Legal update

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When does "commencement of drilling" commence?

The English Commercial Court considered in *Vitol E&P Limited v. Africa Oil and Gas Corporation*[1] the meaning of the phrase "commencement of drilling", which had not been defined in the relevant contract and therefore was open to different interpretation by the parties.

The main issue considered by the Court was whether "commencement of drilling" in Clause 7.1 (B) of the Sale and Purchase Agreement ("SPA") meant *"the initial turning of the drill bit into the seabed (also known as "spudding")*, as Vitol E&P Limited ("Vitol") contended or whether it referred *"to a broader concept of the drilling process as a whole which commences with mobilisation of the rig"* as Africa Oil and Gas Corporation ("AOGC") contended.

If Vitol's interpretation of "commencement of drilling" was correct, it was entitled to be paid deferred consideration of $7.4 million under the SPA but if AOGC's interpretation was correct, no such payment was required. Payment of the deferred consideration depended upon when drilling had commenced.

Background

Vitol's subsidiary, Padina Energy Limited ("Padina"), owned a Congolese company called Raffia Oil SARL ("Raffia").

Raffia and its co-venturers were granted an exploration permit by the Republic of Congo for an offshore area known as "Marine XI" for up to 3 consecutive "exploration periods" and entered into a Production Sharing Contract ("PSC") with the Republic of Congo and a Joint Operating Agreement with each other.

In order for the second or third exploration period to be granted, the permit holders were required to have drilled at least one well in the preceding exploration period. After having drilled one well in the second exploration period, Raffia's co-venturers voted to drill a further discretionary well in the second exploration period at the site known as Lideka East ("the Well"). Vitol opposed drilling the Well because in its view further drilling in that location was not going to yield significant results.

At around that time, Vitol was approached by New Age (African Global Energy) Ltd ("New Age") who was interested in purchasing Vitol's interest in, amongst other things, the exploration permit for Marine XI. However, New Age was also not interested in drilling the Well since it did not consider that it was worth drilling.

Vitol and New Age entered into an agreement with each other whereby New Age would purchase Vitol's shares in Padina and hence its economic interest in the PSC. Such agreement was conditional upon there being no exercise of pre-emption rights by the parties to the PSC. AOGC, who was a party to the PSC at that time, exercised its pre-emption rights to purchase Vitol's shares in Padina on the same terms as agreed between Vitol and New Age and as a result Vitol's shares in Padina were transferred to AOGC.

The SPA provided that part of the consideration payable by AOGC to Vitol under the SPA was deferred consideration which was payable only if one of two conditions set out in Clause 7.1 of the SPA was satisfied.

The dispute in this case centred around whether the condition in Clause 7.1 (B) of the SPA was satisfied or not. Clause 7.1 (B) stated that the deferred consideration was payable *"if the drilling of the Lideka East Well is not commenced before the date of expiry of the Second Exploration Period..."* The Second Exploration Period expired on 30 June 2013.

The deferred consideration of $7.4 million reflected the costs which Raffia would have to contribute under the PSC for drilling the Well. This provision for deferred consideration had originally been agreed with New Age since it did not consider the Well worth drilling and therefore did not want to pay full value for the shares under the SPA and also be required (through Raffia) to contribute towards the cost of drilling the Well under the PSC.

[1] [2016] EWHC 1677 (Comm)

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After the SPA was entered into, a drilling rig became available, on 20 April 2013, to drill the Well and a letter of award was issued to the drilling contractor on 14 May 2013 for the contract. On 21 May 2013, the mobilisation of the rig commenced from Rio de Janeiro to Congo. The drilling rig arrived one nautical mile from the location of the Well on 3 July 2013 and the Well was spudded on 20 July 2013. Spudding of the Well would have taken place earlier in mid-June 2013 had it not been for a delay during the towage of the rig to the location of the Well due to a broken line.

Dispute about whether the deferred consideration was payable

Vitol claimed that the deferred consideration was payable by AOGC pursuant to Clause 7.1 (B) of the SPA since commencement of drilling had not occurred before 30 June 2013, i.e, before the expiry of the Second Exploration Period. Vitol contended that "commencement of drilling" here meant "spudding" the Well, which only occurred on 20 July 2013.

AOGC contended that drilling referred to a *"phase of operations commencing with the mobilisation of the drilling rig"* which had commenced on 21 May 2013.

Therefore, in order to decide whether the deferred consideration was payable under the SPA by AOGC, the Court had to decide whether commencement of drilling in Clause 7.1 (B) of the SPA meant spudding the Well or mobilisation of the rig.

Many cases regarding the principles of interpretation of contracts, including an English case which had previously considered this term, were cited to His Honour Judge Waksman QC, sitting as a Judge of the High Court, who gave judgment in the Commercial Court in London. However, the Judge only considered it necessary to refer in any detail to the most recent Supreme Court decision on interpretation of contracts in *Arnold v Britton*[2] in which Lord Neuberger emphasised various factors relevant to interpreting a written contract, including that *"the reliance placed in some cases on commercial common sense and surrounding circumstances....should not be invoked to undervalue the importance of the language of the provision which is to be construed."*

Lord Neuberger also stated in the *Arnold* case that *"while commercial common sense is a very important factor to take into account when interpreting a contract, a court should be very slow to reject the natural meaning of a provision as correct simply because it appears to be a very imprudent term for one of the parties to have agreed."*

HHJ Waksman QC referred to another Supreme Court judgment, *Rainy Sky v. Kookmin Bank*[3], in which, Lord Clarke stated that if there are two possible constructions, the Court is entitled to prefer the construction which is consistent with business common sense and reject the other. The Judge stated that this did not mean that business common sense should trump the natural meaning of the expression.

Decision

HHJ Waksman QC decided that there is a "natural" interpretation of the words "*commencement of drilling*" and that it is *"the physical penetration of the seabed, i.e, spudding"* and that this is *"to be distinguished from preparations for drilling."*

Therefore, since spudding of the Well took place on 20 July 2013, i.e, after the end of the second exploration period, the Judge found that the deferred consideration was payable by AOGC to Vitol under Clause 7.1 (B) of the SPA.

Comment

The case provides useful clarification of the meaning of the term "commencement of drilling" in a contract.

It is also a reminder that parties should be careful when drafting a contract to ensure that the language used in the contract is clear and reflects their intentions. Following the *Arnold* case it is clear that the English courts will be slow to reject the natural meaning of the language used in the contract simply because it is commercially imprudent for one of the parties to have agreed to it.

[2] *[2015] AC 1619*
[3] *[2011] 1 WLR 2900*

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