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# Annual Review of developments in English oil and gas law

2019 Edition

September 2019

# Contents

# Introduction

## Welcome to the 2019 edition of the CMS Annual Review of developments in English oil and gas law.

Last year's edition of this Annual Review was published against the background of rising global demand and a recovery of oil prices to around USD 80–85 per barrel. Since then, Brent fell to USD 50.47 per barrel before recovering to around USD 60 per barrel. At the same time, the global spread of natural gas prices has continued to grow. In July 2019 the International Energy Agency recorded Henry Hub at USD 2.35/MMBtu (and West Texas Waha hub prices at USD 0.48/MMBtu) whilst long-term oil linked contracts in Asia at USD 9–9.50/MMBtu.

However, none of this seems to have halted the deal flow. Internationally, Occidental Petroleum agreed to purchase Anadarko Petroleum for USD 38bn. In the UK, Chrysaor agreed to acquire ConocoPhillips' UK oil and gas business for USD 2.675bn.

As a result of continued market activity, we have seen interesting oil and gas court decisions and arbitral awards relating to issues as diverse as natural gas pricing, operator's reimbursement under joint operating agreements and force majeure under production sharing contracts. Although not all of these are English law disputes, the guidance these decisions and awards give is highly relevant to English law practitioners due to the common concepts used across the industry. Outside the oil and gas sector there have also been some interesting decisions and awards that illuminate certain issues relevant to oil and gas contracting – such as those relating to construction or engineering contracts. This Annual Review seeks to capture as much of this relevant material as possible.

As always, any given case summary might relate to a multitude of issues. As a result, many articles that are contained within specific chapters of this year's Annual Review could equally be applicable to other chapters. They are in chapters for convenience only.

This Annual Review has been collated by our lawyers to be relevant to you, with a direct focus on legal developments affecting companies in the oil and gas industry. We hope that you find it interesting and of assistance in navigating the legal challenges and opportunities faced in the industry.

I would like to thank the many contributors across CMS for their articles, comments and assistance. Involving teams in London, Rio, Dubai, Singapore and Aberdeen, the Annual Review continues to be a global effort. It is not possible to mention all of those who have made significant contributions by name. However, I would like to give particular thanks to Anna Rose and Madalena Houlihan, for their considerable efforts in assisting me collate this year's Annual Review, and David Rutherford, Leontine Mathew, Aidan Steensma and Phil Reid, for their considerable contribution in writing Law-Now publications throughout the year on which much of this Annual Review is based. Finally, but by no means least, I would like to thank Valerie Allan and Judith Aldersey-Williams for providing the update on the UK regulatory regime – which is a critical issue for those dealing with the oil and gas sector on the UK Continental Shelf.

I hope you find this Annual Review useful. Please do not hesitate to contact us if you have any questions or feedback.

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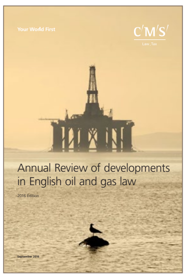
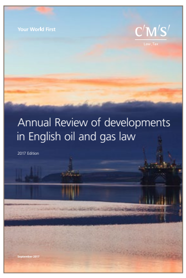
### Previous editions





Previous editions of the CMS Annual Review of developments in English oil and gas law are available at **cms.law**.

# Joint Operating Agreements and Production Sharing Agreements

Production Sharing Agreements are at the heart of 'vertical' relationships between co-venturers and the Government granting the relevant Block. In turn, Joint Operating Agreements are central to the regulation of the 'horizontal' relationship between the co-ventures. Judicial and arbitral guidance on such contracts are rare. However, the past year has resulted in two cases of significant interest.

— In *Spirit Energy Resources Ltd & Ors v Marathon Oil UK LLC* [2019] EWCA Civ 11, the Court of Appeal dealt with whether an operator, under a Joint Operating Agreement, was entitled to charge joint venture participants for pension fund shortfalls in excess of sums in the approved work programme and budget. The reasoning of the Court of Appeal might also apply to any work that an operator has carried out that exceeds the original approved budget.

— In *Gujarat State Petroleum Corporation Ltd et al. v Republic of Yemen et al* (Civil Action No. 16-cv-1383 (DLF)), the United States District Court for the District of Columbia confirmed an arbitral award deciding that a contractor was entitled to terminate a production sharing agreement pursuant to a force majeure clause. Although not an English law case, the arbitral award is a useful reminder that the manner in which an arbitral tribunal or court might construe such a clause depends heavily on the precise wording of the clause, and on the relevant laws to be applied.

# JOAs: Court of Appeal deals with JOA budget overruns and operator pension deficits

In *Spirit Energy Resources Ltd & Ors v Marathon Oil UK LLC* [2019] EWCA Civ 11, the Court of Appeal dealt with an appeal concerning whether an operator, under a Joint Operating Agreement, was entitled to charge joint venture participants for pension fund shortfalls in excess of sums in the approved work programme and budget. In a decision that is likely to have great significance for the global industry, the Court of Appeal upheld the Commercial Court decision that the operator was entitled to recover sums properly incurred to close the pension shortfall from other joint venture participants. The reasoning of the Court of Appeal might also apply to any work that an operator has carried out that exceeds the original approved budget.

## Facts

Marathon Oil UK LLC ('**Marathon**'), Spirit Energy Resources Limited (formerly Centrica Resources Limited), TAQA Bratani Limited and TAQA Bratani LNS Limited (together the '**Participants**') were parties to a Joint Operating Agreement ('**JOA**') and a Unitisation and Unit Operating Agreement ('**UUOA**') for operations in the Brae fields in the North Sea. Marathon (the '**Operator**' and/or the '**Respondent**') was designated as the operator.

The terms of the JOA and UUOA were materially similar.

In relation to the conduct of joint operations, the JOA and UUOA required the Operator have exclusive charge:

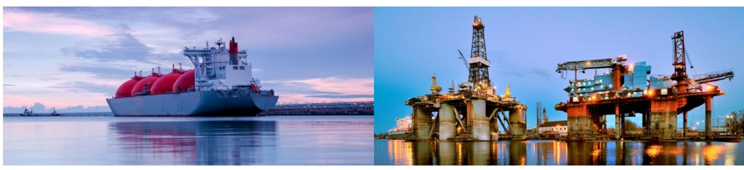
> *'5.2 In accordance with approved programmes and budgets and under the overall supervision and direction of the Operating Committee, and subject to this Agreement, Operator shall have exclusive charge of and shall conduct all operations under this Agreement either by itself or by its duly authorized agents or by independent Contractors engaged by it'.*

In respect of work programmes and budgets to be carried out by the Operator the JOA and UUOA required:

> *'7.2 On or before the 15th day of December of each year, the Operating Committee shall agree upon and adopt an operating programme and budget for the 12 month period beginning on the 1st day of January of the following year and for such further periods as the Operating Committee deems appropriate, which shall include as a minimum the work required to be performed under the Licence in respect of the Contract Area during such budget periods and the requirements of [the] Operator having regard to previously approved programmes and budgets and its obligations hereunder. At the time of agreeing upon and adopting an operating programme and budget, the Operating Committee shall provisionally consider, but not act upon or adopt, an operating programme for the calendar year next succeeding the period covered by such approved operating programme and budget'.*

The sharing of costs under the JOA and UUOA was in proportion to the Participants' interests:

> *'10.1 All costs and expenses of all operations under this Agreement in or in respect of the Contract Area or the Licence, including the handling, treating, storing and transporting, whether within or outside the Contract Area, of Petroleum produced from the Contract Area, and all costs and expenses properly incurred by the Operator in its performance of the relevant provisions of the Decommissioning Security Agreement except for costs and expenses which are solely attributable or relevant to a Party, shall be borne by the [p]articipants in proportion to their respective Participating Interests from time to time except as herein otherwise specifically provided. Furthermore, the costs of all assets, including materials and equipment acquired for the Joint Account of the [p]articipants shall be for the account of the [p]articipants in accordance with their Participating Interests from time to time, and, similarly, liabilities shall be borne in such proportions.*
>
> *10.2 All costs and expenses of whatsoever kind that are incurred in the conduct of operations under this Agreement shall be determined and settled in the manner provided for in the Accounting Procedures hereto attached and marked Exhibit A, which is hereby made part of this Agreement, and Operator shall keep its records of costs and expenses in accordance with such Accounting Procedure. In the event of conflict between the main body of this Agreement and the said Accounting Procedure, the provisions of the main body of this Agreement shall prevail'.*



In addition, 'Exhibit A' to the JOA was entitled *'ACCOUNTING PROCEDURE'*. The Exhibit began with this statement:

> *'The purpose of this Accounting Procedure is to establish equitable methods for determining charges and credits applicable to [all operations conducted in accordance with the Agreement by or on behalf of any party with a Participating Interest] under the Agreement and to provide that Operator neither gains nor loses by reason of the fact it acts as Operator. In the event of a conflict between the provisions of this Accounting Procedure and the provisions of the Agreement, the provisions of the Agreement shall control'.*

The question between the parties concerned the costs of staff employed by the Operator (in practice through an affiliate) in connection with the operations.

More specifically the question is whether the Participants were liable to meet a share of a proportion of deficit recovery charges ('**DRCs**') in respect of a defined benefit pension scheme (the '**Scheme**') of which some of those employees were beneficiaries.

The reference to a *'share'* was the share of the costs of operations for which Participants were, between them, responsible. A proportion only was involved because the Scheme included some employees who did not work on operations in the Brae fields, and some who worked on operations there for some periods and on other unrelated tasks for other periods.

At first instance, the Participants argued that they had no liability as a matter of contract under the JOA and UUOA. The Participants accepted that the Operator was entitled to select employees and their hours of work and their remuneration (including benefits such as pension provision). However, they argued that the Operator's ability to recharge the cost was, and remained, subject to the provisions for approved operating programmes and budgets and the direction of the Operating Committee. They argued that the JOA made it clear that the Operator is not entitled to incur any expenditure in the nature of remuneration without the approval of the Operating Committee as part of a work programme and budget found in the business management plan ('**BMP**').

In their appeal, the Participants maintained that, properly construed, they were not liable under the JOA for the DRCs and that, it follows, the Operator must be the sole bearer of these costs. It had been in the Operator's power to take steps to ameliorate pension liabilities and having failed to do so, they should now be held responsible for these *'runaway costs'*.

The Participants added to this that under the JOA they were not required to pay for future liabilities which they never foresaw nor contemplated when the Operating Committee approved and authorised the operating programme and budget. Moreover, that there was nothing in the background knowledge available to the Participants, to indicate the existence of a requirement to bear such unforeseen costs.

As at first instance, the Participants argued that the Operator's approach that it was entitled to such costs, even when outside the agreed budget, involved their signing a *'blank cheque'*.

In their appeal, the Participants also contended that the hold-neutral provisions in Exhibit A of the JOA were '*not an absolute*' and should not be accorded substantial weight as a guide to the construction of the JOA.

## Decision

In rejecting the Participants' appeal and finding in favour of the Operator, the Court of Appeal started its analysis with the specific provisions of the JOA, which impose liability upon the Participants for costs incurred by the Operator.

It considered that, under the scheme set out in the JOA, once the operations and budget had been approved on an annual basis by the Operating Committee, the Operator was entitled (authorised) to charge the related costs to the joint account and these costs were then to be borne by the Participants. It was not in dispute that the additional pension costs were a cost that was consequential upon the prior approval by the Operating Committee of the operations. The Court of Appeal considered that several Articles in the JOA make clear that the Participants are required to pay the pensions costs:

1. Article 7.2 imposes an obligation ('*shall*') on the Operating Committee to '*agree upon and adopt*' the Operators requirements '*having regard to*' previously approved programmes and budgets.
2. Article 10.1 concerns '*all*' costs and expenses of '*all*' operations and stipulates that they '*shall*' be '*borne*' by the Participants. The language used is mandatory and not discretionary.
3. Article 10.2, which governs settlement of costs as between Participants, referred in the broadest possible terms to '*all costs and expenses of whatsoever kind that are incurred in the conduct of operations*'. It went on to provide that these '*shall be determined and settled in the manner*' set out in Exhibit A, which is a part of the JOA. The Article was mandatory ('*shall*') and, as with Article 10.1, was all encompassing. This is confirmed by '*all*' and reinforced

by the phrase *'of whatsoever kind'*. There was nothing in the contractual language which carved out costs, the full nature and extent of which was unknown and/or unknowable at the point in time when the head of cost was first approved and authorised.

4. In respect of the *'overall purpose of the clause and the [agreement]'*, Exhibit A (Accounting Procedure) of the JOA required an equitable allocation of costs and benefits as between Participants, and an Operator 'hold-neutral' principle. These lead to the conclusion that the Participants are liable for the pension cost overrun. The 'hold-neutral' purpose supports the conclusion that nothing in the accounting procedures should lead to the Operator bearing a loss.

On this basis, the Court of Appeal concluded that the normal and ordinary meaning of the JOA and UUOA was that the Participants must bear the cost of the pension shortfall.

The Court of Appeal then turned to the *'commercial common sense'* of the JOA scheme. In one regard, it considered this exercise unnecessary, as the commercial rationale was identified in the terms of the JOA. That said, the Court of Appeal found that commercial common sense supported the natural and ordinary meaning of the JOA, including:

— The rationale behind the Operator being required, annually, to spell out its future operating programme and budget accompanied by relevant estimates, assumptions and contingences was to enable the Operating Committee to consider, and if appropriate, revise and then approve or disapprove the budget. If the budget was approved then the Operator is authorised to incur the expenditure. Having exercised this '*judgment call*' and '*expressly authorised the operations*' the Participants assumed responsibility for those liabilities and cannot argue that it was the fault of the Operator. It was their decision of approval and authorisation that was at fault for a cost overrun, and not that of the Operator.

— There was '*no identifiable logic whereby the Participants can take the benefits but avoid the risks*'. On the Participants' analysis, having approved the Operator's operations and its budget, and thereby induced the Operator to expend money including on pensions, the Participants, or each of them according to their own narrow self-interest, could refuse to agree to pay (bear) their allotted portion of the costs leaving the portion they would otherwise bear, to be borne by the Operator (who also happens to be a Participant). They could '*take the benefit but none of the burden*'. The Court of Appeal was unpersuaded that this could '*ever be considered commercially rational in the context of an agreement of this sort*'.

In relation to the risk of Operator non-performance, the Court of Appeal considered that Participants were adequately protected by the law. They would not be liable for any costs incurred by the Operator in bad faith or dishonestly. The Operator accepted that where the JOA or UUOA conferred a contractual discretion it was under an implied duty to exercise that discretion genuinely, honestly and in good faith (see *Socimer International Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116).

In the alternative, the Operator relied upon Article 5.7 of the JOA, which grants an indemnity to the Operator. It argued that if it were wrong as to its primary argument about the construction of the JOA and UUOA then it relied upon this clause as plugging the gap and imposing a duty upon the Participants to indemnify the Operator. As the Operator succeeded, the Court of Appeal did not feel it necessary to deal with this issue.

## Comment

As it stands, key points arising from the decision for joint venture participants seem to be: (1) it gives comfort to operators regarding the 'hold-neutral' principle, but (2) might lead to operating committees requiring more detailed information and imposing greater financial scrutiny about the conduct of operations from the start. That said, it is not entirely apparent that the JOA in this case has all of the provisions seen in the model forms widely used in the UK and internationally. As such, there is likely scope for arguments in the future as to the application of the Court of Appeal's decision.

The 'no loss, no gain' principle ('Operator hold-neutral principle') of operatorship is contained in most JOAs and regularly referenced in disputes concerning operator reimbursement. As with the Commercial Court, the Court of Appeal was clearly swayed by the fact that it considered the Participants enjoyed the benefit of the employment of the staff in question and it would be wrong to require the associated costs/liabilities to fall to the Operator.

As set out at pages 7 to 8 of the 2018 edition of the CMS Annual Review of developments in English oil and gas law, the text of the Commercial Court decision suggests that the relevant JOA and UUOA only expressly dealt with additional authorisation for cost overruns in the context of decommissioning budgets. It follows that the JOA and UUOA did not contain the clauses found in many JOAs, including the AIPN Model Form and Oil & Gas UK Model Form, which specifically authorise limited cost overruns by the Operator for the budget as a whole and/or specified line items of the budget. As such, the Court of Appeal was not required to ask whether recovery of such cost overruns by the Operator was limited to the extent permitted by such clauses in the absence of additional approval.

That said, the Court of Appeal's decision:

— Provides a clear 'road map' as to the scheme of many JOAs and the balance to be struck between Operators and participants in respect of cost overruns; and

— adds to the debate about the circumstances in which an Operator is entitled to recover costs in excess of an approved budget, which arise under joint operating agreements governed by a variety of national laws.

In the context of pension fund liabilities, the consequences are potentially significant. The operator in this case is far from alone in finding itself with a pension deficit. Other operators will doubtless be considering whether to adopt the same approach and prepare plans to recover pension shortfalls from joint venture partners.

Conversely, non-operators will wish to consider whether the absence of the usual provisions dealing with operator cost overruns in the JOA/UUOA in this case means that the decision of the Court of Appeal is limited in its application to the facts of the case.

When it comes to drafting JOAs, non-operators might also wish to consider whether pension liabilities should be specifically addressed in accounting procedures. The issue might be more important where the operator is an established oil company with a final salary pension scheme (or similar).

Finally, although the facts of the case relate to the pension liability for staff of an operator, the decision could be equally applicable to almost any cost-overrun concerning JOAs on similar terms.

A report by EY in 2014 suggested that cost overruns in oil and gas mega-projects were in the order of USD 500bn. Of 365 oil and gas mega-projects surveyed by EY, 64% were facing cost overruns. In absolute terms, the cumulative cost of the projects reviewed had increased to USD 1.7tn from an original estimate of USD 1.2tn. According to EY: '*Geographically, the proportion of projects facing cost overruns is highest in the Middle East (89%), followed by Asia-Pacific (68%), Africa (67%), North America (58%), Latin America (57%) and Europe (53%)*'. Similar research conducted by Oil & Gas UK suggested that the average project on the UK Continental Shelf was 35% over budget.

As initial work programmes and budgets are often closely aligned to original FID estimates, the potential exposure of participants in the oil and gas industry to budget overruns is significant and issues relating to the liability for those overruns critical to financial success. Therefore, the decision has potentially wide and market critical implications.

**Judges:** Hamblen J, Henderson J and Green J

# PSAs: Scope of force majeure Clauses in Yemen PSA

In *Gujarat State Petroleum Corporation Ltd et al. v Republic of Yemen et al* (Civil Action No. 16-cv-1383 (DLF)), the United States District Court for the District of Columbia confirmed an arbitral award deciding that a contractor was entitled to terminate a production sharing agreement pursuant to a force majeure clause. The arbitral award is a useful reminder that the manner in which an arbitral tribunal or court might construe such a clause depends heavily on the precise wording of the clause, and on the relevant laws to be applied.

## Facts

### The PSAs

In 2008, Gujarat State Petroleum Corporation Ltd and others (the '**Contractor**') and the Yemen Ministry of Oil and Minerals and others (the '**Ministry**') entered into three production sharing agreements with materially identical terms (the '**PSAs**'), under which the Contractor was to carry out petroleum exploration and production activities in Yemen.

