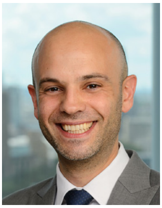
Liberty Specialty Markets

THE CHALLENGES ASSOCIATED WITH TRANSFERRING FROM CONSTRUCTION TO OPERATIONAL COVER



Onshore "Oil & Gas" Construction projects require a smooth handover from Construction to Operational insurance, and yet clauses in the two policies are rarely aligned. Amin Khairallah, Vice President - Risk Engineering, Liberty Specialty Markets, Dubai sets out the common issues that can occur when transferring construction projects onto Operational insurance policies.

A common challenge faced by Onshore Oil & Gas underwriters is the review of the readiness to transfer construction projects onto operational insurance policies. This can be particularly challenging with respect to large or mega projects which have been split into sub-packages, but even some of the more straightforward projects have not historically been easy to transfer to operational cover.

This paper highlights some of the common issues faced during the request to transfer to Operational cover, and possible ways to address them.

Construction Policy Period

The end of the period of cover for Erection All Risk (EAR) insurance policies for onshore Oil & Gas (also includes Petrochemical and Chemical) risks has no standard definition. Typically, it seems to vary between:

a. The point of issuance of Provisional Acceptance Certificate (PAC). For example:

   “Period: Construction Period estimated from 00:00:01 hrs local standard time on 1st December 2019 to the issuance of the final Provisional Acceptance Certificate (PAC) (anticipated date as per the table below) or 1st January 2023 whichever the earlier.”

b. A defined end date. For example:

   “Period Of Reinsurance: From 1st December 2019 To 1st January 2023. Including Hot testing and commissioning period up to a maximum of 4 weeks and 3 months total testing. Followed by 12 months Extended Maintenance (MRe 004).”

c. Commencement of “Commercial Operation” (more common to power projects, and so will not be discussed further in this paper). For example:

   “Period: The Project Period being from 00:01 hrs on 1st December 2019 being the Financial Close date and continuing until 23:59 hrs on 31st December 2023 or Interim Commercial Operation Date (ICOD) as defined in the applicable contracts, including hot testing / commissioning / initial operations individually any one plant or unit.”

Continuation of Cover

Ideally, and to ensure continuation of insurance cover for the Insured, once the Construction Policy comes to an end, there should be an immediate transfer to an Operational Policy.

Looking at this from a slightly different angle, the Construction Policy should not end until it is confirmed that Operational cover is fully in place.

Establishing the correct point of transfer to an Operational policy is absolutely critical for our policyholders to ensure there is no gap in cover, and the challenges often associated with this highlight a significant disconnect between the requirements of the Construction and Operational Policies, as shall be further explained below.

In some cases, Construction Policies may offer a “property taken into use” extension of cover. This is intended to apply to minor elements of a project, where the exposure in operating these minor elements is understood by the underwriters. There are also cases where “initial operation” of an asset may be covered under the Construction Policy. These cases may arise in exceptional circumstances but are relatively rare in the Oil & Gas industry, so will not be explored further in this paper.

Transfer to Operational Cover

Operational Policies include a Testing and Commissioning Clause (T&C Clause) which defines the conditions under which assets may be accepted onto the Operational Policy. This clause is the critical gateway for the Operational Insurers. Currently, the most commonly used and accepted standard wording for the T&C Clause is the LMA5197A:

Property And Plant Testing & Commissioning Clause

1. It is hereby noted and agreed that this (Re) insurance does not cover destruction of or damage to property in course of construction or erection, dismantling, revamp or undergoing testing or commissioning including mechanical performance testing and any business interruption resulting therefrom.

2. Acceptance of property hereon is subject to satisfactory completion of the following:

   2.1. Mechanical completion.

   2.2. Testing and Commissioning.

   2.3. Performance Testing conforming to 100% Contract Design Critieria having been maintained by the entire plant in a stable and controlled manner for a continuous period of a minimum of 72 hours duration.

2.4. Official acceptance by the insured following formal hand over without reservation or waiver of guarantee conditions.

2.5. Any deficiencies identified during the testing, commissiong and start-up that may affect the mechanical integrity, process safety or reliability of the plant, having been declared to (Re)Insurers prior to attachment.

