NOMINATIONS – TALKING ABOUT TAKE-OR-PAY

A RECENT ENGLISH COURT OF APPEAL JUDGMENT CONSIDERING TAKE-OR-PAY OBLIGATIONS IS OF REAL PRACTICAL, COMMERCIAL IMPORTANCE – NOT ONLY TO LAWYERS, BUT ALSO TO THE WIDER PROJECT FINANCE COMMUNITY. BY **JUSTIN WILLIAMS**, HEAD OF ENERGY DISPUTES AND INTERNATIONAL ARBITRATION PRACTICE IN LONDON, AND **JULIAN NICHOL**, HEAD OF ENERGY PROJECT DEVELOPMENT PRACTICE IN LONDON, **AKIN GUMP STRAUSS HAUER & FELD**.

Why? Because take-or-pay is part of the fabric that underpins the commercial basis of numerous energy transactions worldwide – and many of those transactions are governed by English law. The judgment also catches the eye because judicial consideration of take-or-pay is as rare as hen's teeth, with most take-or-pay disputes being resolved under the cloak of international arbitration where decisions are confidential and typically known only to the parties involved.

Therefore, how does the Court of Appeal's judgment impact the commercial interpretation and effect of take-or-pay? And what lessons can be learned as to how this mechanism should be structured and operated?

Background

The Court of Appeal's judgment in British Gas Trading Ltd (BG) v Shell UK Ltd and Esso Exploration & Production UK Ltd (sellers) [2020] EWCA Civ 2349 was handed down on December 4 2020. It concerns two largely identical, long-term gas sales agreements (GSAs) under which the sellers sold natural gas from the UK North Sea's Sole Pit Reservoirs (Sole Pit) to BG.

The agreements are field-specific depletion contracts by which the sellers must provide a minimum amount of gas that BG must either take delivery of and pay for, or not take delivery of but pay for, every year. Those obligations are by reference to the total reservoirs' daily quantity (TRDQ), which the sellers are able to vary by notice to ensure it is in line with the anticipated depletion profile of Sole Pit. BG had the right to nominate daily quantities up to 130% of the TRDQ.

Although the GSAs were concluded in 1988, the sellers only issued variation notices to reduce the TRDQ from 2000 to 2009. Therefore, after 2009 the TRDQ did not reduce with diminishing Sole Pit production, with the result that over time TRDQ significantly exceeded production from that reservoir. However, because the take-or-pay obligation was by reference to the TRDQ, the volumes that sellers had to continue to supply, and BG had to continue to take and pay for, or not take but pay for, were quantities in excess of Sole Pit production. The sellers made up the difference with gas from other sources.

This arrangement may have worked commercially for both sides had the price under the GSAs tracked market prices. However, the price under the GSAs was substantially higher than market, and therefore it was in BG's commercial interests to restrict its take-or-pay obligations to volumes produced at Sole Pit. BG therefore argued that the sellers were in breach of contract because the volumes of gas produced from Sole Pit fell below their capacity obligations.

What the Courts said

BG's claim failed at first instance in the High Court. However, it appealed and the Court of Appeal found that the TRDQ and the sellers' capacity obligation related to gas produced from Sole Pit. Therefore, the sellers were in breach of their capacity obligation. However, the court also found that BG suffered no loss as a result of the breach and was entitled to no damages.

Under English law, contractual damages are intended to put the innocent party into the position in which it would have been had the contract been properly performed. In this case that would mean putting BG into the position it would have been in had the sellers met their capacity obligation. Because the sellers made up the shortfall with gas from elsewhere, therefore BG suffered no loss.

However, the outcome may have been different had the Court of Appeal instead considered whether the sellers breached an implied obligation to exercise their discretion to vary TRDQ in line with declining production at Sole Pit.

Lessons to take away

Every take-or-pay contract contains "levers of power". Getting those levers right in drafting a contract, and operating them correctly during the life of the contract, is critical to protecting a party's commercial interests. The Court of Appeal's decision in this case points the way to a number of key issues to bear in mind:

- *Make sure a party is required to notify under the nominations regime, rather than simply having the option or right to nominate* – The fact that the sellers had the option, rather than an obligation, to vary the TRDQ in line with Sole Pit depletion is a clear

fault-line in the drafting of the GSAs from BG's perspective. Not only did this enable the sellers to use gas from other reservoirs to make-up the TRDQ, it also had the unusual result of the sellers being in breach of the GSAs for not being able to meet the capacity obligation from Sole Pit. But practically BG suffered no loss: it still received the contractually obligated quantities of gas, albeit not Sole Pit gas. If BG had negotiated terms in the GSAs requiring the sellers to serve a variation notice in line with Sol Pit decline instead of giving them an option to notify, the sellers would presumably have complied with that obligation – and had they not done so, BG would likely have been entitled to damages to compensate for its loss.

Those who are party to a take-or-pay contract where the seller has committed to a capacity obligation for a product from a specified source are encouraged to review the nomination regime in light of the comments above. This is especially the case where the take-or-pay contract allows the seller to reduce capacity in line with the production decline of the product.

- *A breach of capacity obligation by the seller is a breach that cannot be remedied by supply of product from another source* – In light of the Court of Appeal's judgement in the BG v Shell and Esso case, parties would do well to make it clear in their take-or-pay contract that any breach by the seller of its capacity obligation cannot be remedied by the supply of product from another source.
- *Using make-up quantities to meet the agreed capacity obligation* – If you want to use other product, commingled or from an unspecified source, to make up shortfalls, then make this explicit in the take-or-pay contract. The Court will not usually imply terms into the take-or-pay contract. The general assumption is that the parties engaging in long-term take-or-pay contracts are sophisticated and should say what they mean in the contract. It is noteworthy that the detailed variation notice provisions in the BG v Shell and Esso case are exclusively concerned with the ability of the sellers to produce gas from the Sole Pit Reservoirs. They say nothing about the sellers' possible use of gas from other reservoirs to maintain the TRDQ and associated delivery capacity. This was cited by the Court of Appeal as a strong indication that such gas is not intended to be taken into account for the purpose of determining whether the sellers have met their capacity obligation.
- *Capacity obligation versus a supply obligation* – Where a product being supplied is required to come from a specifically identified source such as a specific gas field or mine, make sure the take-or-pay clause talks about a capacity obligation: an obligation to provide and maintain a certain capacity to deliver a specified product from a specified location, and not a generic "obligation to deliver" the product. The latter might inadvertently open up the ability of the supplier/seller to deliver a commingled product or a product without a specified source.
- *Subsequent bolt-on contracts must interface properly* – Since take-or-pay contracts typically run for a long term, it is not uncommon for there to be subsequent amendments and bolt-on contracts affecting the take-or-pay regime. It is critical that these interface clearly and correctly with the seller's capacity obligation. In the BG v Shell and Esso case, the parties had entered into a separate agreement in 1997 for the allocation of gas processed at the Bacton terminal. This muddied the waters and its impact on the GSAs may not have been fully thought through. Any amendment agreements or bolt-on contracts should be read as a whole with the relevant take-or-pay contract to ensure that one does not have an unintended consequence on the other.
- *If a contract is not being complied with, raise this at an early stage* – In the BG v Shell and Esso case, BG appears to have waited several years before claiming breach. As a result substantial losses had accumulated and a commercial resolution may have become more difficult to achieve. ■

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