The PSAs were governed by Yemeni law, and included the following provisions:

— Article 22.2 of the PSAs defined '*force majeure*' as *'any order, regulation or direction of the Government… or any act(s) of God, insurrection, riot, war, strike (or any other labor disturbances), fires, floods, or any cause not due to the fault or negligence of the Party invoking force majeure, whether or not similar to the foregoing, provided that any such case is beyond the reasonable control of the party invoking force majeure'.*

— Article 22.1 excused the Contractor for any non-performance or delay in performance by the Contractor of any obligation under the PSAs *'if, and to the extent that, such non-performance or delay is caused by force majeure'.*

— Article 22.4 gave the Contractor the option to terminate its obligations under the PSAs upon prior written notice if the force majeure event *'continues in effect'* for a period of six months.

### The Termination

From January 2011, the security situation in Yemen appeared to deteriorate. A number of tribal clashes, attacks and kidnappings took place, and a number of governments advised their citizens to leave Yemen. In March 2011, the Yemeni government declared a 'State of Emergency'.

Following these events, the Contractor issued a notice to the Ministry in April 2011 declaring '*force majeure*' under the PSAs. Around two years later, in February 2013, the Contractor sought to terminate the PSAs pursuant to Article 22.4, and referred the matter to arbitration under the Rules of Arbitration of the International Chamber of Commerce (seated in Paris).

## Decision

In deciding that the termination was valid, the arbitral tribunal considered a number of issues, which are outlined below.

**Qualifying Events**
Article 22.2 listed several events as 'force majeure' events: (a) direction of the Government, (b) riot, (c) insurrection, and (d) any cause *'not due to [the Contractor's] fault or negligence'* which is *'beyond [the Contractor's] reasonable control'*.

The Contractor pointed out that category (d) included events *'whether or not similar to the foregoing'*, and that, therefore, this category should not be interpreted as restricted in any way by the categories preceding it. Although the award did not explore this in any greater detail, it appears that this wording was sufficient to displace the principle of *ejusdem generis*, to the extent this may have been relevant in Yemeni law. (This principle provides, in summary, that where a list of particular things have a common characteristic, a general term that follows only applies to things that are similar to the particular things.)

***(1) Any Cause***
The Contractor argued that *'the extreme risk of crime and kidnapping and the extreme risk for any kind of transport and logistics activities'* and the unavailability of contractors between March 2011 and February 2013 fell within category (d) above and that, therefore, these events qualify as force majeure.

The Ministry pointed out that in Yemeni law, the concept of force majeure requires proof that a specified event was unforeseen and that performance of contractual obligations has become impossible. It argued that the PSAs were governed by Yemeni law, and that, therefore, the Yemeni law principles of foreseeability and impossibility must be implied into the PSAs.

In agreeing with the Contractor, the arbitral tribunal made the following remarks:

— Article 212 of the Yemen Civil Code provides that *'if the contract provisions are clear, no interpretation may be allowed on the basis of wishing to know the parties intentions'*. The arbitral tribunal considered this to mean that if the wording of a provision of the PSAs is clear, those words must be given effect.

— Further, Article 24 of the PSAs stated that '*[the PSAs] will be governed and interpreted according to Yemeni laws, except the laws which are inconsistent with [the PSAs]*'. Relying on this Article, the arbitral tribunal considered that the terms of the PSAs should prevail over general principles of law, insofar as they make specific provisions for particular matters.

— The PSAs made specific provisions for force majeure. These provisions were clear. There was therefore, no need to imply any further terms, for example regarding unforeseeability and impossibility. The parties had agreed specific wording and such wording should be given effect.

***(2) Direction of the Government, riot, or insurrection***
The arbitral tribunal stated that, because the above events amounted to force majeure, it did not need to determine whether any other events also qualified as force majeure. However, for the sake of completeness, it remarked that there had also been *'directions of the Government'*, *'riots'* and *'insurrections'* falling within the definition of force majeure under the PSAs.

In relation to the reference to a *'riot'* in Article 22.2, the arbitral tribunal decided that it should be given its natural and ordinary meaning, which the Contractor submitted is *'an unlawful disturbance of the peace by a number of people'*. The arbitral tribunal considered that if the parties intended for the term to have a more specific meaning, the PSAs would have said so. On that basis, the Ministry was wrong to argue that it should be interpreted in a way consistent with Yemeni law, so that it meant *'protests which are illegal, not protests which fall within the legitimate right to protest or demonstrate enshrined in the Yemeni constitution'*.

**Causation**
The parties agreed that in order for any non-performance by the Contractor of its contractual obligations to be excused under Article 22 that non-performance must be caused by force majeure. However, they disagreed on what that meant.

The Contractor argued that all that was required was *'a sufficient link between the event and the consequence, nothing more'*. The Ministry argued that the *'but-for'* test applied, so that the Contract's non-performance was only excused if it could and would have performed its obligations but for the force majeure events.

The arbitral tribunal decided in favour of the Contractor, on the following basis:

- The PSAs (at Article 22) set out a self-contained regime for force majeure, and for termination as a result thereof. A requirement to show that a force majeure event was the only cause of non-performance is not found in the text of Article 22.1, which simply requires non-performance to be *'caused'* by force majeure. Applying reasoning similar to that applied in relation to Article 22.2 above, it decided that the wording of Article 22.1 was clear and additional requirements should therefore not be implied.
- Therefore, *'as long as there is an obligation that a party is prevented from performing because of force majeure, then, irrespective of whether some other event could have also caused non-performance, that party is entitled to rely on Article 22 of the PSAs to terminate the PSAs…'*. The Contractor did not need to show a willingness to perform had the relevant force majeure event not occurred.

The arbitral tribunal then decided that, based on the facts, the Contractor's non-performance was *'caused'* by the force majeure events, and those events continued in effect for over six months so that the Contractor was entitled to terminate the PSAs in accordance with Article 22.4.

## Comment

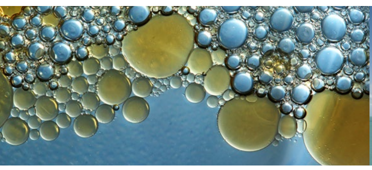
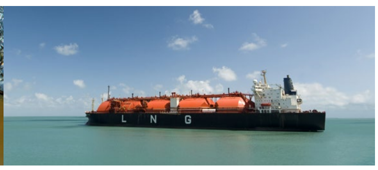
The decision in this arbitration fell on the precise wording of the force majeure provisions in the PSAs. Had the wording been less clear, the operation of force majeure under Yemeni law and the requirements of unforeseeability and impossibility may have been more relevant, and the outcome of the arbitration may have been different. Further, had the categories of events constituting force majeure been less wide or been defined more restrictively, the events that occurred in Yemen between 2011 and 2013 may not have qualified as force majeure events so as to trigger the relevant force majeure provisions.

This case is an important reminder of how drafters can mitigate local political risk through specific and thoughtful drafting of force majeure provisions. Rather than treating such provisions as boilerplate, it would be wise to consider carefully what events should qualify as force majeure, to what extent the parties should exclude or have recourse to principles of the applicable law, and what language should be used to achieve this.

This arbitration also illustrates the significance of the applicable law on the interpretation of force majeure clauses. For example, if the PSAs applied English law, there is a significant body of case law that appears to divide force majeure provisions into (i) contractual frustration clauses; or (ii) contractual exclusion clauses. Further, it is suggested that different principles concerning construction of the clause and rules of causation apply depending upon the category into which the clause properly resides.

Interestingly, however, assuming that English law would have classed the force majeure clause in this arbitration as a 'frustration' clause, as it discharged the obligation to perform, the result would have been the same and the 'but for' test for causation would not have applied.

**Tribunal:** Dr. Laurent Lévy (Chair), Philippe Pinsolle, and Sir Bernard Rix

# Natural gas and LNG sale and purchase agreements

The market for natural gas and LNG projects continues to remain buoyant and has produced interesting guidance for those designing project structures and drafting key contracts. In addition, the pricing of natural gas and LNG continues to give rise to price review disputes across Europe and Asia. Although not all of these arrangements are governed by English law, useful guidance can be taken from the approach taken by international arbitral tribunals in these areas:

- In *Union Fenosa Gas S.A. v Arab Republic of Egypt* (ICSID Case No. ARB/14/4) an arbitral tribunal identified the potential importance of express government undertakings when seeking to secure feed-gas for LNG liquefaction projects from government interference.
- In *Naftogaz v Gazprom* (SCC Arbitration No. V2014/078/080), an arbitral tribunal gave some insight into the proper approach to interpreting a gas price review clause and notice provisions.

# Protecting LNG project feed-gas supply from State interference

In *Union Fenosa Gas S.A. v Arab Republic of Egypt* (ICSID Case No. ARB/14/4) an arbitral tribunal identified the potential importance of express government undertakings when seeking to secure feed-gas for LNG liquefaction projects from government interference.

## Facts

The Claimant ('**Union Fenosa**') (which has now been acquired by another company), was a Spanish company carrying out the liquefaction, shipping, regasification and commercialisation of natural gas. Between 2002 and 2005, an LNG plant in Damietta, Egypt, was constructed by SEGAS, a special purpose entity to which Union Fenosa (80%) as well as Egyptian state-entities EGAS (10%) and the Egyptian General Petroleum Company ('**EGPC**') (10%) were shareholders.

Pursuant to a Sale and Purchase Agreement ('**SPA**') concluded in 2000, EGPC (as later novated to EGAS) was to supply the natural gas for the plant for a period of at least 25 years. The feed-gas to be supplied under the SPA was an important element in the viability of the Damietta project.

Under the SPA, EGPC agreed to obtain from the Egyptian authorities an undertaking not to interfere with the buyer's rights under the SPA:

> *'EGPC undertakes to procure that the Egyptian authorities undertake not to interfere with the rights of the Buyer under this Agreement, and not to dictate or promulgate any act or regulation which could directly or indirectly affect the rights of the Buyer under this Agreement, or affect the capacity of the Buyer to perform its obligations under this Agreement, even in the case of a N[atural] G[as] shortage in Egypt, save for Force Majeure as defined in this Agreement.*
>
> *EGPC shall also assist and actively collaborate with Buyer to obtain any authorization and/or legal, administrative or governmental benefit to the Buyer for the Project and/or construction of the Complex'.*

In a letter dated 5 August 2000 ('**5 August Letter**'), the First Under-Secretary of the Egyptian Ministry of Petroleum wrote to Union Fenosa confirming:

> *'On behalf of the Ministry of Petroleum I have the pleasure to inform you that the Egyptian Government official [sic.] endorsed the natural gas Sales and Purchase Agreement signed August 1st , 2000 between UFACEX and EGPC […]'.*

In the event, EGAS failed to meet its feed-gas supply obligations under the SPA. Between 2006 and 2012, its annual gas supply ranged between 84% and 61% of the contractually agreed quantity. This shortfall was caused by:

- Egypt's long-standing policies of encouraging and subsidising domestic gas and electricity use, together with a failure to encourage the discovery of gas reserves. As foreseen by Wood Mackenzie in 2007, this resulted in a 'supply-demand gap'. The logical result was the curtailment of gas to the Damietta project.
- Subsequently, the Egyptian government decided to discriminate between users of gas. As part of this discrimination, the Egyptian government directed EGAS to limit and eventually halt supplies under the SPA. The purpose of this discrimination was to give priority to domestic users.

**Spain-Egypt BIT**
Article 4(1) of the Spain-Egypt BIT requires Egypt '*to guarantee in its territory fair and equitable treatment of investments made by investors of the other party*' ('**FET Standard**').

## Decision

The arbitral tribunal found that Egypt had breached the Spain-Egypt BIT's FET Standard. However, it did so on grounds more narrowly than those asserted by Union Fenosa.

The arbitral tribunal was content to apply under Article 4(1) the customary international law standard of, *inter alia*, prohibiting conduct which is unjust, arbitrary, unfair, discriminatory or in violation of due process, including conduct that frustrates the investor's *'legitimate expectations'*.

As to the scope of *'legitimate expectations'*, the arbitral tribunal adopted the approach set out in *Philip Morris v Uruguay* (ICSID Case No. ARB/10/7 2016) that: *'It clearly emerges from the analysis of the FET standard by investment tribunals that legitimate expectations depend on specific undertakings and representations made by the host State to induce investors to make an investment'*.

The arbitral tribunal decided that the 5 August Letter was an important element in the project being sanctioned and that the investment would not have gone beyond the signing of the SPA without it. That said, the 5 August Letter did not amount to a government guarantee of the terms of the SPA. In the ICSID tribunal's view, the effect of the 5 August Letter was to preclude Egypt from: (i) interfering with the rights of the buyer under the SPA; (ii) dictating or promulgating any act or regulation that could directly or indirectly affect the rights of the buyer under the SPA; and (iii) affecting the rights of the buyer to perform its obligations under the SPA (subject to force majeure). In other words, Egypt was prohibited from acting contrary to the scope of the undertaking set out in the SPA that the 5 August Letter implicitly provided.

The Egyptian government's decision to cut and curtail gas supply under the SPA was, by its nature and purpose, a sovereign act. Further, it was an act that sought to discriminate against non-domestic users of gas, and the Damietta Plant, specifically. In doing so, the Egyptian government interfered with the legitimate expectations generated by the 5 August Letter.

The arbitral tribunal emphasised that the 5 August Letter was the *'decisive tipping factor'* in finding that Egypt had breached the Spain-Egypt BIT's FET standard. In the absence of such undertaking, the arbitral tribunal expressly stated that Union Fenosa would not have established a treaty violation.

Union Fenosa was awarded slightly over USD 2bn in damages.

## Comment

This case provides important confirmation that pursuing an investment treaty claim against a host State can be considered as distinct from seeking relief against the state-entity under the relevant contract. Further, pursuing both claims in parallel will not necessarily amount to an abuse of process.

The case also emphasises that the nature of a contract claim and a claim based on an international investment agreement are different. In the event that an investor claims under an investment protection treaty that its legitimate expectations have been violated by State action, in breach of a fair and equitable treatment standard, it may need to be in a position to point to specific undertakings or representations made by the State upon which it relied in making the investment. The project structure in this case provided for such *'specific undertaking'*, which was critical to the claimants' argument that Egypt had acted wrongfully.

In this respect, it should be noted that other arbitral tribunals sitting in investment treaty cases have observed that commitments can be 'specific' in two respects: as to their addressee (including when directed at a class of investors) and as to their object and purpose. Thus, it is arguable that under international law a host State may make a binding commitment to foreign investors through its legislation, although general legislative representations to an undefined class of investors will not typically engender legitimate expectations protected under investment law.

Nevertheless, a host State's right to regulate is circumscribed by its international law obligations and, in finding a balance between the stability and flexibility of a legislative framework for the purpose of the FET Standard, arbitral tribunals may consider the nature and extent of any subsequent legislative changes.

In the absence of a 'stand-alone' State guarantee, the investor in this case succeeded because its contractual structuring ensured:

1. There was a relevant investment protection treaty under which the party to the SPA could seek protection from State actions;
2. although the Egyptian State was not party to the SPA, the seller (which was owned by the State) was contractually obliged to seek State undertakings concerning the State's actions concerning performance of the SPA;
3. the state did, in fact, send a letter endorsing the SPA; and
4. in the absence of the State undertaking being given, the investor would be entitled to 'walk-away' from the SPA.

For drafters of long-term gas sales agreements and associated project documentation concerning the construction of liquefaction facilities, the lesson seems clear: it may not be enough to purely rely on the existence of an investment protection treaty to protect the gas supply that is needed to make the investment work against government interference. A representation or undertaking may be needed from the State. Further, the scope of any protection afforded against government interference under an investment treaty might only extend so far as the specific undertakings or assurances given. Insofar as such representations and/or undertakings can be procured expressly and/or in writing, this decision confirms that such written undertakings will greatly assist the investor to evidence its 'legitimate expectations' for the purpose of establishing a breach of the fair and equitable treatment standard. As such, the structure of the project documentation is likely to benefit from a requirement for specific written undertakings and/or assurances from the relevant government ministry.

**Tribunal:** V.V. Veeder (President), J. William Rowley, Mark Clodfelter

# Navigating a natural gas price revision

The publication of arbitral awards in *National Joint Stock Company Naftogaz of Ukraine v Public Joint Stock Company Gazprom* (SCC Arbitration No. V2014/078/080) provides a rare insight into one of the many price review arbitrations that have been conducted with Gazprom concerning sales of natural gas into central and eastern Europe.

It should be reassuring for users of contracts containing price review provisions that, despite the political background to and interest in this dispute, the arbitral tribunal based its decision only on the price review clause wording contractually agreed between the parties. In fact, the natural and ordinary meaning of the words used by the parties appeared to be paramount in the determination reached as to the revised price formula.

## Facts

In the immediate aftermath of the gas crisis of January 2009, which ultimately saw Russia temporarily halt all deliveries of natural gas to Ukraine (both for Ukraine's own use and for onward transmission to other European countries), National Joint Stock Company Naftogaz of Ukraine ('**Naftogaz**') and Public Joint Stock Company Gazprom ('**Gazprom**') entered into a long term contract for the purchase and sale of natural gas for the period 2009 to 2019 dated 19 January 2009 (the '**Gas Sales Contract**'), and into a contract on volumes and terms of transit of natural gas through Ukraine for the same period (the '**Gas Transit Contract**').

Disputes arose under both the Gas Sales Contract and the Gas Transit Contract, and have been determined by way of three separate arbitrations presided over by the same arbitral tribunal members. This article concerns the Gas Sales Contract and the two arbitrations conducted in determination of disputes thereunder. The contracts were governed by Swedish law, with disputes to be resolved by arbitration in accordance with the rules of the Arbitration Institute of the Stockholm Chamber of Commerce.

The issue at the centre of the pricing dispute was Naftogaz's claim to a contractual right to a price review and determination under the Gas Sales Contract. According to Naftogaz, it first requested a price revision by letter dated 20 May 2011. This request outlined developments in the fuel and energy market, which meant that the price of gas payable under the Gas Sales Contract no longer corresponded to the then current price levels of natural gas.

Further letters were exchanged between the parties in respect of the price revision, gas delivery volumes and the postponement of payment for the gas, and they met several times but no final agreement as to price revision was reached. The failure of this process led to the arbitration being commenced by both parties filing requests for arbitration on 16 June 2014.

The main issues in dispute between the parties for consideration and determination by the arbitral tribunal were as follows:

- Naftogaz claimed an adjustment of the price payable under of the Gas Sales Contract, and retroactive compensation for historic overpayments dating from 2011.
- Naftogaz claimed that certain provisions of the Gas Sales Contract should be declared invalid or ineffective – specifically the volume and take-or-pay provision, the destination clause, the unilateral suspension right clause and the mandatory sales clause of the Gas Sales Contract.
- Gazprom denied that Naftogaz was entitled to relief, and counterclaimed for payment of outstanding amounts due for gas delivered and for gas accessible but not off-taken under take-or-pay provisions, plus interest. Naftogaz rejected the counterclaim.

## Decisions

The arbitral tribunal chose to deal with the issues in dispute in bifurcated proceedings. On 8 May 2017 the arbitral tribunal rendered what it deemed a separate award disposing of the issues of fact and law to decide, amongst other issues: (1) whether there was a right to price revision; (2) whether there was a right to price determination and what that price determination should be; (3) whether Gazprom has a right to take-or-pay payments; and (4) whether one or more contractual provisions should be declared void or ineffective (the '**Separate Award**'). In summary, the arbitral tribunal decided as follows:

- Naftogaz had a right to price revision.
- Naftogaz had a right to price determination; the arbitral tribunal determined a new formula on the basis of the pricing mechanism seemingly linked to German Hub prices, taking effect from 27 April 2014.
- Gazprom had no right to retrospective take-or-pay payments for the period 2009–2017.
- Several clauses were declared invalid (notably the destination clause, which had prohibited the sale of gas purchased under the Gas Sales Contract outside of Ukraine), with the take-or-pay provision to be revised in a final award.

