ENERGY EXPERT: ISSUES IN FOCUS

A quarterly review of disputes and complex issues in the hydrocarbon production and processing industries

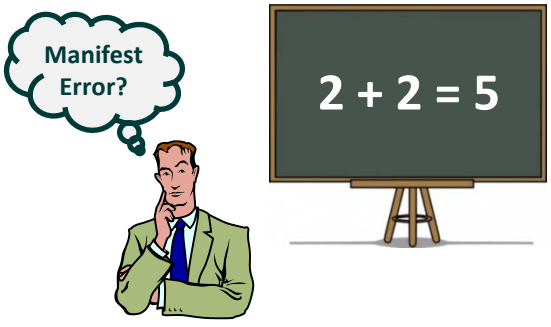
Baker & O'Brien, Inc. www.bakerobrien.com July 2013

When "Manifest Error" May Not be "As Plain as the Nose on One's Face"

International Arbitration, Latin America

By John B. O'Brien, P.E.

A large international engineering/construction firm contracted to upgrade and modernize an oil refinery and associated pipelines in Latin America. The contract was for an amount in excess of US$1 billion. To avoid undue delays associated with potential technical issues that might arise during project execution, the contract called for the appointment of a well-recognized specialty technical firm (the independent engineer or "IE") to resolve such matters. The parties agreed that the IE's decisions would be "final and binding" except in the event of "manifest error" on the IE's part. During the course of the project, over 250 technical disputes (including many change orders) were submitted to the IE for resolution. The IE investigated and ruled on each item—some decisions favored the owner, some the contractor, and some were "split decisions."



As the job approached completion, despite many supporting IE resolutions, the owner had failed to make payment for many millions of dollars of agreed change orders—both design modifications and extra work.

The contractor filed a claim for arbitration—but the owner counterclaimed, alleging, among other matters, deficient work product, off-specification materials, and incomplete work scope. Many of the counterclaims involved "re-opening" of previously resolved IE resolutions, claiming the IE had committed manifest error. Colloquially speaking, manifest error is often described as an error "as plain as the nose on one's face." The owner pleaded that the IE had, in many cases, ruled on legal—rather than technical—issues and that this constituted manifest error. The arbitration panel had to determine, for each IE resolution, whether the IE had exceeded its contractual authority, and if not, whether the ruling contained manifest error.

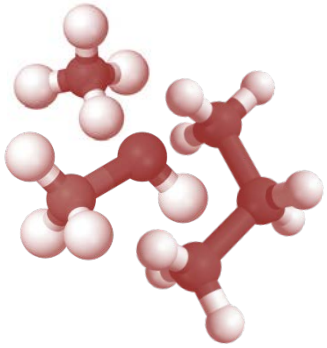
Baker & O'Brien was engaged to review the evidence supporting the claims and counterclaims. Specifically, had the IE considered all the available evidence and had it ruled correctly based on that evidence? Had it exceeded its contractual limits of responsibility? Was there manifest error? Over a period of years, our consultants analyzed all key resolutions, issued reports in both Spanish and English, and testified in three separate arbitration hearings. Opinions were provided on the contractual provisions, the technical specifications, the work performance, and the quantum values. In formulating our opinions, we often had to apply our expertise and knowledge regarding standard industry practice. The arbiters relied on both our reports and our oral testimony—as well as the advice of their own self-appointed consultant—in reaching their decisions.

How "Petroleum" is Defined Can Have Important Contractual Implications

Jury Trial, United States

By Ken Baker, P.E., and Dileep Sirur

An oil and gas partnership agreement stipulated that a third-party consultant—who had been instrumental in a successful discovery—would receive an "incentive override" comprising a percentage of the sales revenues from the "petroleum produced at the concession." When crude oil production initially commenced, the consultant received the agreed override. However, given that associated natural gas was re-injected and not sold, no override was paid on this produced gas.



Over a period of time, a gas processing plant and other facilities were built to recover liquefied petroleum gases (LPGs), and convert the produced gas into derivative products. Although the LPGs and the other products were sold at world market prices, the consultant's override was based on the lower transfer price of natural gas sold to the downstream facilities.

The consultant filed lawsuits against the owners in an effort to have his override paid based on the sales revenues from the downstream products, arguing that the partnership agreement defined petroleum as oil, condensate, natural gas, and all marketable materials produced from them. In their defense, the owners claimed that since crude oil and natural gas comprised the only petroleum "produced at the concession," they were the only products eligible for the override. Resolution of the case depended not only on interpretation of the override agreement, but also the definition of "petroleum." Baker & O'Brien was engaged to provide expertise in petroleum production contracts, natural gas processing, and the production of LPGs and other derivative products. A report outlining our opinions proved instrumental in helping facilitate a settlement between the parties.

Death by 8,000 Cuts – How Changes During Construction Can Impact a Project

Jury Trial, United States

By Don Flessner and Rob Donnell

A chemical manufacturer hired an engineering/construction firm to design and build a chemical plant on a "lump-sum" basis. When the project overran the budget and was not completed on schedule, the owner filed a lawsuit against the contractor, alleging job performance as the cause. In its defense, the contractor claimed recurrent design changes by the owner disrupted the project execution plan.

Completion of a project within the terms of a lump-sum bid requires a well-defined engineering design and scope of work prior to commencement. Owner-requested changes during project execution can disrupt a contractor's work plan and impact overall job efficiency. The cumulative effect of such disruptions can be particularly troublesome and lead to schedule delays and/or cost overruns.

In this case, Baker & O'Brien was engaged to examine how the more than 8,000 owner-requested changes may have

affected the cost and schedule. Such an analysis necessitates an understanding of each party's contractual rights, the bases for the changes, and the construction process. A study of thousands of project documents led our consultants to conclude that the incessant design changes were the root cause of most of the cost increases and schedule delays—only 128 changes were traced to contractor-related issues. Our analysis and calculation of damages weighed heavily in the jury's decision.

Consulting Support for Complex Commercial Disputes

When faced with complex commercial disputes in the energy-related industries, clients often turn to Baker & O'Brien for its independent and objective support. For over 20 years, the firm's consultants have employed their engineering knowledge, industry experiences, and commercial acumen to provide assistance on a wide range of matters. Our project experience includes disputes involving operational incidents, standards of care, asset valuation, commercial supply terms, product quality, large engineering and construction projects, and intellectual property.

Our clients include many of the world's largest law firms, insurance providers, and operating companies. Law firms rely upon Baker & O'Brien to evaluate technical and commercial aspects of a case and provide expert testimony. Our analyses, conclusions, and expert testimony have been heard by judges, juries, and arbitration panels around the world. On insurance matters, clients rely upon Baker & O'Brien's assistance for investigation of industrial accidents, and quantification of resultant property damage and business interruption losses. We are also called upon to assist insurers in subrogation actions by evaluating causation theories and claims for damages.

We would welcome the opportunity to discuss our qualifications in more detail as they relate to your specific area of interest.

BAKER & O'BRIEN INCORPORATED 20 YEARS

Celebrating a Tradition of Service

Dallas Headquarters

12001 N. Central Expressway
Suite 1200
Dallas, TX 75243
Phone: 1-214-368-7626
Fax: 1-214-368-0190

Houston

1333 West Loop South
Suite 1350
Houston, TX 77027
Phone: 1-832-358-1453
Fax: 1-832-358-1498

London

146 Fleet Street, Suite 2
London EC4A 2BU
Phone: 44-20-7373-0925

Baker & O'Brien Inc. is an independent, professional consulting firm specializing in technology, economics, and management practice for the international oil, gas, chemical, and related industries.

www.bakerobrien.com