Commodities

September 2012

COMMODITIES BULLETIN

LNGVOY: a serious contender?

Charterers of LNG carriers are by now accustomed to their charters being concluded on the "ShellLNGTime1" charter form, whether they are fixing vessels on long or short-term time charters or voyage charters. The dominance of "ShellLNGTime 1" is largely explained by the prevalence of time charters in the LNG market and the adaptability of the form for voyage charters in the spot market.

In recent years the LNG spot market has expanded significantly and the indications are that this trend is likely to continue. Against this background, in May 2012, GIIGNL (the International Group of Liquefied Natural Gas Importers) published a LNG voyage charter form, "GIIGNL LNGVOY", with the explicit intention of simplifying voyage chartering of LNG carriers by avoiding the need to adapt the time charter form.

No doubt appreciating that owners, operators and charterers are typically slow to accept new charter forms, and that there is no obvious clamour to move away from "ShellLNGTime 1", "GIIGNL LNGVOY" has a traditional format and language that differs little from tanker voyage charters, except of course where it is necessary to address issues specific to LNG carriers, such as boil-off and heel retention.

LNGVOY comprises two sections: Part I, which is designed for the insertion of specific commercial and operational terms; and Part II, which contains operational provisions of more general application and legal terms.

Part I contains standard clauses relating to vessel description, loading and discharge ports, the laycan, freight, laytime and demurrage. It also contains LNG-specific provisions concerning the condition of the cargo spaces upon arrival at the loadport (i.e. whether cold and ready to load, or requiring cooling down prior to loading), owners' warranties as to boil-off rates and volumes, and the amount of "LNG compensation" per MMBTU that the owners must pay in the event of excess boil-off.

Part II is noticeably short and simply worded. GIIGNL plainly anticipate the inevitable addition of rider clauses if "GIIGNL LNGVOY" is taken up in the market, and have not sought to discourage this by including a large number of legal provisions in the charter form.

The familiarity, brevity and simplicity of "GIIGNL LNGVOY" gives it the best possible chance of gaining broad market acceptance, but its acceptance is far from guaranteed. "ShellLNGTime 1" is likely to remain a popular form for LNG voyage charters for the foreseeable future. Market take-up of "GIIGNL LNGVOY" could be a gradual process.

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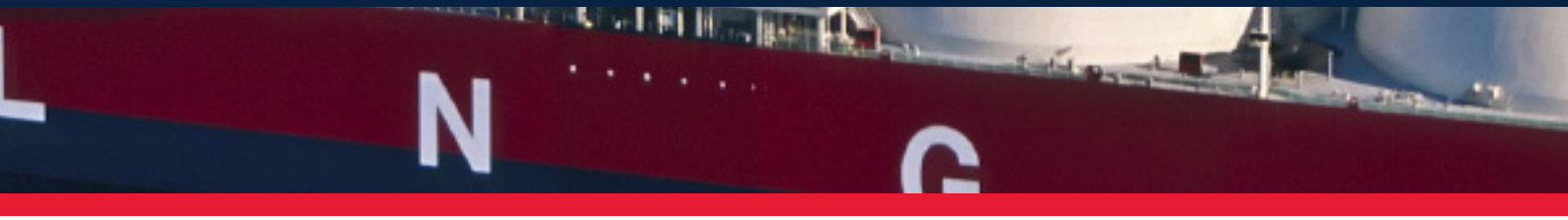
State capacity in derivative contracts

The recent judgment of the English Court of Appeal in *Standard Chartered Bank ("SCB") v Ceylon Petroleum Corp ("CPC")* (27 July 2012) will be of interest to derivatives traders who contract with companies that are wholly or partially state-owned. The case concerned the national oil and gas company of Sri Lanka, CPC, which was established by statute to import crude oil and petroleum products for the Sri Lankan domestic market.