All resulting outstanding issues (including quantum) were to be determined by agreement of the parties or, failing such agreement decided by the arbitral tribunal in a final award after further proceedings. No such agreement was reached, and the arbitral tribunal rendered its final award on 22 December 2017 (the '**Final Award**'). In summary, the result was as follows:

- The parties agreed that the arbitral tribunal should set off amounts owed between the parties in order that a single net amount should be ordered to be paid by one party to the other.
- The net amount payable by Naftogaz to Gazprom, principal and interest included, as per 31 December 2017 was USD 2,018,920,854.91.
- The arbitral tribunal finalised the text of the revised take-or–pay provision (the text of such revision was redacted).

**Separate Award**

In the Separate Award the arbitral tribunal emphasised that its decisions were based on the interpretation of the parties' agreement on the basis of the Swedish law on interpretation of contracts, meaning that provisions would be interpreted *'in accordance with the plain and ordinary meaning of the words used'*. The arbitral tribunal decided the Gas Sales Contract to be *'imprecise and simplistic'* and its provisions *'not well formulated'*. There was limited evidence as to the intentions of the parties, and it appeared to the arbitral tribunal that the parties had not given any real thought as to the meaning of the contract's terms.

Whilst acknowledging the special nature of the relationship between Gazprom and Naftogaz, and indeed Russia and Ukraine, the arbitral tribunal was careful to demonstrate that this special political nexus was not relevant to its decision-making in relation to the price review provisions. The arbitral tribunal considered that *'the relationship between Gazprom and Naftogaz is not merely a normal commercial relationship…..the relationship has also been political….where considerations other than merely commercial considerations have often been decisive'*. However, it clarified that *'[n]eedless to say, the case has, however, been examined by the tribunal from a strictly legal point of view'*.

**Price revision – right?**

The contract price payable under the Gas Sales Contract was based on a price formula made up of a base price, an escalation supplement and a coefficient. The escalation supplement was calculated by reference to the movements in the price of gas oil and fuel oil.

The price revision provision was as follows (there was no agreed translation of the clause; this is the version of the clause that the arbitral tribunal used, specifically Naftogaz's translation from Russian with text from Gazprom's translation inserted reflecting differences in translation):

> *'4.4 If either Party declares that the fuel and energy market conditions have changed significantly compared to what the Parties had reason to expect at the conclusion of this Contract, and if the contract price provided in Article 4.1 of this Contract does not reflect the level of market prices, then the Parties shall enter into negotiations*

> *regarding an adjustment of [Gazprom: proceed to negotiations to consider] the Contract Price in accordance with the provisions of this Contract.*
>
> *4.4.1 A request for price revision [Gazprom: to reconsider the price] shall be submitted in writing and shall be properly substantiated [Gazprom: duly justified by the requesting Party]. Upon receipt of the above-mentioned request by the Party concerned, the Parties shall enter into negotiations within 20 days and, if an agreement is reached, sign the respective addendum to this Contract.*
>
> *4.4.2 If a written agreement on the revision of the Contract Price [Gazprom: to reconsider the contract price] cannot be reached within 3 (three) months from the date of the beginning of negotiations, each of the Parties has a right to dispute the other Party's performance of the present Contract [Gazprom: has a right to challenge the actions of the other Party to perform this Contract] and to submit the matter to arbitration in accordance with Article 8 of the Contract for the passing of a final decision [Gazprom: for the adoption of a final resolution]'.*

In summary, contractually a price review required: (1) a significant change in the fuel and energy market conditions, compared to what the parties had reasonably anticipated when they entered into the Gas Sales Contract; and (2) that the contract price of the Gas Sales Contract no longer reflected the fuel and energy market conditions. If a party wished to declare a price review on this basis, it was mandated to commence a negotiation following a written notification to the other party. If such process did not result in written agreement, the parties were entitled to submit the matter to arbitration.

Naftogaz claimed that changes in the fuel and energy market afforded it a right to a price review under Clause 4.4 of the Gas Sales Contract. Gazprom disagreed, arguing that Clause 4.4 was actually a price renegotiation clause and as such, if negotiations failed, there was no right to have the price revised through arbitration and that therefore the arbitral tribunal did not have jurisdiction to revise, replace, adjust or amend the price.

The arbitral tribunal decided that this provision was a price revision clause, and that where the parties failed to reach agreement in accordance with Article 4.4.1, a party had the right to submit the determination to arbitration in accordance with Article 4.4.2. To reach this determination, the arbitral tribunal considered the plain and ordinary meaning of the wording used in the clause. Of note in the arbitral tribunal's reasoning was the fact that the Gas Transit Contract contained a similar price revision clause which the parties agreed was a price revision clause empowering the arbitral tribunal to revise the price. Although the clauses were different, the arbitral tribunal was of the view that *'it is difficult to find any sensible reason for an intent that the [Gas] Transit Contract should be different in respect to price revision from the [Gas Sales] Contract'*, and the parties were not able to provide any persuasive evidence on this point.

Following a detailed review of the correspondence and evidence, the arbitral tribunal decided that the circumstantial pre-requisites for a submission to arbitration had been met, namely that Naftogaz had declared a change in market circumstances, and had appropriately corresponded and negotiated with Gazprom in respect of a price review. Therefore, Naftogaz had a right to submit the price revision to the arbitral tribunal, and it was appropriate for the arbitral tribunal to determine the price.

**Price revision determination**
To determine the price, the arbitral tribunal considered what was meant by the *'fuel and energy market'*, noting that no contractual guidance was offered. The arbitral tribunal reasoned, based on the wording of the Gas Sales Contract, that the parties wanted to keep the contract price in line with market developments. As to what those market developments were, the arbitral tribunal decided that an exact meaning was not necessary, as the experts in the arbitration agreed that the market condition on which the Gas Sales Contract had been based was the oil price. The market had changed on the basis of European market-wide decoupling of oil-linked prices and hub prices, resulting in hub prices becoming a prominent and important price formation mechanism in European markets.

On this basis, the arbitrators agreed with Naftogaz's argument that the gas price should be market-reflective, switching from 100% price referenced to petrochemical price to 100% referenced to gas market price. As to which specific gas market was the most appropriate to be used in the price formula, much of the arbitral tribunal's reasoning has been redacted. The parties agreed that the Ukrainian market as reference was irrelevant. Naftogaz claimed that Germany, Slovakia and the Czech Republic were the relevant markets, and whilst Gazprom agreed it also considered France, Italy, Poland and Hungary to be of relevance. The arbitral tribunal considered that the parties used three markets in common, namely Germany, Slovakia and the Czech Republic. Although much of the final price formula decision has been redacted from the Separate Award, it appears likely from the Final Award that German hub prices were chosen as the reference market. The arbitral tribunal partially rejected the retrospective claim for overpayment. Naftogaz had originally sought compensation for the price paid from 2011 to 2014, however the arbitral tribunal revised the price from 27 April 2014 (that date being the date on which Naftogaz sent Gazprom a notice of dispute indicating that it intended to refer the price revision to arbitration).

**Take-or-pay**

The arbitral tribunal's determinations on 'take-or-pay' have mostly been redacted. It is understood that, whilst the arbitral tribunal maintained the 'take-or-pay' principle for 2018 to 2019, its terms were modified, with the minimum 'take-or-pay' level reduced to 4BCM. The arbitral tribunal rejected Gazprom's retrospective 'take-or-pay' claim for gas not taken in 2012 to 2017.

**Final Award**

In the Final Award the arbitral tribunal firmly refused to allow the reopening of issues which had been dealt with in the Separate Award. It explained that the decision to render a Separate Award was based on the concerns expressed by the parties that the arbitral tribunal may need assistance in making complex calculations and on the arbitral tribunal's desire to provide the parties with an opportunity to settle outstanding issues. If no settlement was reached, the arbitral tribunal would determine these issues, which were expressly and purposefully of a nature that did not involve the arbitral tribunal considering new legal arguments or new facts:

> *'The intent was not that the parties should re-argue issues that had been fully argued, even less issues that had been determined by the Separate Award, or that the parties should be allowed to make new claims. There is no basis in the Separate Award for allowing this. Nor is there any other decision by the Tribunal to that effect'.*

On this basis, the arbitral tribunal rejected Naftogaz's attempts to further refine the pricing mechanism in the proceedings leading to the Final Award on the basis that these points were not open to re-arbitration. Further, the arbitral tribunal forcefully rejected any attempt by the parties to rewrite the contract:

> *'The fact that the Separate Award has been rendered, and that issues remained to be resolved, does not entail an opportunity for a party to improve its case or the Contract commercially for its benefit. Nor does it open the door for arguments that there are commercial or reasonable contractual solutions that are common or customary, or for solutions which are better or different from the ones that have been agreed by the parties in the Contract, or which may be desirable for avoiding ambiguities. In simple words, the arbitration is not about writing a new, better Contract'.*

## Comment

It is notable that, despite the undeniable political interest in this dispute, the arbitral tribunal firmly applied a strictly legal interpretation of the contractual terms agreed between the parties, acknowledging yet side-stepping contentious political and strategical arguments. As there will frequently be a political backdrop to natural gas sales and LNG contracts, it is notable for negotiators and users of price review mechanisms that the precise wording used by the parties was of paramount importance in interpretation under Swedish law.

The case also serves as a useful reminder of the need for contractual parties to closely comply (and document such compliance) with contractual mechanisms for pre-dispute communication and negotiation, as the arbitral tribunal was careful to ensure that the steps agreed between the parties had been fulfilled.

Although the price review mechanism in dispute was prescriptive as to the actions necessary to trigger a price review, the criteria on which the arbitral tribunal were to review and revise the price were arguably not clearly set out. Whilst the arbitral tribunal in this case disposed of the issue in simple terms by treating the trigger for price review (i.e. the change in market prices) as the basis on which the price formula should be reviewed and revised, this may not always be the case. Where parties wish to exert more precise control over the constituent elements of the price review they may wish to set out clear contractual wording as to the criteria to be applied by the decision-maker.

In this respect, the price review clause in the Gas Sales Contract may be contrasted with those setting out greater guidance for the parties and any arbitral tribunal. For example, in an LNG sale and purchase agreement between Atlantic LNG and Gas Natural the price review clause expressly required:

> *(b) 'In reviewing the Contract Price in accordance with a request pursuant to sub-Article 8.5(a) above the Parties shall take into account levels and trends in price of supplies of LNG and Natural Gas [redacted] such supplies being sold under commercial contracts currently in force on arm's length terms, and having due regard to all characteristics of such supplies (including, but not limited to quality, quantity, interruptability, flexibility of deliveries and term of supply).*
>
> *(c) The Contract Price as revised in accordance with this Article, shall in any event, allow the Buyer to market the LNG supplied hereunder in competition with all competing sources or forms of energy…. And such Contract Price shall allow the Buyer to achieve a reasonable rate of return on the LNG delivered hereunder'.*

As explained in Ashley and Holland, *Natural Gas Price Reviews: Past, Present and Future* (2012) 30(1) *IBA Journal of Energy and Natural Resources Law 29*:

> *'Price review provisions can vary substantially. Experienced natural gas lawyers will understand that the reasons for the variations are numerous, including (to name a few): different cultural pre-dispositions to contractual revision; evolution of drafting preferences over time; differing practice amongst industry participants and markets; differing perceptions of risk; and factors relating to individual negotiations. A more detailed examination of these reasons would be the subject of a more substantial article, which is not possible here and might be of limited relevance in any event.*
>
> *Ultimately the arbitrator's task will depend upon what the contract before the arbitral tribunal requires them to do, which can primarily be ascertained from:*
>
> — *The words of the price review provision.*
>
> — *The existing (or original) price formula.*
>
> — *The governing law of the interpretation of contract.*
>
> — *The arbitration provision.*
>
> — *The relationship between the price review provision, price formula and the rest of the agreement.*
>
> ……
>
> *While some commentators refer to a 'typical price review clause', it is important for an arbitral tribunal to focus on the words agreed between the parties. Price review provisions are not standard form and arbitral tribunals should be careful of accepting arguments that entirely different provisions are intended to achieve the same purpose'.*

It is apparent from the award that the arbitral tribunal in this arbitration recognised that differences exist between price review provisions and, in that context, sought to apply the words used by the parties against the requirements of contractual construction and interpretation stipulated by the governing law selected in the contract. In taking this approach the arbitral tribunal emphasises to drafters of such provisions the importance of the words used and the governing law selected by the parties.

Of further note was the arbitral tribunal's absolute refusal in the Final Award to allow the bifurcated proceedings to provide any party with the opportunity to reopen pricing issues that had already been decided, or which that party had already had the opportunity to raise, in the proceedings leading to the Separate Award. This serves as a useful reminder that in bifurcated proceedings it is not open to the parties to re-open issues already decided by an arbitral tribunal, nor to offer evidence which should have been offered in the first set of proceedings. Similarly, parties should ensure to the greatest extent possible that they provide all appropriate and relevant evidence at the correct point in proceedings in order to avoid the risk of later being unable to do so.

**Tribunal:** Mr. Tore Wiwen-Nilsson (Chair),
Mr. Jens Rostock-Jensen, and Mr. Johan Munck

# Natural Gas Transportation Agreements

The transportation and processing of natural gas is an important element of the value chain. As existing arrangements mature, issues continue to arise concerning appropriate pricing for transportation/capacity and the consequences of failing to ship minimum annual volumes. As this is an international issue not all matters relate to contracts governed by English law, but the guidance given by international courts and tribunals is important to understanding common contractual structures.

— In *CapeOmega AS, Solveig Gas Norway AS, Silex Gas Norway AS, Infragas Norge AS v The state represented by the Ministry of Petroleum and Energy* HR-2018-1258-A (case no. 2017/1891), the Norwegian Supreme Court considered the legality of changes to gas transportation tariffs through the Norwegian Gassled system. The reasoning of the Supreme Court provides some interesting insights into: (i) the extent to which regulatory authorities should be entitled to reduce existing transportation tariffs and (ii) the factors that may be relevant to assessing a reasonable rate of return on infrastructure assets.

— In *National Joint Stock Company Naftogaz of Ukraine v Public Joint Stock Company Gazprom* (SCC Arbitration No. V2014/129) an arbitral tribunal decided that notwithstanding the absence of a typical 'ship-or-pay', or 'send-or-pay', clause an obligation on the seller to deliver minimum annual volumes of gas entitled a buyer to damages when a seller under-delivered against those minimum volumes. However, it also rejected an attempt to alter the tariff.

— In *Teesside Gas Transportation Limited v (1) CATS North Sea Limited; (2) Antin CATS Limited; (3) ConocoPhillips Petroleum Company U.K. Limited; and (4) ENI UK Limited* [2019] EWHC 1220 (Comm) the Commercial Court decided some key aspects of the working of a cost-share regime under a transportation and processing agreement. The decision gives some interesting insights into the proper approach to interpreting the identification and allocation of costs for the purposes of invoicing. It also dealt with the ability of the operator to correct invoices previously containing an error or otherwise needing correction.

# Gassled: Norwegian Supreme Court upholds government's right to amend gas transport tariffs

In *CapeOmega AS, Solveig Gas Norway AS, Silex Gas Norway AS, Infragas Norge AS v The state represented by the Ministry of Petroleum and Energy* HR-2018-1258-A (case no. 2017/1891), the Norwegian Supreme Court considered the legality of changes to gas transportation tariffs through the Norwegian Gassled system. The reasoning of the Supreme Court provides some interesting insights into: (i) the extent to which regulatory authorities should be entitled to reduce existing transportation tariffs and (ii) the factors that may be relevant to assessing a reasonable rate of return. Against the background of changes to the regulatory regime on the UKCS and global regulatory developments, the Supreme Court decision provides some important international guidance.

## Facts

The world's biggest offshore system for the transportation and processing of gas is owned by 'Gassled', a joint venture established in 2003 with the encouragement of the Norwegian authorities. It is owned in part by the Norwegian state and in part by private companies. Nearly all Norwegian gas sold to the UK and Central Europe is transported through the Gassled system. The tariff paid by third parties for shipment through the network is set by regulation (the '**Tariff Regulations**').

The Norwegian Petroleum Act (the '**Norwegian Act**'), section 4–8 subsection 2, provided that Norwegian Ministry of Petroleum and Energy (the '**MPE**') may:

> *'stipulate tariffs […] to ensure that projects are completed with due regard to concerns relating to resource management and that the* ***owner of the facility is provided with*** *a reasonable profit taking into account, among other things, investment and risks' (our emphasis)'.*

In 2013, the MPE amended the Tariff Regulations, reducing the tariffs Gassled owners were able to charge for new contracts from 1 October 2016 and thereby substantially reducing Gassled's future income. Four Norwegian companies with ownership interests (but no shipping interests) in Gassled of a combined 45% (the '**Appellants**') argued that the amendment of the Tariff Regulations was invalid and that the State was liable for the loss of revenues they incurred.

The Appellants argued, amongst other things, that (i) section 4–8 subsection 2 of the Norwegian Act was the only legal basis by which a tariff adjustment could be made; (ii) the MPE should have assessed whether the tariff adjustment was consistent with this *'reasonable profit'* requirement and (iii) the MPE's actions also amounted to a breach of the European Convention on Human Rights ('**ECHR**').

## Scope of Appeal

In the lower Courts, the Appellants sought to argue that the Norwegian government did not have the authority to amend the Tariff Regulations: firstly, because MPE had agreed that the tariffs would remain unchanged during the whole of Gassled's licence period, from 2002 to 2028; secondly, because MPE did not have statutory authority to do so; and thirdly, because the amendment was in contravention of Gassled's rights under the ECHR. In the alternative, the Appellants sought compensation on the basis that the state had provided insufficient guidance in relation to the tariff regime when the Appellants had purchased their interests in Gassled, in breach of Norwegian administrative law.

However, only two of these arguments were put before the Supreme Court:

— MPE lacked statutory authority to amend the Tariff Regulations. The Appellants argued that an adjustment of already established tariffs could only be made in accordance with section 4–8 subsection 2 of the Norwegian Petroleum Act. This subsection gives the MPE the right to change tariffs for gas transport if it is necessary *'to ensure that projects are completed with due regard to concerns relating to resource management and that the owner of the facility is provided with a reasonable profit taking* *into account, among other things, investments and risks'*. The Appellants claimed that the change in tariff was not necessary for this purpose.

— MPE's decision interfered with the Appellants' ECHR right to enjoy their possessions under Article 1 of the first Protocol ('**A1P1**') – which, the Appellants argued, included the right to a return on the possession in question. The level of interference with the Appellants' possessions was disproportionate, and could not be justified in terms of any effect on resource management.

## Decision

The Supreme Court rejected both points and dismissed the appeal.

**Did MPE have statutory authority?**
The Supreme Court first considered the legal basis for the original Tariff Regulations (2003) applicable to Gassled. The Supreme Court found that it was *'clear'* that, when originally established, the tariff regime was implemented on *'the assumption […] that the tariffs could be adjusted based on return'*. In order to adjust tariffs based on return, however, MPE required to amend the Tariff Regulations to adjust the capital element of the tariff formula. This is exactly what MPE had done in 2013.