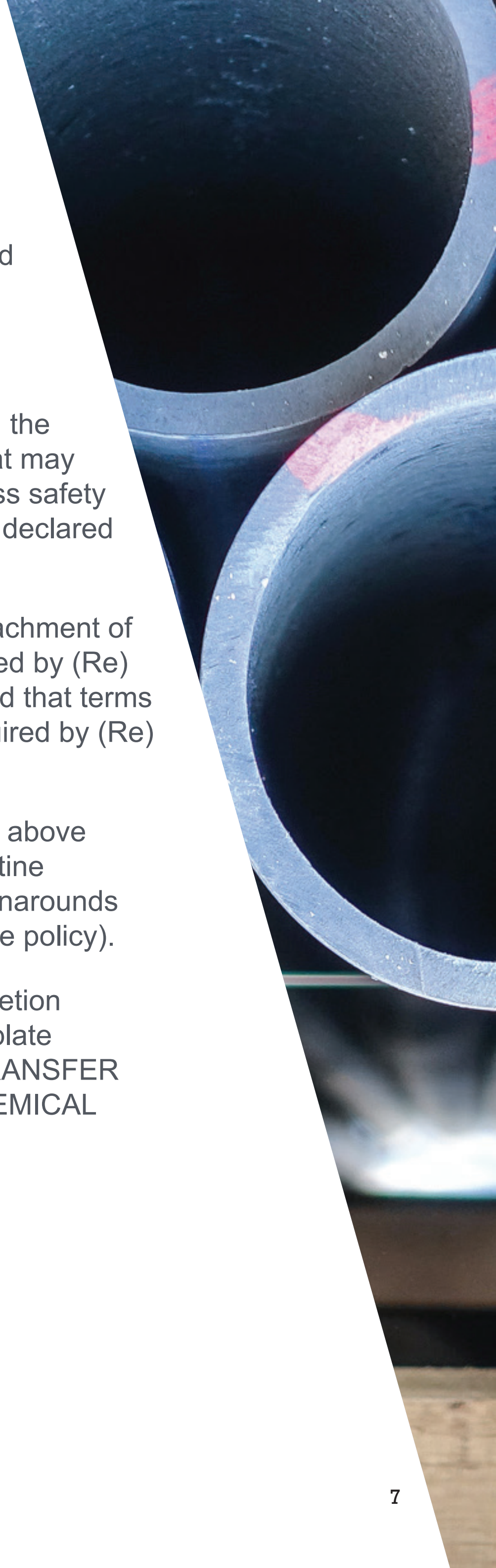
3. NOTWITHSTANDING the above, attachment of property and plant hereon to be agreed by (Re) Insurers. It is further noted and agreed that terms and conditions to be reviewed, if required by (Re) Insurers.

4. It is further noted and agreed that the above provisions do not apply to normal routine maintenance activities, scheduled turnarounds and / or minor works (as defined in the policy).

Additionally, (Re)Insurers request completion of the attached information request template “INFORMATION TO SUPPORT THE TRANSFER OF ONSHORE OIL, GAS & PETROCHEMICAL ASSETS FROM CONSTRUCTION TO OPERATIONAL INSURANCE”.

LMA5197A

27 January 2014



T&C Clause wording in use prior to the development of the LMA5197A in 2014 (and the previous LMA5197) covered largely the same essential requirements; the key elements in all cases of what is required by Operational Insurers may be paraphrased and summarised as:

- There must be no outstanding critical punchlist items (typically classified as Category A or B), or any other deficiencies or warranty items which may impact on the mechanical integrity, process safety or reliability of the plant.

- All Performance Test Runs must be successfully completed, with the plant demonstrated to have met all guarantee conditions, including design rates, in a stable and controlled manner for a continuous period of at least 72 hours.

- The Insured must officially accept the assets following formal handover (i.e. issuance of a Provisional Acceptance Certificate (PAC), sometimes referred to as a Take Over Certificate (TOC)) without waiver of guarantee conditions.

Testing and Commissioning Challenges

Technically, hydrocarbon/feed should not be introduced into a facility prior to close out of all Category A and Category B punchlist items. PAC should also not be issued until all subsequent Performance Test Runs have successfully demonstrated that all guarantee conditions have been met (which should also include operation of the facilities at (100% of) design rates in a steady and controlled manner for a minimum of 72 continuous hours).

There are however a few realities to be addressed:

1. **Construction projects rarely run on schedule:** defining the end of a Construction Policy as a specific date sometime in the future is therefore not necessarily a valid approach, and the project schedule should always be considered a guideline rather than set in stone.

