and the commencement date triggers a change from a mobilization rate to a higher, full operational rate. Is the commencement window firm and binding? Will default arise if the rig is not on location and ready to operate by the end of the commencement window? If the rig arrives early, will a day-rate apply? Are the terms clear with respect to location and condition of the rig at the time of commencement? Is there a specific obligation that the rig be classified properly at the time of commencement? If modifications were required by the operator, does the agreement allocate risk for delays and related issues in connection with the modifications and does the commencement date take such delays into consideration? Does commencement occur at the end of mobilization or is it conditioned on operability and other factors (such as completion of upgrades and/or modifications)? What are the technical/operational tests that the rig must meet to demonstrate that it is ready to commence?

These are often negotiated points in a drilling contract and are driven by a variety of factors including current market terms, unique conditions surrounding a particular rig or project, factors related to timing of commencement, and internal requirements of both the rig owner and operator.

**Term**

The term of a drilling contract may be defined by time or by the drilling of a specified number of wells. Either approach is common in long term drilling contracts. A combination of project and market factors drive this decision.

When a specified time period is contemplated in a drilling contract, provision must be made for the final well in the event drilling is in progress at the end of the specified term. The parties agree to the contract parameters by which a well-in-progress will be completed or suspended before termination of the contract. Safety dictates minimal terms, and from there the parties agree to specific points in the drilling and completion process that will trigger termination and commence the demobilization process.

When the term of a drilling contract is based on the number of wells drilled, a clear definition of "well" should be included. The drilling company has an expectation that at least a certain number of days will be used drilling the firm wells in the contract giving a minimum revenue stream, whereas the operator (i) needs the flexibility to vary the drilling plan as geology dictates, (ii) needs the right to abandon drilling if the target is technically, or from a budget perspective, not obtainable (including after fishing and sidetracks), and (iii) desires to complete the drilling plan as quickly as feasible in an effort to reduce well costs.

To resolve this issue when defining "what is a well," key questions need to be considered. Does each sidetrack or deepening constitute a new well? During drilling, if the rig encounters a strata that cannot be penetrated and the drill bit needs to be repositioned or drilling plan modified directionally to continue drilling, does this constitute a new well? It is important to establish the definition of a "well" in the contract as market conditions may pull the operator and rig owner in different directions in their respective desires to complete their obligations under the contract, and each party needs the certainty of knowing a mid-agreement negotiation or dispute will not surface over issues related to the definition of "well."

In addition to the specified number of wells in a drilling contract in which the term is defined by a specific number of wells, the parties may also negotiate option wells into the agreement giving the operator flexibility to drill additional wells under the original contract pursuant to pre-agreed terms. These provisions are effectively pre-agreed contract extensions with the terms for extension built into the agreement.

**Day-Rate Triggers**
The typical drilling contract implementing a day-rate compensation structure can present ambiguity if not properly drafted. Drilling contracts may include all or some of the following day-rates: (i) mobilization and demobilization rates (payable when the rig is traveling to and from drilling location), (ii) standby rates (payable when the rig is on contract but not used and can have sub-categories of "hot" standby (payable when the rig is ready to re-commence operations on short notice) and "cold" standby (payable when elements of the rig crew and/or services have been demobilized)), (iii) operational rates (payable during drilling activity), (iv) force majeure rates (payable during the period of a force majeure event), (v) repair rates (payable when the rig is not operating and permitted maintenance or acceptable repairs are underway), and (vi) zero rate (payable when the rig is not operating due to fault of the drilling company or under other specified circumstances).

The points in time and causes of the "triggers" at which different day-rates apply need to be clearly defined and documented. One way to capture the pricing structure in a manner that allows each party to perform adequate quality control and insure common understanding is to consolidate all pricing terms in a single contract provision or in a schedule.

The triggers for any change in applicable day-rate must be objective and understandable. If a "zero rate" is contemplated under specific circumstances, these should be outlined in the pricing provision or schedule so neither party is caught off-guard should a zero rate be mentioned in one of the other contract provisions.

Allocation of Risk

Allocation of risk under a drilling agreement is often driven by each party's insurance profile and risk management objectives, taking into account proper placement of business risk associated with the operator and the rig owner. The objective is often to place risk of loss associated with people and property with the party who maintains insurance on that risk. This is typically driven by either a "knock-for-knock" liability regime or a negligence-based regime. Location of the drilling activity is sometimes a driver in risk allocation, as different geographic regions may typically follow one regime or the other for numerous reasons (such as anti-indemnity statutes or historic practice and procedure). There may be carve-outs based: (i) on some level of culpability (such as, gross negligence or willful misconduct) or (ii) on the business risk that naturally or typically lies with one party or the other (such as, liability for the reservoir, the environment, or the drilling rig).