The Supreme Court did not agree with the Appellants that MPE's power to amend the capital element was restricted by section 4–8 subsection 2 of the Petroleum Act. Subsection 2 related to the right to adjust tariffs for shipper agreements already entered into, however the amendment to the Tariff Regulations related to general tariffs for future agreements. In the circumstances, the relevant subsection was subsection 1 – which gave MPE far wider powers to stipulate *'further rules in the form of regulations and may impose conditions and issue orders relating to such access in the individual case'*.

In addition, in coming to its decision, the Supreme Court interpreted the words of statute but also had regard to policy and reports of the regulator. It was these policy documents that had always stipulated that the real return on total capital for Gassled investors should be around 7%.

The Appellants went on to make one final argument: that the MPE had no basis on which to completely disregard the costs the companies had incurred in acquiring interests in Gassled. The Supreme Court found to the contrary: that, whilst the MPE had the opportunity to consider those costs when setting the tariffs, it was not bound to do so. The Supreme Court went so far as to say: *'It is hard to understand why entirely commercial transactions carried out by the owners to realise profit or release capital should influence the tariff level or in fact limit the Ministry's regulatory authority to adjust the tariffs'*.

On this basis, the Supreme Court concluded that MPE did have statutory authority to amend the Tariff Regulations in 2013.

**Was there an interference with ECHR A1P1 right?**
Two questions faced the Supreme Court in considering the Appellants' A1P1 argument. Firstly, whether the tariff adjustment is an interference with the Appellants' possessions; and secondly, whether that interference was proportionate, having regard to the right of states to control the use of property in accordance with the general interest of the community.

Interestingly, the Supreme Court left open the first question, and did not decide whether an interference with an ownership interest protected by A1P1 had taken place. This is in contrast to the Court of Appeal, which had previously found that there was no legitimate expectation on the part of the Appellants that the tariffs would remain unchanged until 2028, and therefore there was no proprietary right afforded protection by A1P1.

In relation to the second question, the Tariff Regulation was not a disproportionate interference for three principal reasons. Firstly, the Appellants knew their ownership interests were tied to a regulatory regime, and were aware of the risk of adjustments to that regime. Secondly, MPE's decision to reduce the tariff was *'handled in a manner to which [the Supreme Court] [has] no objection'*. Notably, the decision had been subject to consultation, including with the Appellants. Thirdly, the adjustment had not in fact affected the Appellants particularly harshly; most of the capacity for the duration of the licence period (which would expire at the end of 2028) had already been booked before 1 July 2013, and was therefore not affected by the change which only took effect from 1 October 2016.

Against this background, the Supreme Court held there was no basis for concluding that the Tariff Regulation in 2013 was a disproportionate interference with the Appellants' right to protection of property under ECHR A1P1.

## Comment

The Supreme Court's decision is another clear statement of the latitude generally afforded to states to regulate their own oil and gas industry. Notably, the Supreme Court considered in some detail the principles of the Norwegian regime which guided MPE's decision to amend the Tariff Regulations – including that *'profit is earned from the fields and not the infrastructure'*.

In both the UK and Norwegian systems there is a balance to be achieved between, on the one hand, upholding national energy policy seeking to maximise resources and revenue from oil and gas fields and, on the other, the commercial interests of other stakeholders. *Gassled* brings into focus the tension which can arise when those competing interests conflict.

In the UKCS, the MER UK Strategy created a legally binding obligation on industry to take the steps necessary to secure that the maximum value of economically recoverable petroleum is recovered. The strategy includes a number of safeguards intended to ensure that this obligation does not discourage investment. One key safeguard provides that there is no obligation to make an investment or fund activity where there will not be a *'satisfactory expected commercial return'* ('**SECR**'). According to the MER UK strategy, SECR is *'an expected post-tax return that is reasonable having regard to all the circumstances including the risk and the nature of the investment (or other funding as the case may be) and the particular circumstances affecting the relevant person'*. Both the SECR definition and the Norwegian Act require an assessment of what is a *'reasonable'* return in light of investment and risk.

The method for calculating tariffs under the Infrastructure Code of Practice on Access to Upstream Oil and Gas Infrastructure on the UK Continental Shelf ('**ICOP**') also reflects the risk/reward principle. ICOP provides that tariffs ought to be '*fair and reasonable*', ensuring that '*risks taken are reflected by rewards*'.

Whilst *'reasonableness'* is a consistent theme across both jurisdictions, the difficulty is in determining what exactly that term means. In the circumstances of *Gassled*, the Supreme Court started from the position that the fact the tariffs were to be based on return implied a principle that, as a starting point, the owners were to earn back their invested capital in addition to a reasonable return, but not more. The Supreme Court found that *'the starting point was […] a real return throughout the licence period of around 7 percent before tax'*. After considering at some length the history of and background to the formation of Gassled and other enactment of the Tariff Regulations, it was held that the Appellants knew and accepted that the MPE was authorised to reduce the tariffs if the real return exceeded 7% of the invested capital. That had been identified as a maximum rate of return in various propositions to the Storting in connection with the Zeepipe network in the late 1990s, the principles for which were then applied as other networks were established.

In comparison, the SECR requirement does not prescribe a particular rate of return – indeed the OGA is at pains not to do so: the SECR guidance explicitly states that it *'does not seek to […] set any new tests as to what should be considered economically recoverable petroleum, or set the rate of return for projects or investments'*.

Nevertheless, it is foreseeable in both jurisdictions that a company may find itself in a position where unhindered exploitation of its assets would yield a certain rate of return, and yet the regulator may expect that company to accept a lower rate of return – not necessarily unprofitable, but nonetheless lower than that company's typical internal hurdle rate for return on investment.

As noted above, the Appellants relied heavily on their rights under the ECHR when litigating before the Supreme Court. Whilst they have now exhausted all domestic avenues to appeal, it remains to be seen whether they will attempt to appeal further, to the European Court of Human Rights.

**Judges:** Bårdsen, Kallerud, Falch, Ringnes, Endresen

# Absence of send-or-pay clause does not necessarily avoid liability for underdeliveries in international transportation agreements

In *National Joint Stock Company Naftogaz of Ukraine v Public Joint Stock Company Gazprom* (SCC Arbitration No. V2014/129), an arbitral tribunal decided that, notwithstanding the absence of a typical 'ship-or-pay', or 'send-or-pay', clause an obligation on Gazprom to deliver minimum annual volumes of gas entitled Naftogaz to damages when Gazprom under-delivered against those minimum volumes.

Although the outcome of this case was very fact-specific, it provides a useful reminder of the need for clear and careful drafting surrounding minimum quantities obligations and the consequences of breaching those obligations.

## Facts

The Ukrainian Gas Transmission System is a complex of pipelines used for the transmission of natural gas from 'entry points' in Russia and Belarus, through Ukraine, to 'exit points' at the borders between Ukraine and

Romania, Hungary, Slovakia, Poland and Moldova. The system is now operated by Ukrtransgaz, a subsidiary of Naftogaz (Ukraine's largest oil and gas producer).

In 2009, Naftogaz and Gazprom (one of the world's largest gas extracting company, majority owned by the Government of Russia) entered into a long-term agreement for the use of the Ukrainian Gas Transmission System to transit very significant volumes of natural gas through Ukraine into Europe (the '**Transit Contract**'). At one time during the 11-year term of the Transit Contract, gas transmitted under it covered approximately 50–60% of Russian natural gas exports to Europe, making Ukraine (in the arbitral tribunal's words) *'the most important transit country in the world'*.

A number of disputes arose between Naftogaz and Gazprom in relation to the Transit Contract and in 2014, Naftogaz commenced arbitration (in accordance with the SCC Rules and subject to the procedural laws of Sweden, as required by the Transit Contract). Amongst other things, Naftogaz sought to argue that:

— The volumes of gas Gazprom was delivering each year for transit was lower than the minimum volumes agreed under the Transit Contract, and Naftogaz was entitled to damages for this underdelivery; and

— the price for transit set out in the Transit Contract should be revised upwards, pursuant to either (i) a price revision clause in the Transit Contract, (ii) an invalidity clause triggered because the pricing provisions are not consistent with Ukrainian law (which had recently undergone a natural gas market sector reform to comply with Ukraine's commitment to follow the EU's 3rd Energy Package Directives for the natural gas market) or EU law, or (iii) the application of the Swedish Contracts Act.

## Decision

The arbitral tribunal accepted Naftogaz's claim for underdeliveries, and rejected its claim for revision of the price. The reasoning provided by the arbitral tribunal is summarised below.

### (1) Claim for Underdeliveries

***Relevant Contractual Provisions***

The Transit Contract applied the substantive laws of Sweden.

Under Article 2 of the Transit Contract, Naftogaz agreed to perform the relevant transit services *'subject to the volumes and terms set out in Article 3'*. Article 3, in turn, stated the following:

— Article 3.1 stated that *'From 2009 to 2019 inclusive, [Gazprom] shall transfer to [Naftogaz] the Natural Gas for transit to European countries in the volume of at least 110 (one hundred ten) billion m3 [except for the year 2009 for which Article 3.1.1 provided a different transit volume] on an annual basis…and [Naftogaz] shall ensure its acceptance and further transit through the territory of Ukraine…'* (Article 3.1).

— Article 3.2 stated that after 2009, annual gas volumes shall be specified in supplements, or addenda, to the Transit Contract. It then stated that *'In case of the Parties' failure to execute such Supplement prior to the commencement of the relevant Contractual Year, the volumes of the Gas transit in the relevant year shall be determined based on the aggregate obligations to supply minimum annual quantities of Gas under the Contracts of [Gazprom] with the European buyers which receive the Gas transited through the gas transportation system of Ukraine. In that case such minimum annual obligations under the contracts of [Gazprom] have to be confirmed by the auditor'.* Naftogaz and Gazprom agreed volumes for the years 2010- 2015 in addenda to the Transit Contract, but failed to agree volumes in the other years.

The Transit Contract did not contain what is typically referred to as a 'ship-or-pay', or 'send-or-pay', provision (essentially, a provision providing for payments based on reservation of capacity); Naftogaz proposed such a clause as part of contract negotiations, but Gazprom rejected it. However, the Transit Contract did contain a general liability provision: Article 10.1 required one party that failed to perform any of its obligations under the Transit Contract to *'reimburse the other party for any proven damages caused by such failure to perform'*.

***Underdeliveries from 2009–2015***

The volumes of gas actually delivered in this time period were less than those set out in the Transit Contract and relevant agreed supplements. Naftogaz argued that this was in breach of Article 3.1, which obliged Gazprom to transit certain minimum volumes, and that Gazprom was required to compensate Naftogaz for damages caused by such breach pursuant to Article 10.1.

Gazprom, on the other hand, relied on the evidence of a witness who stated that the volume was intended as *'no more than a forecast'*, to ensure that sufficient capacity to meet Gazprom's anticipated transit needs was available in Naftogaz' system. It pointed to Article 3.2 to argue that the volume of gas to be transited under the Transit Contract was *'inextricably'* linked to the needs of Gazprom's European customers, and that, for this reason, the volume specified in Article 3.1 could not have been intended as a commitment of Gazprom to transit a minimum volume. In any event, Gazprom argued that the absence of a ship-or-pay (or send-or-pay) clause in the Transit Agreement shows an intent to agree not to undertake financial liability for underdeliveries, notwithstanding the words in Article 10.1.

On the basis that *'testimony was mostly contradictory and generally followed the interest of the party who called the witness'*, the arbitral tribunal considered it impossible to decide this issue on the basis of such testimony. It therefore sought to interpret the relevant contractual provisions in accordance with the *'plain and ordinary meaning of the words used'*. Doing so, it agreed with Naftogaz, concluding that:

— The words of Article 3.1 are straightforward in creating a binding minimum obligation of transit volumes. Relevant to the arbitral tribunal's reasoning was the second sentence of Article 3.1, which required Naftogaz to ensure transit of the relevant gas through Ukraine. The arbitral tribunal found that this effectively amounted to a legal obligation on Naftogaz to transit the minimum volume specified in Article 3.1 (unless otherwise agreed in subsequent addenda), which meant Naftogaz had to reserve transit capacity for Gazprom in that volume to comply with its obligation. On Gazprom's interpretation of Article 3.1, Naftogaz would have had to reserve capacity for Gazprom without being paid for the capacity that Gazprom would not use, and without the possibility to sell such unused capacity to anyone else. The arbitral tribunal considered that this was not likely to be correct.

— In relation to liability for breach of Article 3.1, Article 10.1 *'says what it says, whatever Gazprom now states were its intentions'*. Therefore, Gazprom must compensate Naftogaz for proven damages caused by such breach.

***Underdeliveries from 2016–2017***
No supplements were agreed regarding volumes of gas to be delivered in the years 2016 and 2017. Gazprom argued that by a letter dated 30 December 2016, it informed Naftogaz of the results of an audit undertaken pursuant to Article 3.2, which determined the relevant volumes of gas for these two years. This represented a reduction of the annual volume according to Article 3.1.

Gazprom argued that Article 3.2 did not require Naftogaz to verify the auditor's report, nor did it specify a deadline for issuing the report or set out a procedure for challenging the report. It therefore did not matter for the purpose of Article 3.2 that Gazprom's letter amending the volumes in 2016 and 2017 was only issued on 30 December 2016, and that Naftogaz was not provided with an opportunity to verify it before the commencement of contract years 2016 and 2017.

Naftogaz argued that although not expressly stated, the procedure in Article 3.2 is subject to an *'obvious time limit'*. It is implied that any request for revision to the 110 billion square metre annual transit volume must be received by Naftogaz sufficiently ahead of a delivery year to allow Naftogaz to consider the request and adapt to Gazprom's export needs, and, in the case of non-agreement, to verify the audit report before the start of the delivery year in question. On that basis, the letter was issued too late to set the delivery volumes for the years 2016 and 2017.

In agreeing with Naftogaz, the arbitral tribunal focused on the *'purpose of the system established by Article 3.2'*, which is that Gazprom quantifies its needs for gas transit in the Ukrainian Gas Transmission System before the delivery year, so that Naftogaz has a chance to mitigate its losses (e.g. by offering capacity to other shippers). The arbitral tribunal considered that Gazprom's position did not accord well with this purpose. Without going into detail, the tribunal also considered it relevant that Naftogaz had presented evidence that cast doubt on the accuracy of the volumes set out in Gazprom's letter for contract year 2017.

**(2) Claim for replacement / revision of price**

***Relevant Contractual Provisions***
Article 8.1 of the Transit Contract set out the formula for calculating the 'tariff' (price) Gazprom was to pay Naftogaz for performing transit services.

The Transit Contract also contained, at Article 8.7, the following provision for revising the tariff:

> *'In case of a significant change in 2010 and subsequent years of the terms for the determination of transit tariffs in the European gas market as compared to what the Parties had reason to expect at the conclusion of this Contract, and if the price for transit services specified in Clause 8.1 of this Contract does not correspond to the level of transit tariffs in the European gas market, each Party is entitled to apply to the other Party with a request for revision of the price for transit services'.*

Further, Article 8.7 provided that any such request for a price revision shall be made in writing, and be properly substantiated, and that if the parties failed to agree on a price revision within a specified time period, the dispute could be referred to arbitration.

Article 13.2 was what may be referred to as an *'invalidity'* Clause. Pursuant to this Article, *'If any of the provisions of the present Contract becomes legally invalid pursuant to the applicable legislation or ineffective, this shall not effect the validity of other provisions hereof. If any of the provisions of the present Contract becomes invalid or ineffective, the Parties shall agree to replace such invalid or ineffective provision with a new provision that would have the economic effect as close as possible to that of the invalid or ineffective provision'.*

***Replacement of tariff due to incompatibility with competition and energy law***

Naftogaz claimed that Ukrainian and/or EU competition law and related energy law should apply to this dispute. Further, a number of provisions in the Transit Contract, including the tariff, are contrary to such law and therefore invalid. It argued that, pursuant to Article 13.2, these provisions should be replaced in a manner that would result in Gazprom having to make significant further payments. Specifically and by way of example:

— Naftogaz argued that EU competition law applied to the Transit Contract, including Articles 101 and 102 of the Treaty on the Functioning of the European Union (which prohibit agreements that have as their object or effect the restriction, prevention or distortion of competition within the EU, and prohibit abuse of a dominant position within the EU). Naftogaz sought to rely on the application of the 'qualified effects doctrine'. The arbitral tribunal confirmed that this doctrine applies if Naftogaz can show *'not only that there is a negative effect on competition within the EU, but further that this negative effect is 'immediate', 'substantial', and 'foreseeable'*. The arbitral tribunal considered that, as a matter of fact, Naftogaz did not show this. Reference to the laws of an EU state was not enough; it must be shown that competition within the EU is affected in an immediate, substantial, and foreseeable manner. As Naftogaz did not show this, the qualified effects doctrine did not apply and, consequently, EU competition law did not apply.

— Naftogaz also sought to argue that Ukrainian competition and energy law applied to the Transit Contract through Article 7(1) of the Rome Convention. (Naftogaz argued that certain provisions of Ukrainian competition law mirror Articles 101 and 102 of the Treaty on the Functioning of the European Union (see above) with respect to competition in Ukraine.) The arbitral tribunal disagreed with Naftogaz, on the basis that the parties expressly chose Swedish law both as the governing law of the Transit Contract and as the procedural law of the arbitration. It found that Article 7(1) of the Rome Convention does not allow for foreign states' public law to be applied to Swedish arbitral tribunals, apart from cases where the opposite follows from Sweden's international obligations.

In relation to these claims, the arbitral tribunal emphasised that *'it is not the role of the Tribunal to implement desirable reforms to meet energy policy targets or requirements according to Ukrainian legislation'*. Instead, this is within the competence of the Ukrainian authorities.

***Revision to tariff pursuant to Article 8.7 of the Transit Contract***

Alternatively to its claim for replacement of the tariff due to non-compliance with competition and energy law (see above), Naftogaz claimed for invalidity and replacement of the tariff pursuant to the price revision clause at Article 8.7 of the Transit Contract.

Naftogaz issued a letter to Gazprom in June 2009, which referred to a reduction in transit volumes during the first five months of 2009 and stated that this is less than the volumes provided for in the Transit Contract. Further, the letter states that the decline in volumes *'leads to a substantial decline in the revenues of [Naftogaz] from the provision of transit services and carries a threat of significant unplanned financial deficit for the Company in 2010 and subsequent years', and 'provides a basis for its revision in accordance with clause 8.7 of the Contract'.*

Naftogaz argued that this constituted a valid request for price revision pursuant to Article 8.7, and provided the arbitral tribunal with a number of grounds for revision. Gazprom disagreed on the basis that Article 8.7 required any request to be properly substantiated, and the letter did not contain such substantiation. Further, it argued that the grounds for revision stated by Naftogaz in the letter are not the same as those advanced in the present arbitration.

The arbitral tribunal considered that Article 8.7 contains within its words two conditions:

— First, there must have been a significant change in 2010 and subsequent years of the terms for determination of transit tariffs in the European gas market as compared to what Naftogaz and Gazprom had reason to expect at the conclusion of the Transit Contract.

— Second, the price for transit services as provided for in Article 8.1 of the Transit Contract does not correspond to the level of transit tariffs in the European gas market.

