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GAS PRICE RISES AND THE IMPACT ON KEY CLAUSES IN SALE AND PURCHASE CONTRACTS

Commodities markets are experiencing extreme price fluctuations, whether in metals, agri-commodities or energy. The various effects of the Covid-19 pandemic, supply chain disruption and unique weather activity have led to record price highs and lows.

We have written previously about some of the challenges commodities traders face and the steps they can take to protect themselves. Here we focus on the gas market, which is facing particular pressure, to consider how this may impact key clauses in gas sale and purchase contracts.

What has happened?

The gas market has experienced a prolonged period of price spikes. Wholesale European gas prices rose more than 800 per cent in 2021, initially driven by resurgent global demand and competition with Asia when the pandemic restrictions eased earlier in the year, then exacerbated as supplies from Russia slowed dramatically after a series of disagreements relating to the certification of the Nord Stream 2 pipeline. The latest price increase has come as the Russian-owned Yamal-Europe pipeline used by Gazprom to supply natural gas to north-west Europe stopped flows as temperatures plunged in Moscow and Gazprom decided not to book export capacity.

The situation has been further exacerbated by recent geopolitical tensions in respect of Ukraine. This has led to speculation that stronger sanctions against Russia could further impact supply issues and push gas prices ever higher. See our alert on how client can prepare for further sanctions.

In this environment, gas traders are finding it difficult to protect against price volatility: they often use derivatives to hedge against price swings in the market and to lock in the margins, typically by way of selling futures contracts linked to European gas prices. It is much harder to hedge effectively in a volatile market. As the gas price increases, the losses on futures contracts also increases, which leads to calls for large margin payments to the brokers and increases the financial pressure on traders.

This environment means that gas traders face increased contractual risk, in particular the risk of counterparty default due to insolvency or where contracts are no longer profitable; and the risk of inability to deliver where supply is in doubt. Strong KYC and solid contractual provisions are key in anticipating these risks, along with other protections explained in our previous briefing.

What is the impact on key clauses in gas sale and purchase contracts?

Force majeure

Force majeure ("FM") clauses take on greater significance in a difficult market because they have the potential to offer a party under pressure an escape from its contractual obligations. They have been the focus of much interest since the pandemic began.

In the current market, where a party may be unwilling to perform a contract because extreme price hikes have rendered it unprofitable, FM could seem to offer an escape route. However, the English courts take a dim view of attempts to use FM clauses to avoid performance for economic reasons. English case law clearly demonstrates that just because a contract has become more expensive - or even uneconomic - to perform, that will not constitute FM.

That will not necessarily prevent a party under pressure from trying to claim FM. If your counterparty triggers the FM clause in an existing contract, it does not follow that they are (or will continue to be) entitled to do so. Take advice on your next steps. For example, remember that parties must follow the procedure set out in the FM clause strictly, including for example as to the form, timing and content of any notice required. Remember too the obligation to mitigate the consequences of any FM event.

You should also pay close attention to the terms of FM clauses when negotiating new contracts. For example, consider whether the FM events included (or excluded) are appropriate and whether the appropriate remedy should be a suspension of contractual obligations or the right to terminate.

Take or Pay clauses

Take or pay arrangements are common in long-term gas sale contracts. They are more for the benefit of the seller than the buyer – although the buyer is guaranteed a regular supply, they must pay (usually for a specified minimum amount) whether or not they lift the contractual cargo in full. There have been relatively few English law cases relating to take or pay clauses, which is typically a sign that they work well. However, the effect of the current market could expose them to renewed scrutiny.

A take or pay clause has been challenged in the past on the basis that it constituted a penalty clause and was therefore unenforceable[1]. In that case, the Court concluded that whilst such a provision could amount to a penalty, the particular clause in question did not. In theory, it therefore remains possible successfully to challenge a take or pay clause as an unenforceable penalty. In such an extreme market, there is an increased risk that a buyer may try to do so in order to avoid its contractual obligations.

However, it is unlikely that such a challenge would succeed because in a subsequent case[2], the Court held that only secondary obligations can constitute penalty clauses and it is probable that under English law, a take or pay obligation would be considered a primary obligation. Even if a take or pay clause was found to be a secondary obligation, where it was in proportion to the seller's legitimate interest to include it, and where it was negotiated and entered into freely by parties with legal representation and with comparable bargaining power, it seems unlikely that it would be characterised as a penalty by an English Court.

Sellers entering into new gas supply contracts should take care when negotiating the take or pay provision to ensure that it is not vulnerable to challenge as an unenforceable penalty.

Substitution clauses

In circumstances where supply is uncertain, substitution clauses will become more significant. These clauses allow a supplier to supply gas from another source in the event it is unable to supply the gas provided for under the contract itself.

Substitution clauses can be an effective mechanism to prevent the buyer from claiming that the supplier has not met its delivery obligations by allowing the supplier flexibility in relation to sourcing. However, there is a risk that the buyer may try to claim that the supply obligations have not been fulfilled where the gas supplied does not fit the required purpose.

Given the increased likelihood that a seller may wish to rely on the substitution clause in the sale contract, both parties should pay attention to the circumstances in which the right to substitution will arise, the description of the product which can be supplied and what rights or obligations the buyer has to reject or accept a substituted supply.

Conclusion

In such a difficult market, it is prudent to pay particular attention to key clauses when committing to long term agreements. Contracts drafted carefully and on the basis of good legal advice can help both parties by allocating risk effectively ahead of time and by limiting a counterparty's opportunities to avoid its obligations by relying on a poorly drafted clause should difficulties arise.

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[1] *M & J Polymers Limited v Imerys Minerals Limited [2008] EWHC 344 (Comm)*

[2] *Cavendish Square Holdings BV v Makdessi and ParkingEye Ltd. V. Beavis* [2015] UKSC 67