2. **Punchlist items are not always correctly classified.** This is often due to misunderstanding the risk/criticality of the punchlist item or, in rare cases, is deliberate in order to apply contractual conditions upon the EPC Contractor. In both cases, the criticality may be either over-stated or under-stated, and will be reviewed and queried by Operational Insurers when assessing readiness to attach to an Operational policy, in line with Section 2.5 of LMA 5197A.

3. **Hydrocarbons will often be introduced despite there being outstanding Category A and/or B punchlist items**, and often with limited evidence of these outstanding items being risk assessed. This infers that hydrocarbon/feed was introduced to the facility prior to close out or adequate waiver of these punchlist items. It cannot definitively be stated why this occurs, though one might consider commercial pressures to be a potential factor, as well as the issues highlighted in point (2) above.

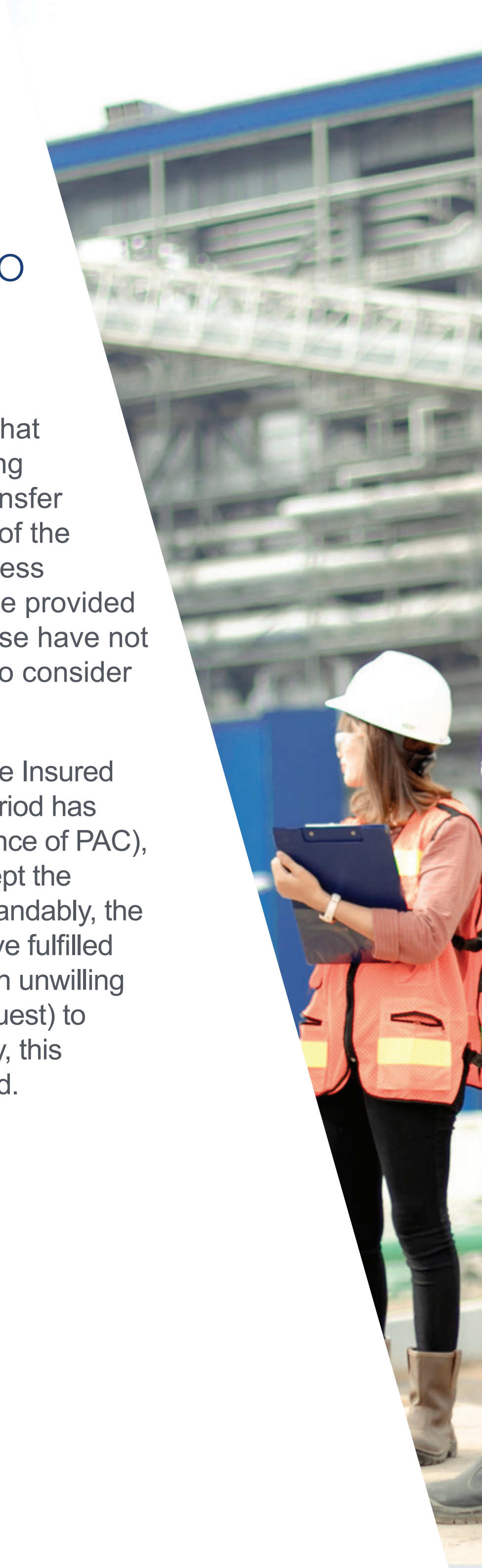
4. **Testing and commissioning doesn’t always go to plan**, either due to feedstock or customer availability challenges or, in the worst case, technical challenges.