The June 2009 letter from Naftogaz made no mention of either of these conditions. While the arbitral tribunal acknowledged that a request does not need to set out all relevant facts and legal arguments and the exact revision requested in order to satisfy the conditions of Article 8.7, it considered that *'there must nevertheless be a minimum reflection of what Article 8.7 requires that has to be satisfied'*.

The arbitral tribunal decided that on the facts there was no such *'minimum reflection'*, and, therefore, no valid request was made pursuant to Article 8.7.

Having rejected the claim on procedural grounds, the arbitral tribunal did not consider the grounds argued by Naftogaz for revising the tariff pursuant to Article 8.7.

***Revision to tariff pursuant to Section 36 of the Swedish Contracts Act.***

Alternatively to its claim for replacement of the tariff due to non-compliance with competition and energy law, and to its claim for invalidity and replacement of the tariff pursuant to Article 8.7 of the Transit Contract (see above), Naftogaz also claimed for invalidity and replacement of the tariff pursuant to section 36 of the Swedish Contracts Act.

In short, section 36 of the Swedish Contracts Act allows Courts to set aside or modify contractual terms or contracts in their entirety on the basis of 'unconscionability'. It has been established in Swedish law that although the section is primarily applied in disputes between consumers and commercial entities, it can also be applicable in relationships with commercial parties.

Naftogaz argued, amongst other things, that it had an inferior bargaining position when the Contract was entered into, that Gazprom abused / leveraged its dominant position, that the tariff deviated from standards in the gas transit market, and that the decline in volumes of gas delivered each year rendered the tariff unconscionable, so as to trigger section 36 of the Swedish Contracts Act.

The arbitral tribunal decided that there is *'not sufficient evidence'* that section 36 of the Swedish Contracts Act should apply. First, it could not be concluded that Naftogaz was in an *'inferior position'* during negotiations prior to execution of the Transit Contract. While Ukraine was reliant on Russia for gas supplies, Russia was also reliant on Ukraine for transit through Ukraine into Europe. Secondly, the arbitral tribunal considered that there was no *'obvious deviation from generally accepted principles of competition'* so as to render the tariff unconscionable. In this context, there is not sufficient evidence to displace the fundamental Swedish contract law principles of *pacta sunt servanda* ('agreements must be kept') and *rigor commerciallis* ('freedom of contract').

***Damages***

The arbitral tribunal awarded Naftogaz approximately USD 3.9bn (plus interest) in damages for Gazprom's under-delivery of volumes of gas. This figure represented Naftogaz lost profits, i.e. the amount of fees that Gazprom would have paid if it had transited the minimum volumes that the Transit Contract obliged Gazprom to transit, less the revenues that Naftogaz had in fact received under the Transit Contract, less all costs that Naftogaz had saved as a result of the underdeliveries. The costs saved included: costs associated with the volume of fuel gas saved and the cost of royalties (i.e. tax) saved.

Set-off against these damages were:

— The approximately USD 2bn amount owed to Gazprom pursuant to a separate arbitration between Gazprom and Naftogaz. This separate arbitration concerned the price payable by Naftogaz for natural gas received from Gazprom under a gas sales contract executed on the same day as the Transit Contract. Further to an arbitral award issued on 22 December 2017, this price was revised downward from 27 April 2014.

— The amount of transit tariff overpaid by Gazprom as a result of the price revision under the gas sales contract. (One element of the transit tariff formula is the price payable by Naftogaz for natural gas received from Gazprom under the above gas sales contract). The parties agreed in the present arbitration that, pursuant to the operation of the transit tariff formula, the downward revision to the price for gas in the gas sales contract resulted in a downward adjustment to the transit tariff payable in the Transit Contract, meaning Gazprom had made overpayments totalling USD 44m (plus interest).

## Comment

**Remedies**

This award demonstrates alternative ways in which parties to transportation contracts may protect themselves contractually in the event that minimum volumes are provided for transit.

Ship-or-pay (or send-or-pay) provisions, which require a shipper to either use the transportation service to which a contract relates, or pay for it anyway, are a familiar feature in many energy-sector transportation contracts. These provisions provide an operator with a pre-agreed 'income stream' forming part of the operator's financing arrangements (see *Amoco (UK) Exploration Company v Teesside Gas Transportation Limited and another* [2001] UKHL 18). In English law, failure to pay such an income stream will likely be construed as a 'debt' (i.e. a definite sum of money fixed by an agreement as payable by one party in return for the performance of a specified obligation by the other party). See Ashley and Holland, *Enforceability of take-or-pay provisions in English law contracts – revisited* (21013) 31(2) J.E.R.L. 205. As such, it will provide a clear specified sum due regardless of volumes delivered.

In the present case, the relevant transportation contract did not include a 'ship-or-pay' (or send-or-pay) provision. However, as Gazprom's actions amounted to a breach, Naftogaz was nonetheless entitled to compensation in the form of damages for loss of profits, resulting from Gazprom's failure to comply with a contractual obligation to deliver minimum annual volumes of gas. However, the measure of damages would be loss of profits – which would ordinarily be less than a sum due under a 'ship-or-pay' / 'send-or-pay' clause as profit would be merely one element of the sum due under such a provision.

Whilst this award may give some comfort to operators of pipelines whose contracts do not contain a send-or-pay provision, such operators should be alive to the differences between making a claim for payment of a debt (e.g. pursuant to a ship-or-pay provision) and making a claim for damages for breach of contract (as Naftogaz did in the present arbitration). These differences will vary depending on the relevant applicable law. For example, in relation to English law contracts, *Chitty on Contracts*, 33rd Ed, 2018, Volume 1 at para 26-009 explains:

> *'rules on damages do not apply to a claim for a debt, e.g. the claimant who claims payment of a debt need not prove anything more than his performance or the occurrence of the event or condition on which the sum becomes payable; there is no need for him to prove any actual loss suffered by him as a result of the defendant's failure to pay; the whole concept of the remoteness of damage is therefore irrelevant; the law on penalties does not apply to the agreed sum; the claimant's duty to mitigate his loss does not generally apply; and the claimant will usually be able to seek summary judgment'.*

In the present arbitration, the fact that Naftogaz's claim was for damages for loss of profits, and not a debt claim for payment for services rendered, meant that, for example, the arbitral tribunal considered Naftogaz's duty to mitigate its losses, and also meant that VAT was not payable.

***Governing Law and Changes in Law***

In addition, this is the latest in a series of cases concerning modifications to contractually agreed tariffs in long-term gas transportation agreements. (See, for example, *PT Transportasi Gas Indonesia v Conocophillips (Grissik) Ltd & Anor* [2016] EWHC 2834 (Comm) in the Annual Review of developments in English oil and gas law (2017 Edition at pages 48 to 50).)

The present award is another reminder of the significance of the law chosen to govern a contract. If the Transit Contract had applied the substantive laws of, for example, Ukraine, then it is likely that the arbitral tribunal would have found that Ukrainian competition law applied. Where there is freedom to agree the governing law of a contract, parties should think carefully about which law to adopt in order to best preserve their respective positions.

As the Transit Contract applied Swedish law, the arbitral tribunal was apprehensive about invalidating or amending provisions of the Transit Contract pursuant to Ukrainian or EU law, remarking that this is the *'task of the regulator'*. It remains to be seen what, if any, regulatory reform is implemented in Ukraine before the expiry of the Transit Contract at the end of this year, and what, if any, impact this might have on the provisions of the Transit Contract.

Meanwhile, in a press release dated July 2018, Naftogaz confirmed that in the months following receipt of the award, it has followed the proper process for requesting a tariff revision pursuant to Article 8.7 of the Transit Contract, and has subsequently re-referred the matter to arbitration when agreement could not be reached with Gazprom. Naftogaz has preliminarily estimated the value of its fresh tariff revision claim at approximately USD 12bn, excluding interest.

**Tribunal:** Mr. Tore Wiwen-Nilsson (Chair), Mr. Jens Rostock-Jensen, and Mr. Johan Munck

# Complications in transition to cost share pricing

In *Teesside Gas Transportation Limited ('**TGTL**') v (1) CATS North Sea Limited; (2) Antin CATS Limited; (3) ConocoPhillips Petroleum Company U.K. Limited; and (4) ENI UK Limited* [2019] EWHC 1220 (Comm) (the Defendants collectively referred to as the '**CATS Parties**') the Commercial Court decided some key aspects of the working of a cost-share regime under a transportation and processing agreement. The decision gives some interesting insights into the extent to which such agreements are agreements of good faith, and the proper approach to interpreting the identification and allocation of costs for the purposes of invoicing. It also dealt with the ability of the operator to correct invoices previously containing an error or otherwise needing correction.

## Facts

The Central Area Transmission System (known as '**CATS**') is a natural gas transportation and processing system that transports gas from the Central North Sea to a processing terminal at Teesside.

The CATS Riser Platform is owned and operated by the CATS Parties. The CATS Riser Platform is linked, by a bridge, to a production platform, not owned by the CATS Parties, namely the North Everest platform. A 404km high-pressure gas pipeline (the '**CATS Pipeline**') runs from the CATS Riser Platform to an onshore redelivery terminal and gas processing plant (collectively, the '**CATS Terminal**') at Teesside. Several production fields in the North Sea are linked to the CATS Pipeline, delivering gas to it either directly or through a series of connections at the CATS Riser Platform. Since becoming operational in 1993, the CATS Pipeline has been one of six principal pipelines delivering North Sea gas to the UK mainland.

On 10 September 1990, the TGTL, as shipper, and the predecessors of the CATS Parties, as owners, entered into a Capacity Reservation and Transportation Agreement ('**CRTA**'). Under the CRTA, TGTL was entitled to a pre-determined capacity of pipeline gas, through the exclusive use of specified points of entry (for gas entering the system) and exit (the redelivery of the gas from the transportation facilities into the processing facilities). The effect of this was to grant TGTL *'a pipeline within a pipeline'*.

The central issue in dispute was the amount payable by TGTL to the CATS Parties under the CRTA. The CRTA provided for two different payment regimes:

— From April 1993 (when the CATS became operational) until 1 October 2013, TGTL paid a fixed *'Transportation Fee'*. That fee was not in issue in these proceedings.

— From 1 October 2013 to 1 October 2018 (being the end-date of the CRTA), TGTL was to pay a non-fixed *'Capacity Fee'*. That fee was to be calculated pursuant to a contractual formula, which was at the heart of this dispute.

The '*Capacity Fee*' was calculated as follows:

> *'[Capacity Fee] = ([Capacity Reservation Rates] / [CATS Capacities]) ([Operating Expenditures] + [Extraordinary Operating Expenditures] + [Capital Expenditures]) (1.15)'.*

In this respect:

— '*Operating Expenditures*' were to be *'reasonable Operating Expenditures (expressed in Pounds) incurred by the CATS Parties in connection with the CATS Transportation Facilities in the Contract Year in question'*.

— '*Extraordinary Operating Expenditures*' were to be *'reasonable Extraordinary Operating Expenditures (expressed in Pounds) incurred by the CATS Parties in connection with the CATS Transportation Facilities in the Contract Year in question'* and of *'a non-capital non-recurring nature'*.

— Capital Expenditures were *'Capital Expenditures (expressed in Pounds) amortised over their useful life reasonably and necessarily incurred by the CATS Parties after 6 o'clock a.m. on 1st October 2013 to operate the CATS Transportation Facilities'*, being *'all costs and expenditures of a capital nature for the design, purchase, construction, installation, repair or replacement of property, materials, plant and equipment, provided that Capital Expenditures shall not include any Abandonment ['decommissioning, demolition or removal'] Costs attributable to such property, materials, plant and equipment'*.

As to the definitions:

— Each of these definitions contained a provision that no expenditure shall fall within more than one of those three categories.

— The definitions of Operating Expenditures and Extraordinary Operating Expenditures required that the relevant costs be *'reasonable'*; the definition of Capital Expenditures contained the more stringent requirement that the costs be *'reasonably and necessarily incurred'*.

— Only expenses classified as Capital Expenditures required amortisation (being of a 'capital nature').

— Each of the definitions also confined the relevant expenses to those incurred *'in connection with the CATS Transportation Facilities'*.

— The term *'CATS Transportation Facilities'* meant *'the facilities to be constructed, owned and operated by the CATS Parties, as described in Schedule I'*.

Under Clauses 7.10(b) and 7.12 of the CRTA, the CATS Operator was to notify TGTL with an estimated Capacity Fee on 1 July of each relevant year, three months prior to the commencement of each contract year on 1 October. That estimated fee was then invoiced monthly to TGTL in arrears. Under Clause 7.10(c), by 1 December two months after the end of the contract year the CATS Operator was to calculate the actual Capacity Fee owed, according to the formula set out above. The difference was to be paid by the CATS Parties to TGTL if the estimated fee was too high, and vice versa.

Of the amounts invoiced by the CATS Parties in respect of the five-year Capacity Fee period, TGTL had withheld some GBP 37.7m. TGTL sought various declarations as to its entitlement to withhold all or some of that amount; the CATS Parties counterclaimed in debt for the full unpaid sum, with contractual interest.

A significant number of disputes arose, amongst many other things, concerning:

— Whether, and if so, how, to allocate costs partly relating to the CATS Transportation Facility and partly to other activities.

— Expenditure that should be treated as Capital Expenditure, as opposed to Operating Expenditures and Extraordinary Operating Expenditures (and therefore should be amortised).

— The entitlement of the CATS Parties to '*restate*' Capacity Fees for previous periods that they wished to correct (upwards).

## Decision

**General principles of contractual construction**
In relation to its approach to construction and interpretation of the CRTA the Commercial Court considered:

— The CRTA was drafted in 1990 and amended in 1998. It was intended to govern TGTL and the CATS Parties' relationship until 2018. Considering the length and complexity of the document, and the requirement for reference to be made to the associated Transportation Allocation Agreement in interpreting the CRTA, it would be *'imprudent to begin the process of construction by assuming that every phase in such a document is as elegantly crafted or as logically integrated with every other as it might be desired'* and that it would be *'equally unrealistic to consider that drafters will have envisaged every possible factual scenario which might arise under the contract'*.

— Also, *'in relation to such long term contracts it is often appropriate for the court to adopt a relatively 'flexible approach' to construction in order to give effect to the reasonable expectations of the parties, which may go so far as to require a certain (and fact sensitive) degree of co-operation between the parties'*.

— Certain clauses of the CRTA explicitly provided for a good faith requirement in respect of particular discrete aspects of performance (for example, the right to dispute an invoice in good faith). The CRTA thereby defined, exhaustively, the extent of any good faith obligations arising under it. It would be inconsistent with those terms to imply a wider duty of good faith, notwithstanding that it was a *'relational contract'*.

**Whether, and if so, how, to allocate costs potentially partly relating to the CATS Transportation Facility and partly to other activities**
The CRTA made no express provision for allocation of costs between the CATS Transportation Facility and

other activities. However, the Commercial Court considered that the ability of the CATS Parties to include an allocated proportion of the costs of shared equipment/operations derived from an implied term of the CRTA. In this respect, the industry experts instructed by each party were in agreement that cost sharing and cost allocation in the offshore industry needs to be on a *'fair, equitable and reasonable basis'*.

The implied term of the CRTA could be expressed as being that the CATS Parties can include in the CRTA a proportion of the costs of shared equipment/operations provided that the allocation or apportionment methodology used is fair, equitable and reasonable.

Ultimately the question the Commercial Court had to answer was whether the methodology adopted by the CATS Parties to allocation was not fair, equitable and reasonable. The Commercial Court considered that that methodology could properly be said to be fair, equitable and reasonable. There may be other methodologies which could also be said to be fair, equitable and reasonable, but that does not imply that this one was not.

**Expenditure that should be treated as Capital Expenditure, as opposed to Operating Expenditures and Extraordinary Operating Expenditures (and therefore should be amortised)**
Capital Expenditure had to be amortised before it is included in the Capacity Fee. Thus, by way of example, a capital cost of GBP 5m incurred by the CATS Parties in one contract year would not be added to the Capacity Fee as GBP 5m (multiplied by the CRR/CC quotient) but instead, if its amortisation period was 20 years, only GBP 250,000 (multiplied by the CRR/CC quotient) would be included for the year that the expenditure was incurred, and for each subsequent year of the Capacity Fee period. As such, the categorisation of costs was critical.

However, the definition of Capital Expenditure did not give any defined meaning to '*of a capital nature*'. The Commercial Court considered:

- In using the phrase '*of a capital nature*', the parties have adopted a generic term, and must be taken to have contemplated reference to more detailed accounting standards or guidance to inform the categorisation of specific items of expenditure.
- The guidance which they can be taken, at the time of conclusion of the CRTA, to have had in mind as providing more detailed content to the concept of *'capital nature'* was that contained in IAS 16 (1982). IAS 16 (1982) provided, in part, in relation to expenditure on an asset subsequent to its initial acquisition that *'only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross carrying amount'*.
- Though the question of whether costs were of *'a capital nature'* would only become relevant in the Capacity Fee period, the parties should be taken to have intended that reference could be made to accounting standards applicable at the outset of that period unless materially different from those which were known to them, and which they must be taken to have had in contemplation, at the time of the entry into the CRTA (i.e. IAS 16 (1982)). This permitted reference to the recognition criteria in FRS 15.
- The parties should not be taken to have intended that the test for what items were *'of a capital nature'* would vary markedly over time, depending on the accounting standards in force at a particular time.
- The recognition criteria in IAS 16 (2003) are materially different from those in IAS 16 (1982), and thus are materially different from those which the parties must be taken to have had in contemplation at the time of conclusion of the CRTA.
- An approach to categorisation of expenditure as *'of a capital nature'* similar to or based on that in IAS 16 (2003) does not fit easily into the Capacity Fee calculation because under it, if a replacement or repair cost satisfies the recognition principle then the carrying amount of the replaced/repaired part is derecognised. It is unclear how derecognition costs would be classified.

As such, the Commercial Court decided that the CRTA provided for subsequent expenditures on repair and replacement to be treated as Capital Expenditures only if they enhance the economic benefits of the asset. That said, it accepted that the CRTA should be construed as importing all aspects of FRS 15 that were not materially different to IAS 16 (1982).

**The entitlement of the CATS Parties to '*restate*' Capacity Fees for previous periods that they wished to correct (upwards)**
Following the 2015–16 audit, and against the background of the parties' ongoing dispute concerning the Capacity Fee, the CATS Operator sent TGTL the CATS Report on 12 October 2016. The net effect of the various amendments made in this report was substantially to increase the Capacity Fee payable for the Contract Years 2013–14 (by nearly GBP 3m) and 2014–15 (by some GBP 2.2m). TGTL contended that the CATS Parties were not entitled to '*restate*' the Capacity Fee in this way.

TGTL submitted that the CRTA contained an exhaustive mechanism for the invoicing of the Capacity Fee (through estimated and adjusted fees), and that the time limits for recalculating and invoicing any adjusted Capacity Fee are fixed and immutable.

The CATS Parties contended, primarily, that they had *'a substantive right to payment of the Correct Capacity fee for each Contract Year'*, which is unaffected by *'the notice provisions and […] mechanics for payment'*. In the alternative, they contend that the *'restated'* amounts were notified in accordance with the contractual audit regime: *'TGTL itself commenced an audit of the Capacity fee for 2013–14. Having opened up the Capacity fee, TGTL cannot now resile from the consequences of the audit because it results in an unfavourable result. The restatements were in response to the audit that TGTL wanted'.*

The Commercial Court accepted the CATS Parties' arguments, as:

— The CATS Parties' substantive right to payment arises by virtue of the Capacity Fee being due under Clause 7.1 and Clause 7.10.