CPC entered into numerous oil derivative contracts with a range of financial institutions, including SCB, to hedge against the risk of rising oil prices. Two of the contracts with SCB (the "Contracts") were concluded on the 2002 ISDA Master Agreement. The Contracts provided that SCB would make payments to CPC when oil prices exceeded a specified ceiling and that CPC would make payments to SCB when prices fell below a specified floor. The payments to be made by SCB were capped, with the effect that CPC's potential liability to SCB was greater than SCB's potential liability to CPC.

While oil prices were high, SCB made the contractual payments to CPC. When prices fell dramatically during the financial crisis in late 2008, CPC became liable to make payments to SCB, which it did for a short period but subsequently ceased to do. CPC argued that it had not had capacity to agree the Contracts under the powers given to it by the Sri Lankan Ceylon Petroleum Corporation Act 1961 (the "Act").



SCB commenced proceedings against CPC in the English Commercial Court to recover approximately US$166 million allegedly due under the Contracts.

By way of an aside, CPC had entered into similar derivative contracts with Citibank and had also stopped making payments under those contracts. Citibank commenced English arbitration to recover the payments and CPC advanced similar arguments to those made in the SCB case. Citibank and CPC agreed that speculating on the price of oil was beyond CPC's capacity. The arbitral tribunal therefore considered whether the derivative contracts were entered into to hedge exposure to losses under physical contracts or by way of speculation. The tribunal concluded they involved speculation because they involved assuming a new risk in the hope of making a financial gain rather than managing the existing risk of increased oil prices. This led the tribunal to conclude that the contracts with Citibank were beyond CPC's capacity and entirely void.

In the dispute with SCB, the Commercial Court also considered CPC's capacity to enter into the Contracts in the context of whether they were hedges or speculation. It held they were hedges because they were designed to limit CPC's exposure to the market in relation to future purchases. CPC appealed.

The Court of Appeal took a markedly different approach, observing that hedges and speculation *"shade into each other"* and that distinguishing between them was ultimately a *"false question"*. It focused instead on CPC's statutory objects.

Section 4 of the Act stated that CPC's general objects included carrying on business as an importer, exporter, seller, supplier or distributor of petroleum. The Court of Appeal interpreted this to mean that, although it was formed to act in the public interest, its commercial function was engaging in international and domestic trade, so that the legislature must have intended CPC to be able to enter into the whole range of transactions a commercial organisation acting in its field would ordinarily undertake. This included acts that were incidental or conducive to its statutory objects and meant that CPC had capacity to use the *"increasingly sophisticated tools"* available to it to attempt to mitigate risks it was exposed to as an importer of oil.

The Court of Appeal found that the Contracts were incidental and conducive to CPC's objects because they afforded it a (albeit modest) degree of protection when the market was high as well as much needed cash flow, and that CPC saw the Contracts as sound business at the time they were entered into. The Court further observed that the fact the transactions looked imprudent with hindsight did not automatically mean CPC lacked capacity to enter into them. The transactions were within CPC's capacity and were binding upon them.

The Court of Appeal's judgment will no doubt be welcomed by commodities traders generally, as providing reassurance that the English courts are prepared to enforce obligations of NOCs and other state entities. It should also be welcomed by national commodity importers as an encouragement to existing and potential counterparties.

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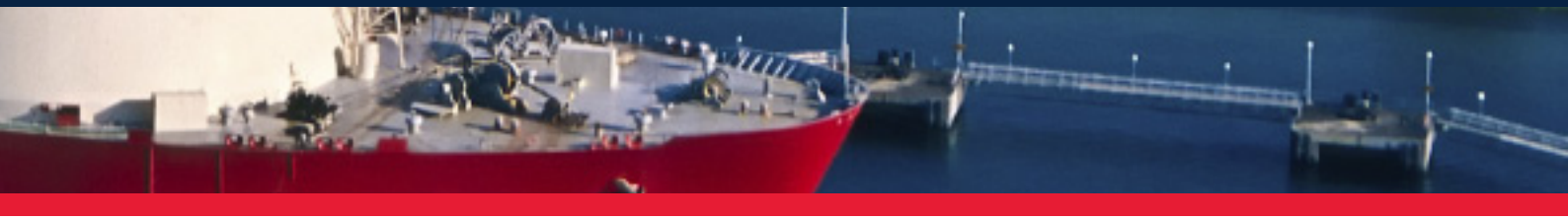

Prospect of Russian export restrictions continues to affect grain markets

On 31 August 2012, Russia's Deputy Prime Minister announced that the Russian government would not limit grain exports for the time being, even if its exportable surplus was exhausted. Russia is suffering drought conditions, and there have been fears that this would lead to a ban on exports, as happened during the last serious drought in 2010.