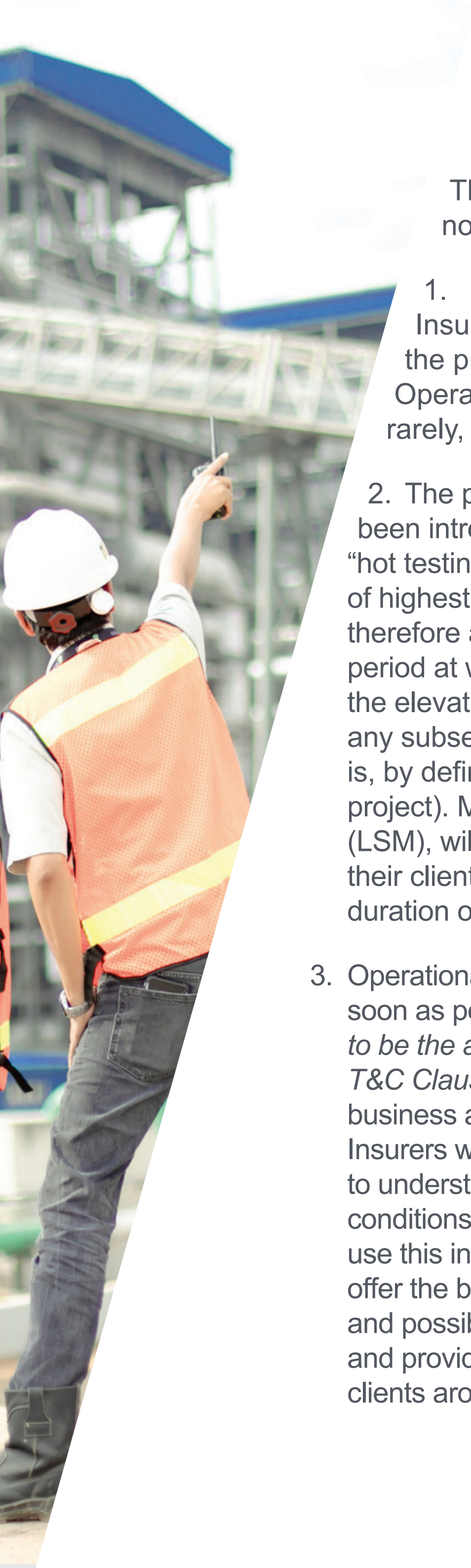
5. **Provisional Acceptance often takes place despite the issues noted in points (3) and (4) above.** Whilst it is surprising that Insureds may be willing to waive contractual agreements with their contractors, there may again be other factors coming into play in their decision.

Demonstrating readiness to transfer to Operational Cover

The consequence of the above points is that Operational Insurers are increasingly being approached with requests to attach or transfer assets to Operational Policies without all of the T&C Clause requirements being met. Unless sufficient and adequate justification can be provided to support why elements of the T&C Clause have not been met, Operational Insurers struggle to consider provision of Operational cover.

This can cause a particular challenge for the Insured when the end of the Construction Policy period has been "triggered" (for example, by the issuance of PAC), yet Operational Insurers are unable to accept the assets onto an Operational Policy. Understandably, the Construction Insurers will consider they have fulfilled their side of the bargain, and if they are then unwilling (or have not been approached with the request) to extend the period of the Construction Policy, this leaves Insureds (at least partially) uninsured.





There are three very important points to note at this stage:

1. Often, but not always, the same Insurance companies will be involved in the provision of both the Construction and Operational Policies (though note that it is very rarely, if at all, the same underwriter).

2. The period during which hydrocarbon/feed has been introduced to the facility (referred to as the "hot testing" period) is considered to be the period of highest risk to Construction Insurers. There is therefore a preference for them to minimise the period at which they are at risk, despite "pricing in" the elevated exposure for the hot testing period and any subsequent period extensions (as any extension is, by definition, within the hot testing phase of the project). Many, including Liberty Specialty Markets (LSM), will however look to understand and support their clients' needs and may offer extensions to the duration of cover.

3. Operational Insurers are keen to come on risk as soon as possible, *but only once it is demonstrated to be the appropriate time to do so as per the T&C Clause requirements*, as this represents new business and generates premium growth. Operational Insurers will therefore always work with the Insured to understand the reason(s) why the T&C Clause conditions have not been met in their entirety, and will use this information to take a pragmatic approach to offer the best solution(s) possible wherever practical and possible. LSM has taken a lead role in this area and provided innovative solutions to many of our clients around the world.