— The mechanism for identifying that sum is not the source of the obligation to pay. On a proper construction of Clauses 7.10 and 7.12, they provide for a notification mechanism which is prescriptive, but which does not conclusively determine the CATS Parties' entitlement.

— Time is not of the essence in this notification mechanism. This is because (i) Clause 7.10 does not expressly stipulate that the time limit for the notification of the adjusted Capacity Fee is fixed and/or final and/or immutable; (ii) there is no 'deeming provision' such that if the notice is not served by 1 December, a particular Capacity Fee is '*deemed*' to be the adjusted figure and/or the CATS Parties are denied their right to payment of the adjusted Capacity Fee; (iii) Clause 7.10(c) does not say that any notice of the adjusted Capacity Fee that is served on 1 December is conclusive and/or binding on the parties; and (iv) the terms of Clause 7.10(c) are to be contrasted with the provisions for certain adjustments to billing statements (not relevant for present purposes) under Schedule III, which provided for such statements to be presumed true and correct after 24 months. There was nothing in the wording of Clause 7.10 to suggest that no changes to the invoiced adjusted Capacity Fee can ever be made after 1 December following the end of the relevant Contract Year.

— In the alternative, the audit provisions would have allowed a restatement.

## Comment

Transportation and processing agreements remain amongst the most complex of oil and gas contracts. As such, it is perhaps not surprising that the calculation of the Capacity Fee by the CATS Parties under the CRTA have given rise to a significant number of disputed issues significantly greater than those summarised above.

The fact that transportation and processing agreements are drafted, and agreed, to endure over significant periods of time poses special challenges to drafters seeking to deal with events that might occur 20 years later. The shift from a tariff-based mechanism to cost share is a regular source of disputes over the categorising of costs. Many agreements provide limited guidance on the operation of the cost-share phase, which is often far from the parties' immediate concerns at the time the agreement is negotiated and executed.

However, for drafters of such agreements the decision of the Commercial Court seems to provide some useful guidance:

— Notwithstanding that the contract is likely to be a long-term relational contract, the use of the words *'good faith'* in some clauses is likely to preclude other clauses in the agreement being subject to a standard of good faith performance.

— Where costs are incurred in respect of multiple activities, some of which may not be reimbursable by the shipper, English law might imply a term as to the allocation of such costs. In this instance, the Commercial Court implied a term that the allocation by the transporter needed to be on a *'fair, equitable and reasonable basis'*.

— If generic terms such as *'capital nature'* are used to define costs it will give the court a broad discretion on how to interpret such words. However, in doing so it shall look to relevant accounting/industry standards available to the parties at the time of drafting the contract. It may also allow the definition to evolve over time, provided that it does not diverge significantly from what the parties would have anticipated at the time of drafting by reference to current standards.

— In correcting sums miscalculated, it would require express words or deeming provisions to prevent invoice correction. Absent such provisions, the law would allow invoices to be restated. In addition, or alternatively, audit provisions (widely used in the oil and gas industry) would also assist such restating.

It is understood that this decision is under appeal which might result in Court of Appeal guidance on some of the issues addressed above.

**Judge:** Butcher J

# M&A and Tax

As oil and gas basins mature, the treatment of taxation between buyer and seller have become key economic drivers of M&A deals. Two recent cases illustrate some of the risks involved in not getting drafting of tax provisions or notices correct:

- In *Minera Las Bambas SA & Anor v Glencore Queensland Ltd & Ors* [2019] EWCA Civ 972 the Court of Appeal decided that a tax indemnity only applied at the point that an enforceable obligation to pay arose. The decision is capable of having an important impact on limitation periods for tax indemnity claims.
- In *Stobart Group Ltd & Stobart Rail Ltd v Stobart & Tinkler* [2019] EWCA (Civ) 1376, the Court of Appeal decided that valid notice had not been given for the purposes of the limitation period, but only for the purposes of the conduct provisions relating to potential tax covenant claims. The claim under the tax covenant was time-barred as a result.

# Tax indemnities in international M&A

In *Minera Las Bambas SA & Anor v Glencore Queensland Ltd & Ors* [2019] EWCA Civ 972 the Court of Appeal upheld the Commercial Court's decision that a tax indemnity only 'bit' at the point that an enforceable obligation to pay arose. As a consequence, it might not be possible to rely upon the indemnity until an appeals process with the tax authorities was resolved. Such an outcome might have important implications in the event of limitation periods that drafters of tax indemnities in the oil and gas sector should beware of.

## Facts

Minera Las Bambas SAC and MMG Swiss Finance AG ('**Purchasers**') had entered into a share purchase agreement ('**SPA**') with Glencore Queensland Limited and Glencore South America Limited ('**Sellers**') for the purchase of Xstrata Peru SA, which was the indirect owner of a mining project in Peru. The sale and purchase of the shares completed in July 2014.

The target group had in November 2011 entered into a swap agreement in connection with the project, under which a transfer of land took place between Minera Las Bambas SA and a rural community. No Peruvian VAT was accounted for in relation to the swap agreement, but following closing under the SPA in July 2014 the Peruvian tax authorities issued a tax assessment asserting that VAT was payable by the target group in connection with the swap agreement.

The SPA included a tax indemnity under which the Sellers agreed to pay the Purchasers an amount equal to any *'tax payable'* by a Group Company that related to the period prior to closing and had not been discharged or paid on or prior to closing. The SPA also granted conduct rights for the Sellers in relation to any third-party claims that could result in the Sellers becoming liable to the Purchasers under the SPA, subject to the Sellers indemnifying the Purchasers against any related costs and expenses. Having entered into a deed of indemnity for this purpose, the Sellers exercised their rights to take conduct of the VAT claim, and disputed it with the Peruvian tax authority.

Before the Commercial Court, the Purchasers were seeking to recover the outstanding amount of VAT from the Sellers on the basis that the assessment by the tax authority had resulted in it being payable, notwithstanding the ongoing dispute. Alternatively, they asserted that the reduction by the Peruvian tax authority of the credit balance for the target group (against which the VAT payable by the target group to the tax authority could be set-off), or the reduction of amounts of VAT otherwise refundable to the target group, fell within the scope of tax payable by the target group.

As set out at page 49 of the 2018 edition of the CMS Annual Review of developments in English oil and gas law, the Commercial Court decided that VAT was not *'payable'* for the purposes of the SPA due to the tax indemnity in the related deed of indemnity which provided full indemnity for the amount claimed.

## Court of Appeal Decision

The appeal was dismissed, and the decision by the Commercial Court broadly upheld.

The decision concerned a number of points, but the three more significant issues considered related to when tax is *'payable'*; whether rejected VAT credits could amount to *'tax payable'*; and the effect of a purchaser not availing themselves of a 60% discount on penalties and interest on their ability to claim under the indemnity:

**Tax is *'payable'* when it is ultimately determined**
The tax indemnity at the centre of the dispute provided that the Sellers would indemnify the Purchasers in relation to *'an amount equal to any Tax payable by a Group Company'*. The key consideration was at what point in time the amount of tax would become *'payable'*, given that the tax assessment was under appeal. The Court of Appeal agreed with the Sellers' interpretation (and the Commercial Court decision) that, under the SPA, *'payable'* was reasonably understood to mean that there was an enforceable obligation to pay tax and not merely that the liability to pay had been established by the issuing of a tax assessment. To trigger the Sellers' obligation to indemnify the Purchasers at a point where the Purchasers had not yet come under an enforceable obligation to pay was inconsistent with the nature of an indemnity.

***'Tax payable'* does not include rejected VAT credits**
Additionally, the Peruvian tax authority had disallowed certain cash refunds of VAT credits that the target company had obtained. The Purchasers argued that the disallowance of a tax credit was equivalent to a recognition of a liability to pay tax, and therefore that the rejected VAT credits should come within the *'tax payable'* definition. The Court of Appeal disagreed, finding that the loss of the right to receive repayment of a tax credit could not be characterised as an obligation to pay tax. Any claim for that element had to be made under the specific limb of the tax indemnity giving protection for loss of tax credits. The Court of Appeal also partly deviated from the Commercial Court's decision, in holding that the unduly refunded VAT was not within the definition of an *'indemnified VAT receivable'* for which the Sellers would be liable to indemnify the Purchasers.

**A buyer that does not claim a discount may be unable to claim full amount from Sellers**
To encourage payment of sums which are the subject of an appeal, the Peruvian tax system operates a 'graduality regime' under which the penalties charged by the tax authority (and interest on those penalties) are reduced if payment is made in full of the disputed tax liability before an appeal is filed. The size of the discount depends on the stage at which payment is made. If it is made before the filing of a first appeal to the tax authority, the taxpayer is entitled to a 60% discount. If the payment is made following a first appeal but before filing a second appeal to the tax court, the discount is 40%. The Purchasers' failure to take advantage of the 60% discount on penalties and interest, by making payment of the relevant sum before the filing of the first appeal, was found not to be a failure to take reasonable steps to mitigate losses. However, the Sellers did potentially have a defence to any claim by the Purchasers for an indemnity for a larger amount in respect of penalties than would have been necessary to pay to obtain the discount, despite the lack of culpability on the Purchaser's part.

## Comment

Disputes concerning words such as 'paid' and 'payable' in the context of indemnities or insurance/reinsurance are far from new. It was in such a case that Lord Hoffman gave his well-known decision in *Charter Reinsurance Co. Ltd. v Fagan* [1997] A.C. 313.

That said, in the context of a tax indemnity, it is perhaps not surprising that payment does not have to be made by the seller until the underlying liability to pay the tax authority has been determined in circumstances where the underlying liability is disputed. It should be noted again that, given this meaning of '*payable*', a claim could potentially fall outside of the limitation period in circumstances where the underlying liability has not been determined by a court until after the limitation period has expired. Purchasers should therefore be careful to avoid being inadvertently 'timed-out' from bringing a claim by any contractual limitation periods.

It might also have been expected that rejected VAT credits would fall outside of the meaning of '*tax payable*'. Purchasers should ensure that if they require protection for loss of a right to receive a repayment of tax, this is expressly provided for (which is usually the case in practice).

The analysis surrounding the failure of the Purchaser to avail themselves of a potential discount on penalties and interest for early payment is perhaps the most interesting feature of the case. The implication is that a purchaser may need to pay tax earlier, and at a time when the sellers are not yet required to account to the purchaser under the indemnity, or risk being unable claim for the penalties and/or interest that could have been mitigated had it done so. While tax-specific limitations and conduct provisions may deal with this point, purchasers in particular should seek to ensure the position is clear, even in the short-form tax indemnities common in international M&A in the natural resources sector.

**Judge:** Moulder J

**Court of Appeal:** The Chancellor of the High Court (Vos LJ), Leggatt LJ and Longmore LJ

# Tax covenant notice provisions considered in the Court of Appeal

In *Stobart Group Ltd & Stobart Rail Ltd v Stobart & Tinkler* [2019] EWCA (Civ) 1376, the Court of Appeal considered the extent to which valid notice had been given of a tax covenant claim prior to the expiry of the relevant limitation period. The Court of Appeal dismissed the appeal and upheld the original judgment, finding that valid notice had not been given for the purposes of the limitation period, but only for the purposes of the conduct provisions relating to potential tax covenant claims. The claim under the tax covenant was time-barred as a result.

## Facts

Mr Stobart and Mr Tinkler (the '**Sellers**' or '**Vendors**') had sold the entire issued share capital in Stobart Rail Limited to Stobart Group Limited (the '**Purchaser**'). The sale and purchase agreement ('**SPA**') for the shares contained a tax covenant, which alongside other typical pre-completion tax liabilities of Stobart Rail Limited expressly covered any employee remuneration schemes in which HM Revenue and Customs ('**HMRC**') had indicated an interest. A liability covered by this limb of the tax covenant subsequently arose.

The SPA contained two provisions relevant to giving notice of tax covenant claims. The first was in the conduct provisions relating to tax covenant claims, and broadly required that upon becoming aware of a potential assessment or claim by a tax authority for a liability for which the Sellers may be liable under the tax covenant, the Purchaser would notify the Sellers of such claim. The provision stated:

> *'Upon the Purchaser or the Company becoming aware of any Claim, the Purchaser shall as soon as reasonably practicable, and in any event within 10 Business Days of the date thereof, give notice of such Claim to the [Sellers'] Representative stating how the liability arises under paragraph 3 or pursuant to the Tax Warranties and a reasonable estimate of the quantum of the Liability to Taxation or other liability, and upon the Purchaser or the Company becoming aware of any event, fact or circumstances which may give rise to such a Claim, the Purchaser shall give notice thereof and of the possible Claim to the 'Sellers'] Representative provided that the giving of notice under this paragraph 7.1 shall not be a condition precedent to the liability of the [Sellers] under this schedule'.*

It then went on to provide a mechanism by which the Purchaser was obliged (a) to ensure that the company being purchased provided information and assistance to the Sellers in relation to disputing the claim and (b) to delegate the conduct of the defence of the claim to the Sellers or their agents or professional advisers at the Sellers' request.

The second was in the limitation schedule, and provided that the Sellers would not be liable for a claim under the tax covenant unless written notice of that claim was given to the Sellers by the seventh anniversary of completion. The provision stated:

> *'The [Sellers] shall not be liable in respect of a Tax Claim unless the Purchaser has given the [Sellers] written notice of such Tax Claim (stating in reasonable detail the nature of such Tax Claim and, if practicable, the amount claimed) on or before the seventh anniversary of Completion in respect of such Tax Claim unless a Tax Authority is [un]able to assess the Company in respect of the Liability to Taxation or other liability giving rise to the relevant Tax Claim because of fraudulent conduct'.*

Having received the claim from HMRC, the Purchaser gave notice of that claim to the Sellers under the conduct provisions relevant to the tax covenant, and the Sellers subsequently exercised their conduct rights and inputted into correspondence with HMRC. As the seventh anniversary deadline approached, the Purchaser wrote to the Sellers and stated that unless the Sellers agreed by return to extend the deadline so as to allow the dispute with HMRC to continue, the Purchasers would serve notice for the purposes of the limitation provision. The Sellers did not agree, and the Purchasers sent a further letter on 24 March 2015, shortly before the limitation period expired. The Sellers argued that this letter did not constitute valid notice for the purposes of the limitation provision, and applied for summary judgment that the claim was time-barred.

Although the Court of Appeal did not consider this issue, it is interesting to note that at first instance the Purchasers also argued that the Sellers were estopped (either by acquiescence or by convention) from asserting that the notice was not compliant. This was rejected, and permission to appeal on this ground refused.

## Court of Appeal Decision

The Court of Appeal set out the authority on the proper approach to the construction of notices by reference to *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] AC 749, in which Lord Steyn held the *'cardinal principle of construction'* to be that:

> *'The question is not how the landlord understood the notices. The construction of the notices must be approached objectively. The issue is how a reasonable recipient would have understood the notices. And in considering this question the notices must be construed taking into account the relevant objective contextual scene'.*

Lord Justice Simon distinguished a unilateral notice, where the court construes words used by one party as opposed to agreed words, from a contract. By reference to the case of *Wood v Capita Insurance Services Ltd* [2017] UKSC 24; [2017] AC 1173, the Court of Appeal upheld the approach that it is irrelevant in which order the analysis of the notice was carried out and that the Judge at first instance should not be criticised for considering the wording of the notice before the factual context.

The Court of Appeal assessed whether it should consider subjective intent or common assumption of parties to a notice. By reference to Lord Steyn's judgment in *Mannai Investment*, it was accepted that *'if it is clear that the parties have a common understanding as to the effect of a contractual term, the court should construe the contract in accordance with that understanding. One situation in which this rule may bite is where there is a clear mistake in a contract, for example 'a party has misstated the relevant contractual provision by one numeral (paragraph 6.2 for 6.3) but where otherwise the intent is clear'*.

The Court of Appeal did not accept the broad submission of the Purchaser that an objective approach to construction should not be adopted where a common subjective intent can clearly be demonstrated. There was a practical difficulty in obtaining evidence of subjective evidence, other than by admission or subsequent conduct. In the present case, even if the Court of Appeal took an approach based on the Sellers' subjective intention, there was no basis on which to ascribe this intention to the Sellers due to the lack of contemporaneous evidence shedding light on their understanding in relation to the notice.

The Court of Appeal concluded its review of the authorities by emphasizing the importance of making the terms of a notice clear, in sufficiently formal terms. The importance of certainty of notices is reiterated in *Senate Electrical Wholesalers Ltd v Alcatel Submarine Networks Ltd (formerly STC Submarine Systems Ltd)* [1999] 2 Lloyds L.R 423 where Lord Justice Stuart-Smith found that:

> *'Notice clauses of this kind are usually inserted for a purpose, to give some certainty to the party to be notified and a failure to observe their terms can rarely be dismissed as a technicality'.*

The Court of Appeal found that the letter of 24 March was not compliant with the notice provisions for the purposes of the limitation period. In doing so, the Court of Appeal noted that the letter made no reference to a Tax Claim (the defined term used in the SPA for claims under the tax covenant), or to notice of a claim being given for the purposes of the limitation provision. Instead, it identified a '*potential liability*' under the tax covenant, and reference to confirming the extent to which the Sellers wished to continue discussions with HMRC pursuant to the conduct provisions. A person receiving this letter would therefore have understood it to be a further notice under the conduct provisions.

While the Purchaser argued that it would be absurd to have given a further notice of this type, the Court of Appeal noted both that the form of the notice was strikingly similar to that given once the original claim was received from HMRC, and that the March 24 letter included a different subject matter relating to the claim (the payment of dividends rather than national insurance contributions). The March 24 letter was therefore not valid notice for the purposes of the limitation provisions, and the claim under the tax covenant was time-barred.

## Comment

The provisions considered in this case are typical of tax covenants given on M&A transactions. These will commonly include a requirement to notify the seller (or the relevant covenantor) once a tax assessment or claim is received from HMRC that suggests they may be liable under the tax covenant, as well as also requiring notice to be given before the expiry of a limitation period if a claim is to be permitted. The two types of claim relevant to these provisions will usually be defined using very similar terms, as they were here. This case demonstrates the importance of ensuring that when giving notice in relation to a tax covenant, it is very clear for which of these two purposes the notice is being given.

**Judge:** Phillips J

**Court of Appeal:** The Master of The Rolls (Sir Terence Etherton), Simon LJ, and Hickinbottom LJ

# Supply Chain and EPC Contracts

As explained in last year's annual review, the significant supply chain expenditure on engineering, project and construction ('**EPC**') contracts puts them at the heart of managing risk. This year has resulted a number of decisions of the English, and other, courts that are relevant to those drafting or managing EPC contracts:

— In *Triple Point Technology Inc v PTT Public Co Ltd* [2019] EWCA Civ 230 the Court of Appeal suggested that many liquidated damages provisions providing compensation for delay may fall away entirely on termination of the contract.

— In *Arcadis Consulting (UK) Limited v Amec (BCS) Limited* [2018] EWCA Civ 2222 the Court of Appeal highlighted the risks and uncertainties that can be involved when proceeding with works or services under a letter of intent.

— In *Imperial Chemical Industries Limited v Merit Merrell Technology Limited* [2018] EWHC 1577 (TCC) the Technology and Construction Court awarded damages for withholding payment against contractors with a view to pushing them into insolvency.