The Deputy Prime Minister's announcement on 31 August was initially followed by a fall in prices, but prices then began rising again. Traders seemed to take the view that the extent of the shortfall in the Russian harvest was likely to lead to some degree of export restriction in due course. This view will have been strengthened by a statement made on 21 September 2012 by the Russian Economy Minister to the effect that Russia might be forced to introduce measures to limit grain exports if prices kept rising.

Others factors contributing to rising prices have been strong demand from Egypt, the world's biggest importer, and severe drought conditions in the United States, which have left almost half of this year's US corn crop in poor or very poor condition.

Circumstances of restricted supply and rising prices inevitably create legal uncertainty. Buyers with Russian origin supply contracts will be worried about reliability of supply and conversely, higher prices may tempt sellers to find ways to escape existing contracts in search of new ones on better terms.

Parties will not have the legal remedies that would be open to them if there were an outright ban on Russian exports. In the event of an outright ban, sellers can generally rely on a prohibition clause in their contract. For example, the standard GAFTA prohibition clause allows a seller to cancel a contract where fulfilment is prevented as a result of prohibition of export or an executive or legislative act by the government of the country of origin of the goods or the country from which the goods are to shipped.

Force majeure clauses, which allow a party to cancel a contract or delay or suspend performance on the occurrence of a specified event that is outside its control, and the common law doctrine of frustration, which allows a contract to be discharged where it has become physically or legally impossible to perform, should be considered. However, they are also unlikely to offer a remedy in the present circumstances. Where rising commodity prices have simply made it more difficult or expensive for one party to perform the contract this will not be regarded as a force majeure or frustrating event by English courts or arbitrators, unless such conditions are expressly referred to in a force majeure clause.

Even if the Russian government were to introduce export restrictions, they might not take the form of an outright ban. They could involve export quotas, like those introduced by Ukraine in 2010 in the face of its own drought. In such circumstances it would be technically possible, though possibly very difficult, to apply for and obtain export quotas, and it would therefore be hard for sellers to establish the existence of conditions sufficient to allow reliance on a prohibition clause.

Other restrictions might include increasing adminstrative burdens for exporters, such as complicated inspection processes and limited access to transport. Such measures could lead to sellers under Russian origin contracts struggling to perform their obligations, without having any recourse to contractual provisions excusing performance.

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Conferences & Events

Mining Sector Reception
HFW London
(2 October 2012)

Innovation in International Trade Seminar
Lausanne
(3 October 2012)
Chris Swart, Damian Honey, Brian Perrott, Katie Pritchard, Jeremy Davies, Sarah Hunt and Peter Murphy

Commodities Breakfast Seminars
HFW London
(9 and 23 October 2012)

India Shipping Summit: "Feeding India's ever growing hunger for energy"
Mumbai
(8-10 October 2012)
Anthony Woolich

Argus European Crude Trading 2012
Geneva
(11 October 2012)
Chris Swart and Jeremy Davies

Coaltrans Turkey
Istanbul
(14-16 October 2012)
Chris Swart, Rory Gogarty, Nigel Wick and Rebecca Lindsey

Bulk Commodity Exports
HFW Melbourne
(16 and 18 October 2012)
Hazel Brasington

C5's 3rd EU OTC Derivatives & Clearing Conference
London
(17-18 October 2012)
Robert Finney

Global Energy Conference
Geneva
(29-31 October 2012)
Brian Perrott

Investing in Asian Mining Indaba
Singapore
(29-31 October 2012)
Brian Gordon and James Donoghue

International Cotton Association Conference
Hong Kong
(1-2 November 2012)
Brian Perrott

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