How to ensure a smooth transition from Construction to Operational Cover

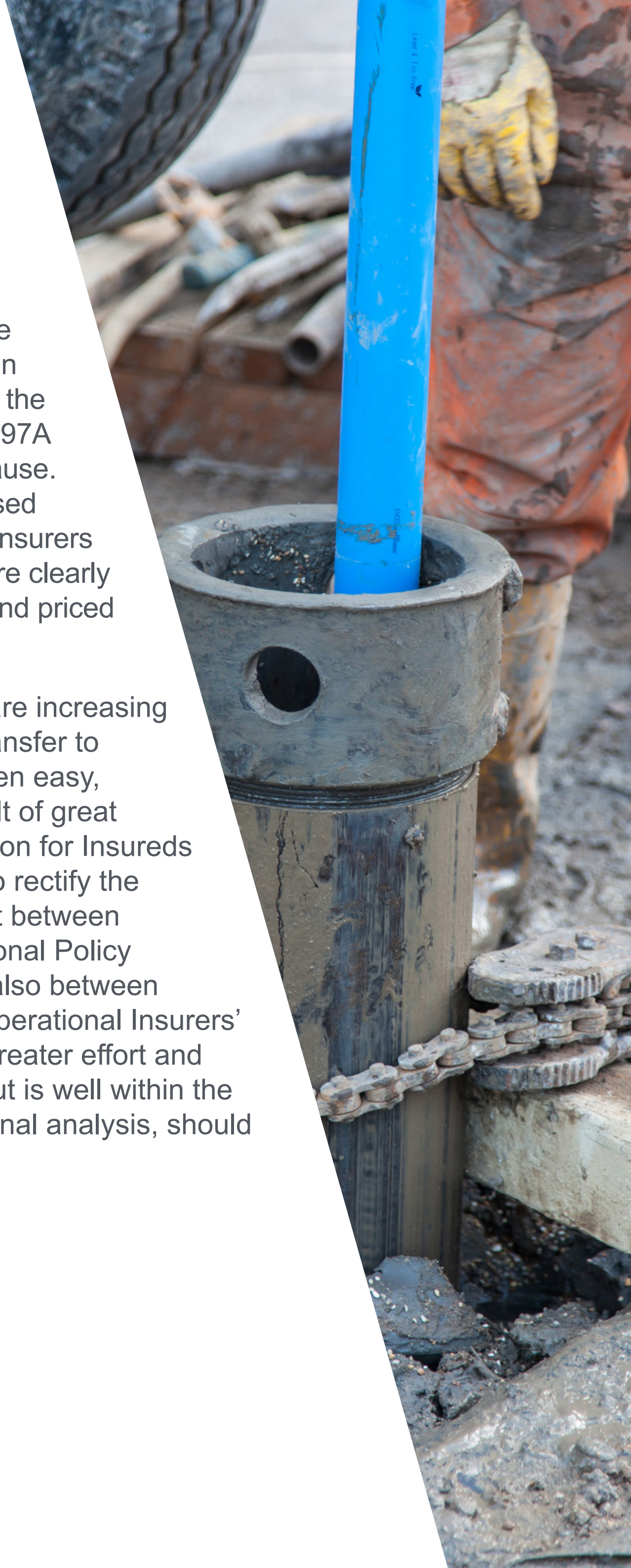
The following may be considered possible solutions to the increasingly regular issue of Insureds facing potential periods with no/incomplete insurance cover:

1. Brokers and Insurers need to help Insureds to better understand the Operational Insurers' requirements with respect to the Operational Policy T&C Clause. Lender and contractual requirements are not the only considerations when it comes to determining whether to accept assets from the contractor. Insurers and brokers should play a greater role in explaining these requirements early on in the project, and also in setting realistic expectations with respect to the readiness to transfer/attach assets to an Operational Policy.

2. Insureds are encouraged to be proactive and flag up potential challenges to meeting the Operational T&C Clause requirements as early as possible to help prevent reaching a point where they are hard-up against a looming deadline of Construction cover coming to an end. Operational Insurers want to understand the issues and help by offering acceptable solutions. Clear and easy lines of communication should be maintained at all times to allow two-way discussion.

3. Consideration should be given to the development and implementation of a Construction Policy clause which defines the end of the Construction Policy period in a way which is aligned with the requirements of the LMA5197A Operational Policy T&C Clause. This could mean an increased exposure for Construction Insurers but one which could be more clearly understood by all parties, and priced accordingly.

Unfortunately, the instances are increasing in frequency where project transfer to Operational cover has not been easy, with the unfortunate end result of great frustration, stress and confusion for Insureds and Insurers alike. It is time to rectify the disconnects that are apparent between the Construction and Operational Policy wordings in this respect and also between Insureds' expectations and Operational Insurers' requirements. This requires greater effort and transparency by all parties, but is well within the capabilities of all, and in the final analysis, should be very easy to achieve.



WP1026-01-20