— In *Clancy Docwra Limited v E.ON Energy Solutions Limited* [2018] EWHC 3124 (TCC) the Technology and Construction Court identified the risks of appending pre-contractual documentation to EPC contracts. Despite the use of a priorities clause and the insertion of general provisions allocating the risk of ground conditions to the contractor, exclusions contained in tender documentation appended to the contract were found to remain operative.

— In *Maeda Kensetsu Kogyo Kabushiki Kaishaalso known as Maeda Corporation and another v Bauer Hong Kong Ltd* [2019] HKCFI 916 the Hong Kong High Court considered the effect of claims notification provisions that require a contractor to state the contractual basis of a claim.

— In *Mears Ltd v Costplan Services (South East) Ltd & Ors.* [2019] EWCA Civ 502 the Court of Appeal provided authoritative guidance as to when 'practical completion' of construction works will be achieved.

# Court of Appeal resolves post-termination liquidated damages debate

In *Triple Point Technology Inc v PTT Public Co Ltd* [2019] EWCA Civ 230 the Court of Appeal provided authoritative guidance as to the effect of termination on liquidated damages provisions in relation to delay. The decision resolves conflicting authorities on this issue stretching back more than a century. The Court of Appeal's reasoning suggests that many liquidated damages provisions providing compensation for delay may fall away entirely on termination of the contract, leaving the employer to prove a claim for general damages for delays both before and after termination.

## Facts

PTT Public Co Ltd ('**PTT**') entered into a contract for the procurement of software and related services from Triple Point Technology Inc ('**Triple Point**'). The contract documents provided for payment by milestones, but also included specific dates for payment. Work under the contract was delayed and Triple Point sought payment according to the dates referred to in the contract documents. PTT refused payment on the basis that the relevant milestones had not been achieved. Triple Point suspended work for non-payment and PTT purported to terminate the contract for Triple Point's default.

Among other issues in dispute, a question arose as to whether PTT could claim liquidated damages for delay. The clause in question required Triple Point to pay *'the penalty at the rate of 0.1% (zero point one percent) of undelivered work per day of delay from the due date for delivery up to the date PTT accepts such work'*. The Technology and Construction Court decided that PTT was entitled to liquidated damages up until the date of termination in respect of incomplete milestones.

## Court of Appeal Decision

The Court of Appeal upheld Triple Point's appeal on this point and found that no liquidated damages accrued for incomplete milestones in circumstances of termination. The Court of Appeal set out the three inconsistent lines of legal authority noting that a previous House of Lords decision (in *British Glanzstoff Manufacturing v General Accident, Fire and Life Assurance Co* [1913] A.C. 143 ) had not been cited in the modern cases despite it being *'a decision of our highest court, which has never been disapproved'*.

Although the outcome in each case depends on the precise wording of the clause in question, the Court of Appeal expressed doubts about the cases which permit liquidated damages for delay to persist beyond termination.

The Court of Appeal also identified difficulties with the view, favoured by most textbooks, that liquidated damages apply up to the date of termination, but not beyond. Whilst this might be said to preserve accrued rights, it may be artificial to divide the employer's right to damages for delay into a period of liquidated damages prior to termination and a period of general damages after termination: *'It may be more logical and more consonant with the parties' bargain to assess the employer's total losses flowing from the abandonment or termination, applying the ordinary rules for assessing damages for breach of contract'.*

The clause before the Court of Appeal specifically referred to liquidated damages accruing *'up to the date PTT accepts such work'*. This was found to be similar to that considered in *British Glanzstoff* in that the completion of the work was expressly contemplated. Accordingly, the proper interpretation was that the entitlement to liquidated damages in respect of incomplete milestones fell away entirely upon termination and was replaced by a right to claim general damages for delay, subject to proof by PTT.

## Comment

Whether a clause entitling an employer to claim liquidated damages for delay will survive termination has been decided inconsistently in previous cases. A House of Lords decision in 1912 in *British Glanzstoff* decided that such a clause applied only where the original contractor completed the works and was not applicable upon termination. However, this decision appears to have been overlooked in the modern cases.

More recent cases have decided that liquidated damages accrue up until the date of termination, but not thereafter. The employer is then left to bring a general claim for unliquidated damages for post-termination delays. Other recent cases have decided that liquidated damages continue post-termination until the works are completed by the employer or a new contractor. The justification for this is said to be that any other approach would reward the contractor for its own default. This was the line taken most recently by the Commercial Court in *GPP Big Field v Solar EPC Solutions* [2018] EWHC 2866.

This is an important Court of Appeal decision providing significant clarity in a controversial area of the law. Whilst each case will depend on the drafting of the clause in question, it appears that clauses which refer expressly to liquidated damages accruing until the completion of the works are more likely to fall away entirely upon termination in accordance with the *British Glanzstoff* decision. A large number of construction contracts are drafted in this way, including FIDIC forms. Employers considering the termination of a construction contract where the contractual date for completion has been overrun should carefully consider the implications of this decision. Termination in such circumstances may mean that any entitlement to liquidated damages for delay no longer applies, requiring the employer to prove actual delay losses. These may be more or less than the level set for liquidated damages – or difficulties of proof may in some circumstances render them irrecoverable. Arguments may also arise as to whether the liquidated damages provision, albeit inapplicable, remains relevant to the assessment of any claim for general damages.

In relation to the oil and gas industry, specific issues may arise in relation to an oil company's ability, as employer, to succeed in a claim for non-liquidated damages in the face of extensive 'consequential loss' exclusion clauses or 'knock-for-knock' regimes. Such a scenario might seemingly pit the express exclusions in the contract that apply to non-liquidated damages claims against authorities, such as *Kudos Catering (UK) Ltd v Manchester Central Convention Complex Ltd* [2013] EWCA Civ 38, which suggest that exclusions should not apply where there has been a complete failure of performance by the counterparty. As such, careful thought should be given to the impact of this Court of Appeal decision in drafting offshore oil and gas contracts – where the availability of non-liquidated damages claims are generally more limited in scope than other construction or engineering contracts.

**Judges:** Lewison LJ, Floyd LJ, and Sir Rupert Jackson

# 'Let's just crack on...' – the dangers of working (and continuing to work) under letters of intent

In *Arcadis Consulting (UK) Limited v Amec (BCS) Limited* [2018] EWCA Civ 2222 the Court of Appeal overturned a Technology and Construction Court judgment in which a consultant was held not to have the benefit of any limitation on its liability due to a failure to agree final terms and conditions whilst working under a letter of intent. Whilst the case turns very much on its own facts, it highlights the risks and uncertainties that can be involved when proceeding with works or services under a letter of intent.

## Facts

Amec (BCS) Limited ('**Amec**') was a specialist sub-contractor on two projects and wanted to appoint Arcadis Consulting (UK) Limited ('**Arcadis**') as it design sub-consultant for works on both projects. The parties entered into negotiations to agree a framework agreement under which it was intended both sets of works (and other future projects) would be carried out. During the course of the projects they exchanged various draft terms, each of which included a cap on Arcadis' liability in one form or another.

In the event no formal contract was agreed and signed, and defects arose on the second project, a car park, in respect of which Amec sought to recover losses from Arcadis in the region of GBP 40m. Arcadis argued however that the parties had been proceeding under a set of interim terms which included a limitation of its liability to Amec.

The Technology and Construction Court, at first instance, found that whilst a contract had existed between the parties, it was a 'simple' contract which served only to secure performance and payment, and that none of the terms which the parties had been negotiating had been effectively incorporated – as none of them had received unqualified acceptance. As such, Arcadis' liability was uncapped.

## Court of Appeal Decision

Arcadis appealed the first instance decision and succeeded in having it overturned. The Court of Appeal found that in relation to the first project, Amec had instructed Arcadis to proceed under a set of 'interim' terms pending agreement of the framework agreement (which terms contained a cap on Arcadis' liability). By its conduct, and subsequent written confirmation, Arcadis proceeded under these terms which thus were found to be the terms which governed the contract for the first project.

Some months later Amec issued another letter of instruction for Arcadis to commence performance of its services for the second project on *'the terms and conditions we are currently working under with yourselves'*. The Court of Appeal disagreed with the Technology and Construction Courts view that this should be interpreted as *'working on'*, i.e. under negotiation. Instead it decided that the natural meaning of the words meant that the second project was to be governed by the same terms as the first project.

Once again, Arcadis was deemed to have accepted these terms by performance of its services, and by subsequent letter. The Court of Appeal found that the judge had made an error in concluding that the terms had not been agreed, and had not recognised that the parties had entered an interim contract pending the conclusion of a final agreement. In doing so he had created an *'extraordinary result'* whereby Arcadis would have accepted unlimited liability despite the fact that all of the draft terms which the parties had exchanged in attempting to reach agreement had contained a limitation of liability of one sort or another.

## Comment

This decision emphasises the need for parties to take care when using letters of intent / letters of instruction to proceed with works or services pending the conclusion of a final set of contract terms. Whilst these can offer a practical way of keeping a project moving, parties must be clear about what terms they are agreeing to, and be satisfied that they offer adequate comfort.

It is not uncommon to see parties, as was the case here, agreeing to extend the scope of a letter of intent to continue performance under it whilst the main terms or contract documents are still being negotiated. Again, this can be a convenient temporary solution, but makes it that much more important to be satisfied with the terms of the letter. Extending the letter too far can also cause parties to lose sight of settling the final contract terms whilst focusing on project delivery, and can deprive a paying party of its commercial leverage to agree beneficial final terms. It also risks negotiations being overtaken by events which both parties intended to be governed by the final contract and which are not addressed by the letter of intent – that was the position in the present case as regards liability for defects.

Whilst letters of intent can be useful tools to allow parties to push forwards with a project whilst finalising their contract, the following guidance should be borne in mind:

- Keep the scope limited in cost, time and work packages to keep the parties focused on finalising the contract terms;
- include drafting in both the letter of intent and the contract when agreed that makes it clear that the contract terms supersede those in the letter of intent and that all preceding works and services are deemed to have been carried out under the contract terms (and that payments made to date shall be payments on account under the contract); and
- be clear about all of the key terms that are currently agreed to minimise any doubt as to the terms that the parties are working under.

Finally, despite the outcome of this appeal, the first instance decision should not be ignored. If the facts had been slightly different, Arcadis might well have been found to have entered into a simple contract to perform the works without any limit on its liability.

**Judge:** Coulson J

**Court of Appeal:** Underhill LJ, Holroyde LJ, Gloster LJ

# Withholding payment: the legal implications of pushing contractors into insolvency

In *Imperial Chemical Industries Limited v Merit Merrell Technology Limited* [2018] EWHC 1577 (TCC) the Technology and Construction Court highlighted the dangers of withholding payment against contractors with a view to pushing them into insolvency. The Technology and Construction Court allowed damages for the recovery of insolvency professional fees as well as a substantial sum reflecting a reduced settlement reached with a third party on a separate project. The Technology and Construction Court's decision has ramifications for any party seeking to withhold large payments under an EPC contract against a party who is likely to suffer serious cash-flow pressure as a result.

## Facts

Imperial Chemical Industries Limited ('**ICI**') engaged Merit Merrell Technology Limited ('**MMT**') to manufacture and install steelwork and pipework for a new paint manufacturing facility. Part way through the contract in October 2014, ICI ceased making payment to MMT and issued an instruction to cease all welding work. ICI alleged that MMT's welding was of very poor quality. Welding recommenced in January 2015 but the following month ICI purported to terminate the contract for repudiatory breach by MMT on account of quality issues. MMT strenuously disputed ICI's allegations and challenged the validity of ICI's termination. MMT claimed that ICI had repudiated the contract and served its own notice of termination.

At a trial on liability issues, the Technology and Construction Court found that background cost pressures had led to ICI devising a strategy to force MMT into insolvency. ICI's allegations of very poor welding were largely made up and designed to provide an excuse for ICI to stop payment and terminate the contract. MMT commenced adjudication proceedings in relation to an interim payment due in November 2014. The adjudicator awarded MMT GBP 7m but the time taken (until March 2015) to enforce the decision through Technology and Construction Court proceedings led to MMT's bank losing confidence in it and withdrawing its lending facilities.

ICI's conduct had a profound impact upon MMT's business as a whole and MMT sought professional advice from lawyers and insolvency practitioners and proposed a creditor voluntary agreement ('**CVA**') to its creditors, a move that inevitably damaged its commercial reputation. MMT was owed substantial sums from clients on other projects and, as a direct result of its financial problems, was forced to settle these sums for a reduced value. One of these clients, Murphy, received notice of the CVA plans and dramatically reduced its final account offer to MMT by GBP 1.3m on the basis that any adjudication award obtained by MMT would be stayed on financial grounds. Eventually, MMT entered voluntary liquidation in early February 2017.

ICI brought Technology and Construction Court proceedings against MMT to recover the sums paid pursuant to the adjudicator's decision. MMT counterclaimed for repudiation and sought to recover a wide range of losses flowing from the deterioration of its financial position. As noted above, in a separate liability trial the Technology and Construction Court found ICI's claims to be groundless and held it to have repudiated the contract. In awarding indemnity costs against ICI for the liability trial, the Technology and Construction Court noted that ICI was aware that it did not have grounds to assert a repudiatory breach at the time it sought to terminate and that the evidence at trial was *'extraordinarily thin, verging on factually non-existent'*.

## Decision

In its decision on quantum, the Technology and Construction Court awarded a number of heads of loss to MMT including loss of profit on the remaining work under the contract. With regard to the deterioration in its financial position, MMT recovered:

- GBP 1.3m in respect of the reduced final account settlement accepted from Murphy.
- Wasted management time of GBP 266,472.
- GBP 239,369 incurred for professional advice in relation to the proposed CVA.
- Additional banking costs of GBP 168,599 (including bank advisor fees).
- A VAT loan for GBP 58,994 which was necessary for cash flow reasons.

In relation to the reduced settlement sum, the Technology and Construction Court accepted that the financial difficulties faced by MMT would have made it very difficult for it to enforce any adjudication decision against third parties because of the principles governing stays of execution upon adjudication enforcement (set out in *Wimbledon v Vago* [2005] EWHC 1086 (TCC)). Murphy's conduct in using this fact to negotiate a lower settlement (described by the judge as *'purely opportunistic'*) was not too remote. MMT was justified in accepting the reduced offer (given its financial position) and could recover the difference from ICI.

## Comment

This decision provides a rare illustration of the dangers of adopting an insolvency-based strategy for the resolution of EPC disputes. The Technology and Construction Court was hugely critical of ICI's ultimately successful attempts to push MMT into insolvency by withholding payment and seeking to terminate the contract when it knew it had no grounds to do so. ICI's knowledge that its conduct was likely to push MMT into insolvency was specifically noted by the Technology and Construction Court in connection with its assessment of the quantum of MMT's counterclaim.

The Technology and Construction Court's ruling in relation to the Murphy settlement is particularly notable. The documentation before the Technology and Construction Court showed that Murphy did not dispute its liability to MMT but was simply attempting to take advantage of the grave financial difficulties caused to MMT by ICI's repudiation. As the large award under this heading shows, claims of this nature represent a very significant exposure for companies considering aggressive disputes strategies with a view to putting their opponents under cashflow pressure.

The Technology and Construction Court's decision in relation to the Murphy settlement also has potential ramifications for genuine payment disputes. The Technology and Construction Court specifically noted that such a loss was within the contemplation of the parties at the time of contracting, which was long before ICI had formulated a strategy to push MMT into insolvency. Such a finding may readily apply to other construction contracts and lead to similar findings where payment is withheld on more genuine grounds.

Overall, the effect of this decision is to show the large and potentially unexpected liabilities which may fall to a company withholding payment on incorrect grounds. Employers and main contractors withholding large sums from their counterparties would be well advised to consider their potential exposure in this regard. Whilst the cashflow pressure which such conduct can exert may produce a commercially attractive settlement, it may also give rise to a considerable counterclaim if the right to withholding is not made out.

**Judge:** Fraser J

# The risks of appending tender documentation

In *Clancy Docwra Limited v E.ON Energy Solutions Limited* [2018] EWHC 3124 (TCC) the Technology and Construction Court identified the risks of appending pre-contractual documentation to EPC contracts. Despite the use of a priorities clause and the insertion of general provisions allocating the risk of ground conditions to the contractor, exclusions contained in tender documentation appended to the contract were found to remain operative.



## Facts

E.ON Energy Solutions Limited ('**E.ON**') engaged Clancy Docwra Limited ('**CDL**') as a sub-contractor to excavate trenches and install heat network pipework at the Barts Square development in London. E.ON were contracted to install an underground district heat network using the by-product heat of its locally based Combined Heat and Power Plant. During the work, CDL encountered adverse ground conditions (consisting of underground brick walls and brick rubble) and, later, a concrete heading which obstructed the proposed route for the pipework. E.ON instructed CDL to investigate the heading and to identify its contents and/or a route around it. A dispute subsequently arose as to whether CDL bore the risk of adverse ground conditions and whether it was entitled to be paid additional sums by E.ON for the work required to overcome such conditions.

The sub-contract between the parties was based on the JCT Standard Building Sub-contract with sub-contractor's design, 2011 edition. E.ON relied on bespoke amendments to the sub-contract which sought to pass the risk of ground conditions to CDL as follows:

*'2.1.7 The Sub-Contractor shall be deemed to have inspected and examined the site and its surroundings and to have satisfied himself before the date of the Sub-Contract as to the nature of the ground, the sub-surface and sub-soil; the form and nature of the site; the extent, nature and difficulty of the Sub-Contract Works; …. and in general to have obtained for himself all necessary information as to risks, contingencies and all other circumstances influencing of (sic) affecting the Sub-Contract Works.*

*2.1.8 Notwithstanding any other provision of this Sub-Contract, the Sub-Contractor shall not be entitled to any extension of time or to any additional payment, damages, or direct loss and/or expense on the grounds of any misunderstanding or misinterpretation of any matter set out in clause 2.1.7, or his failure to discover or foresee any risk, contingency or other circumstance (including, without limitation, the existence of any adverse physical conditions or artificial obstructions) influencing or affecting the Sub-Contract Works'.*

CDL relied on tender documentation which had been appended to the sub-contract as *'Numbered Documents'* and which showed that the tender had been based on a clear corridor for the pipework and did not allow for the breaking out of rock or dealing with obstructions. The *'Sub-Contract Works'* were defined in the sub-contract as *'the works referred to in the Sub-Contract Agreement and described in the Numbered Documents'*.

E.ON in turn relied on a priorities clause in the sub-contract which stated, *'if there is any inconsistency between the Sub-Contract Documents (other than the Numbered Documents) and the Numbered Documents […] those Sub-Contract Documents shall prevail'*. E.ON argued that the ground conditions clauses quoted above had priority over the tender documents relied on by CDL.

## Decision

The Technology and Construction Court agreed that the scope of the *'Sub-Contract Works'* was to be judged by reference to the tender documents appended to the sub-contract. Accordingly, CDL's initial scope of works *'did not include the matters that were specifically excluded by them from their scope of works as set out in their tender submissions …'*.

The ground conditions clauses in the contract applied to CDL's agreed scope of works and did not have the effect of extending that scope. These clauses could not be interpreted as a warranty by CDL that it had satisfied itself that obstructions or other ground conditions risks would not arise or that it agreed to bear the risk of such conditions. That, *'would have the effect that clause 2.1.7 allocated to CDL the risk of carrying out work which CDL had expressly excluded from the Sub-Contract Works: it would have the effect of meaning that CDL had satisfied themselves in respect of the site for the purposes of carrying out works that were not part of the Sub-Contract Works. And that would not make sense'*.