Vessels and helicopters may pose a unique challenge in allocating risk. Sharing arrangements in a particular geographic region may also play into allocation of liability associated with vessels and helicopters. The liability associated with vessels and helicopters is sometimes different from the overall scheme for risk distribution and is often negotiated.

Certainty with risk distribution and assumption of liability is critical when negotiating and documenting the terms of a drilling contract. Each party needs a clear understanding of the risk they are assuming in order to assess the practicability of the contractual relationship from a business perspective.

Breach and Termination

While a drilling contract may include breach and termination provisions comparable to other service and related agreements, there are a number of situations that may arise that are unique to drilling. Unique situations, that may seem obvious, need to be specifically addressed in the agreement if the parties want certainty as to contractual rights and obligations should such a situation occur. For example, if the rig's classification lapses during the term of the agreement does this constitute breach of the agreement? Does breach occur after a specified number of days that the rig is not operable and, if so, are these days cumulative over the term of the contract or during a specified period of time? Should the foregoing give rise to termination rights or are damages an acceptable remedy? The contract should be specific with respect to which breaches may result in termination.

The provisions surrounding termination rights for events of force majeure and loss of the drilling rig should also be carefully considered and documented. The rig owner and operator typically consider proper allocation of force majeure risk and, at times, agree as to how this risk will be apportioned between them. Loss of the drilling rig often results in immediate termination and does not constitute breach under normal circumstances. If an early termination for convenience right exists, clear terms surrounding such termination should be well documented. Early termination is essentially a liquidated damages clause, typically giving the operator a right to terminate before the end of the term. Termination of a drilling contract can pose special problems for both the rig owner and the operator, so it is critical that terms surrounding termination are well understood and well defined.
Assignment and Rig Sharing

While many agreements contemplate assignment rights, in long term drilling contracts the right is often invoked. While the term “assignment” is commonly used, what is often meant (and what the contract terms sometimes reflect) is a novation of the agreement (the legal transfer of all or most of the rights and obligations of one operator to another operator). The contract needs to provide the conditions for assignment (and preferably to a form of assignment agreement). Correct drafting of these provisions and a form of assignment (or novation) can save the parties significant time and frustration when assignment is being contemplated. As assignment agreements often contemplate reassignment of a drilling rig, the assignment agreement will contain terms that may limit certain rights of the assignee, clearly define when assignment and reassignment occur, establish lines of communication during the assignment period that typically involve the assignor, and generally establish the relationship among the parties during a period of assignment.

Operators may elect to collaborate in securing a long term commitment from a rig owner to enable them to share a rig over a specified period of time, or for a given number of wells, in order to maximize efficiencies and flexibility in drilling operations. A longer term contract is typically more attractive to a rig owner and lower rates can be offered and there can also be savings on a per-well cost for mobilization and demobilization.

These rig sharing arrangements may take the form of either (i) a single oil company contracting a rig to drill wells in multiple concessions/PSCs with different subsidiaries holding operatorship under each concession/PSC, or (ii) multiple, unaffiliated operators clubbing together to contract for a rig. These sharing arrangements can apply within a single country or across borders. These sharing arrangements take many forms and range from a series of assignments and reassignments to full collaboration among the parties. In implementing full collaboration, the parties consider staffing of crews and supervisors and may elect for almost total continuity of personnel, supplies, and most equipment. The general belief is that with higher collaboration the parties realize greater efficiency in their respective drilling programs. These arrangements require significant cooperation on the part of all parties and commitment from each party to plan wells and drilling programs in such a manner that allows smooth transitions between wells and permit areas. Liability issues are addressed contractually and may be managed through secondment and similar arrangements as the rig is transitioned between drilling programs.

Conclusion

Drilling contracts contain unique terms that can result in significant operational and financial implications for both the operator and rig owner. If not drafted well, these contracts can be fertile areas for dispute. Avoiding ambiguity, or silence, in the contract with respect to these critical terms, will prevent misunderstandings and conflict should situations arise that require contract interpretation. Proper drafting will also help ensure that each party gets what it expected from the contractual relationship.