An alternative claim by CDL for rectification was dismissed by the Technology and Construction Court on the basis that there was no common mistake between the parties. Although E.ON was aware that CDL had intended to exclude ground conditions risk from the scope of works, E.ON genuinely believed that they had allocated these risks to CDL through the bespoke amendments to the contract conditions quoted above.

## Comment

At first blush, this decision might be said to present a surprising result. Despite bespoke amendments imposing the risk of ground conditions on the sub-contractor, and a clause giving priority to those amendments, the sub-contractor escaped liability for ground conditions by reference to exclusions contained in tender documentation appended to the sub-contract. This highlights the sometimes unexpected outcomes which can arise where pre-contractual documentation is appended to a contract. The tender documents in the present case were taken to have defined the subject matter of the sub-contract, thereby narrowing the scope of the sub-contract conditions.

The present decision also bears resemblance to the *MJ Hojgaard* litigation determined by the Supreme Court last year (see page 44 of the CMS Oil and Gas Annual Review for further detail). That case also involved the Supreme Court giving effect to appendices to a contract in circumstances which were argued to be surprising and unexpected. The temptation in many projects, due to time or cost constraints, is for such appendices to be included without detailed review or consideration. It is also common for different teams to be working on the appendixes to the rest of the contract.

However, the use of a priorities clause is unlikely to fully protect against the risks which arise in such circumstances. English law will strive to give full effect to all of the documents forming the contract. As Lewison, *The Interpretation of Contracts* (6th Ed.) identifies *'In construing a contract all parts of it must be given effect where possible, and no part of it should be treated as inoperative or surplus'* (paragraph 7.03). In doing so, it will seek to avoid reliance on a priorities clause unless there is an irreconcilable inconsistency. This underlines the importance of the role of the technical/commercial teams in reviewing any technical and commercial documents making up a contract.

**Judge:** Jefford DBE J

# FIDIC claims notification provisions: Hong Kong High Court guidance

In *Maeda Kensetsu Kogyo Kabushiki Kaishaalso known as Maeda Corporation and another v Bauer Hong Kong Ltd* [2019] HKCFI 916 the Hong Kong High Court considered the effect of claims notification provisions that required a contractor to state the contractual basis of a claim. Such a requirement now forms part of the standard FIDIC claims notification procedure across all its 2nd Edition forms. The Hong Kong High Court found that such provisions limit the grounds on which subsequent dispute resolution proceedings may be brought, ruling out any which are not specified in the relevant notice.

## Facts

Maeda Corporation ('**Maeda**') were appointed Main Contractor for the tunnelling aspects of the project and subcontracted certain diaphragm wall work to Bauer Hong Kong Ltd ('**Bauer**'). During the course of the works, Bauer encountered unforeseen ground conditions and sought additional payment from Maeda. Bauer initially claimed that the additional work required to overcome the conditions amounted to a variation under the subcontract. By the time the claim had reached arbitration, Bauer had expanded its grounds of claim to an unforeseen ground conditions clause in the subcontract as well the variation clause.

The claims notification provision under the subcontract required Bauer to give a notice of claim within 14 days of the event, occurrence or matter giving rise to the claim. A further notice, described as a condition precedent to entitlement, was to be given 28 days later setting out the *'contractual basis together with full and detailed particulars and the evaluation of the claim'*. The subcontract also made clear that Bauer would have no right to any additional payment unless the claims notification procedure had been *'strictly complied with'*.

It was common ground that Bauer's initial notices of claim only referred to the variation provisions of the subcontract. Maeda argued that Bauer's claim under the unforeseen ground conditions clause was therefore barred.

## Arbitral Award

The arbitrator rejected this challenge, noting that it was unrealistic to expect a party to finalise its legal case within the periods provided for notification of a claim. It was sufficient in his view for the factual basis of a claim to be communicated. As the arbitrator had rejected Bauer's case under the variation clause, this finding was crucial to the success of Bauer's claim (under the unforeseen ground conditions clause).

## Hong Kong High Court Decision

The Hong Kong High Court overturned the arbitrator's award on this issue. Given the notice provisions were to be strictly complied with and were expressly designated as conditions precedent, Bauer's initial notices limiting the contractual basis of its claim to the variation provision were binding. As such, Bauer *'should have no right to the additional extra payment, loss and expense claimed'* under the unforeseen ground conditions clause. As regards any unfairness in requiring Bauer to finalise its legal case within the short period required by the notification provisions the Hong Kong Court decided:

> *'[Bauer] had 42 days from the event or occurrence giving rise to the claim to serve the notice required under Clause 21.2. That is not an unrealistic timeframe to identify the contractual basis of a claim'.*

## Comment

The FIDIC 2nd Edition contracts released in late 2017 contained significant revisions to their standard claims notification procedure. In summary, two notices are required: a first within 28 days detailing the event or circumstance giving rise to the Claim and a second within a further 56 days giving full details of the Claim including *'statement of the contractual and/or other legal basis of the Claim'*.

Failure to serve either notice can result in the barring of a Claim. In such circumstances, the Engineer (or Employer under the Silver Book) may give a notice asserting the operation of the time bar. This may be challenged by the contractor and the late submission of either notice may be excused depending on the circumstances, including any reasons for the delay and any prejudice caused to the Employer.

It is unclear whether the Contractor's statement of the contractual and/or other legal basis of a Claim is intended to limit the scope of any subsequent referral to the Dispute Avoidance and Adjudication Board ('**DAAB**') and thereafter to arbitration. The procedure does, however, require the Engineer (or Employer under the Silver Book) to determine the Claim as put forward in the Contractor's two notices. It is this determination which is then to be referred to the DAAB and then to arbitration. It may be open for the Employer to argue that any new legal basis for the claim is either time barred or must first be the subject of a further round of notices and a determination by the Engineer / Employer as to whether delay in submitting those notices is to be excused.

There are evident parallels between this case and the claims notification procedure under the FIDIC 2nd Edition. Both require a second notice setting out the contractual or legal basis for a claim. Both also contain language barring claims which do not comply with this requirement. The FIDIC procedure permits non-compliance to be excused in certain circumstances, but the decision in this case would appear to remain relevant in circumstances where any non-compliance is not excused.

One argument which does not appear to have been considered by the arbitrator or the Hong Kong court in this case is why the second notice should need to set out an exhaustive statement of legal basis. Provided that a legal basis is stated, it might be argued that the requirements of the notice provision have been satisfied and need not impose any restriction on broadening the legal basis at a later date. On the other hand, the close linkage in the FIDIC procedure between the notices of claim, the subsequent determination by the Engineer / Employer, and the referral of that determination to the DAAB or to arbitration, may provide arguments in support of a stricter interpretation.

Given that notices of claim are often submitted by project teams without legal input, the issue considered in this case is likely to arise with frequency on projects let under the FIDIC 2nd Edition forms. Those parties who find themselves subject to the new claims notification procedure will need to be well prepared and adequately resourced to manage the new provisions. Those who are not may find that entitlements have been unwittingly lost.

**Judge:** Hon Mimmie Chan J

## Court of Appeal clarifies meaning of 'practical completion'

In *Mears Ltd v Costplan Services (South East) Ltd & Ors.* [2019] EWCA Civ 502 the Court of Appeal provided authoritative guidance as to when *'practical completion'* of construction works will be achieved. The existence of patent defects which are more than trifling will be sufficient to prevent *'practical completion'* and the intended purpose of the works is of relevance only in determining whether such defects are trifling. This considerably narrows the approach adopted by the Technology and Construction Court, at first instance, which allowed greater scope to consider the significance of individual defects and their effect on the intended purpose of the works.

### Facts

Mears Ltd ('**Mears**') entered into an agreement for lease with Plymouth (Notte Street) Limited (the '**Developer**') to take a 21 year lease of two blocks of student accommodation to be constructed in Plymouth. The Developer engaged a contractor to build the blocks under a JCT Design and Build contract and appointed Costplan Services (South East) Ltd ('**Costplan**') as its Employer's Agent.

The building of the blocks was delayed by almost a year and Mears alleged there were a number of defects in the works. Most notably, Mears claimed that around 50 of the student rooms constructed had been built more than 3% smaller than specified in the agreement for lease.

In this context, a dispute arose between the parties as to whether practical completion of the works had occurred. Among other things, Mears sought a declaration that practical completion could not be achieved whilst there were known defects which were *'material or substantial'*. The Technology and Construction Court declined this declaration and adopted a more flexible approach: defects which were not *'de minimis'* (i.e. trifling) may or may not prevent practical completion *'depending on the nature and extent of [them] and the intended purpose of the building'*.



## Court of Appeal Decision

Mears appealed on a number of issues. In relation to practical completion, the Court of Appeal made a comprehensive review of the authorities and adopted a narrower approach than the Technology and Construction Court. In the Court of Appeal's judgment, the central question was whether a defect was *'de minimis'* or trifling. If it was, it would not prevent practical completion. If it was not, practical completion could not be certified. In this respect, the Court of Appeal described Mears proposed declaration that practical completion could not be achieved whilst there were material and substantial defects as *'relatively uncontroversial'* (although the Court of Appeal still declined the declaration for other reasons).

In reaching this decision, the Court of Appeal cast doubt on previous cases which had indicated a potentially broader approach (and others which were even stricter). The Court of Appeal also provided helpful guidance more generally as follows:

— Practical completion is itself difficult to define and there are no hard and fast rules.

— The existence of a latent defect will not prevent practical completion.

— It makes no difference whether a defect involves an item of work not yet completed or one that has been completed but is defective.

— The existence of patent defects will be sufficient to prevent practical completion, save where they are trifling in nature.

— The ability to use the works as intended may be a factor in considering whether a patent defect is trifling in nature (for example, in this case the fact that the rooms were 3% smaller did not prevent the rooms from being used as student accommodation). However, such an ability does not necessarily mean that the works are practically complete.

— The mere fact that a defect is irremediable does not mean the works are not practically complete. The question remains whether the defect is trifling in nature.

## Comment

Whilst the phrase '*practical completion*' is generally not used on oil and gas EPC contracts, where such terms are used this is an important Court of Appeal decision which provides significant clarity as to the meaning of practical completion where that term is left undefined in the context of construction works (as is the case with the majority of standard form documents that use the term). Whilst practical completion remains *'easier to recognise than define'*, the Court of Appeal has set the bar at a much higher level than the original Technology and Construction Court decision. Any defects must be *'trifling'* if practical completion is to be certified. Significant defects cannot be discounted on the basis that they do not prevent the works from being used for their intended purpose.

**Judge:** Lewison LJ, Newey LJ, and Coulson LJ

# Guarantees

Guarantees and on-demand bonds remain a critical element of aspects of contracting in the oil and gas industry. In two recent cases the English courts have highlighted issues in relation to the drafting of guarantees and demands made thereunder.

- In *Longulf Trading (UK) Ltd v Niyazi Onen Gida SAN AS & Anor* [2019] EWHC 1573 (Comm) the Commercial Court re-emphasized the importance of properly complying with the terms of a guarantee when making a demand and, if necessary, demanding all sums that may arise in the future.
- In *Rubicon Vantage International PTE Ltd v Krisenergy Ltd* [2019] EWHC 2012 (Comm), the Commercial Court decided that the specific wording of a *'charterer guarantee'* resulted in aspects of it being treated akin to an on-demand bond rather than a co-extensive guarantee with important ramifications.

## Guarantees – the importance of complying with payment triggers

In *Longulf Trading (UK) Ltd v Niyazi Onen Gida SAN AS & Anor* [2019] EWHC 1573 (Comm) the Commercial Court re-emphasized the importance of properly complying with the terms of a guarantee when making a demand thereunder. The Commercial Court decided that a demand for payment of a specific amount pursuant to a guarantee only triggered an obligation on the guarantor to pay the amounts demanded, and did not trigger an obligation to pay any future amounts.

While the Commercial Court's decision relied heavily on the specific wording of the relevant guarantee, the decision serves as a reminder of the need to ensure demands for payment satisfy terms of a guarantee required to trigger the obligation on the guarantor to make payment.

### Facts

Longulf Trading (UK) Ltd ('**LGT**') is an English trading company that procures raw materials from wholesale suppliers for manufacturing companies.

Under a procurement agreement dated 19 November 2016 (the '**Procurement Agreement**'), LGT agreed to procure seafood for resale to Dardanel Onentas Gida

Sanayi A.S. ('**Dardanel**'), a Turkish company founded by Mr Niyazi Onen that produces canned fish products. Dardanel, in turn, agreed to:

— Take delivery of the seafood and pay for it;

— pay a procurement fee to LGT on a monthly basis, which was calculated by reference to the amount owed by Dardanel to LGT (so that the higher the value of any outstanding payments for seafood delivered, the higher the procurement fee); and

— pay interest at a rate of 15% per annum on sums not paid when due, accruing from the due date until the date of payment.

The Procurement Agreement was expressly stated to be conditional upon the provision of a guarantee. Thus, on 23 January 2016, Mr Onen and a company called Niyazi Onen Gida San A.S. (of which Mr. Onen is the chairman) (together, the '**Guarantor**') executed a written guarantee in favour of LGT (the '**Guarantee**').

The Guarantee provided that:

— The Guarantor guarantees the payment of *'the Obligations'*, defined as *'all present and future debts and liabilities of [Dardanel] to [LGT]… in connection with or with respect to the Procurement Agreement'* (Clause 2.1); and

— the Guarantor covenants to pay the Obligations if (i) Dardanel fails to meet its obligations under the Procurement Agreement, and (ii) LGT has issued a written demand for payment to the Guarantor. The demand must be accompanied by a statement setting forth the Obligations to be paid and the basis for the calculations made by LGT in order to arrive at the amount it is demanding from the Guarantor (Clause 2.2).

LGT issued a number of invoices to Dardanel between September 2016 and February 2017 for seafood procured and provided to Dardanel. However, Dardanel failed to make payments against those invoices (the '**Debt**') as they fell due.

On 9 November 2017, LGT issued a written demand to the Guarantor requesting that the Guarantor pays the Debt within 21 days. The demand also stated that LGT reserved its right to claim the full scope of the Obligations incurred by Dardanel, including interest over the Debt at 15% per annum (the rate agreed in the Procurement Agreement) and legal costs, if the Guarantors did not make payment within 21 days. If it did make payment within 21 days, LGT agreed to forego these additional amounts. In the event, the Guarantor did not pay.

Then, between June 2018 and January 2019, Dardanel also failed to pay the relevant monthly procurement fees. No written demand was issued to the Guarantor in relation to this failure by Dardanel.

Instead, LGT brought a claim against the Guarantor for the Debt, for the unpaid procurement fees between June 2018 and January 2019, and for contractual interest over those amounts at 15% per annum.

## Decision

The Commercial Court confirmed that the Guarantee was valid, that Dardanel had failed to pay the Debt when it became due, and that LGT had issued a valid written demand on 9 November 2017 in relation to this Debt. Accordingly, the Guarantor was obligated to pay the Debt pursuant to Clause 2.2 of the Guarantee.

With regards to the procurement fees and interest, the primary questions considered by the Commercial Court were: (i) whether these sums amounted to 'penalties' under English law and were therefore unenforceable, and (ii) whether the written demand of 9 November 2017 triggered the Guarantor's obligation to pay these sums. The Commercial Court's answers to these questions are summarised below.

**Penalties**

The Commercial Court referred to the rule on penalties as set out by Lords Neuberger and Sumption in the Supreme Court decision of *Cavendish Square Holding BV v Makdessi* [2016] AC 1162:

> *'The penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves… the true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation'* (paragraphs 13 and 32).

In relation to the procurement fees, the Commercial Court determined that although the value of these fees was impacted by Dardanel's breach of its payment obligations, the obligation to pay such fees was still a primary obligation that *'forms part of the bargain between the parties'*. It did not depend on any breach of a primary obligation and, therefore, the rule on penalties did not apply.

In relation to interest, the Commercial Court accepted LGT's argument that the rate was not *'out of all proportion'* to LGT's legitimate interest in timely payments, because LGT regularly had to make significant upfront payments to procure seafood on behalf of Dardanel. The interest rate was agreed to encourage prompt performance and provide protection to LGT (e.g. if it needed to procure bridging finance to cover gaps in cash flow), not simply to penalise Dardanel. On that basis, it was also not a penalty.

**Valid demand**
The Commercial Court considered that Clause 2.2 of the Guarantee was clear in requiring the written demand to provide details of the calculation of the sums which were being claimed, before the Guarantor's obligation to pay such sums was triggered.

In relation to the procurement fees, the Commercial Court pointed out that the written demand dated 9 November 2017 did not provide details of the procurement fees, as none were due at the time. Thus, while it remained open to LGT to make a new written demand in relation to these fees, unless and until such further demand was issued, the Guarantor was not required to pay the procurement fees.

In relation to interest, the Commercial Court noted that the written demand specified the amount of interest that had accrued over the Debt since it became due and offered not to claim this amount if payment was made within 21 days. The Commercial Court considered that this was sufficient to comply with Clause 2.2, so that the Guarantor's obligation to pay interest was triggered by the written demand when it did not pay within 21 days.

However, in relation to future interest, the Commercial Court considered that the reservation of the rights in the written demand to claim further amounts was not sufficient to trigger the Guarantor's payment obligation under Clause 2.2. In coming to this conclusion, the Commercial Court placed emphasis on the fact that the written demand did not provide a calculation for interest that would continue to accrue, nor did it actually demand payment of future interest (it simply reserved its right to do so).

The Commercial Court did award LGT statutory interest over the Debt from the date on which the amounts should have been paid until the date of the judgment, at a significantly lower rate, and confirmed that, alternatively, it remained open to LGT to issue a written demand for contractual interest that had accrued since the date of the written demand.

## Comment

Guarantees are widely used across a range of contractual structures and industries.

Where the payment of a sum under a Guarantee is conditional upon the provision of a demand, it is important that the terms of demand are drafted to capture the entirety of the sum that might be sought. In this respect, there is a difference between reserving a right to make a future claim (which by implication suggests that such claim is not made in the demand) and expressing the demand to also relate to sums that will continue to accrue arising from the same underlying set of facts.

The case also confirms the difficulties with arguing that a contractual obligation amounts to an unenforceable penalty under English law. In circumstances where a party can show that a payment obligation is not *'out of all proportion to any legitimate interest'*, the obligation will not amount to a penalty. In truth, it is rare that interest agreed between commercial parties will amount to a penalty.

**Judge:** Christopher Hancock QC (sitting as a Judge of the High Court)

# Unwitting 'on-demand' bond by guarantor

In *Rubicon Vantage International PTE Ltd v Krisenergy Ltd* [2019] EWHC 2012 (Comm), the Commercial Court decided that the specific wording of a 'charterer guarantee' resulted in aspects of it being treated akin to an on-demand bond rather than a co-extensive guarantee. The practical implication of this was that the guarantor, in this case the parent company of the debtor, was required to make payment before the underlying dispute was resolved, whereas payment under what is sometimes called a 'true guarantee' usually only falls due following a decision on the merits of any underlying dispute. The Commercial Court's decision serves as a warning to those that use such instruments that although 'guarantees' are not presumed to be on-demand bonds, they are capable of being treated as having a similar effect to such instruments if that is the natural and ordinary meaning of the words used.

## Facts

Rubicon Vantage International PTE Ltd ('**Rubicon**') is a Singaporean company that owns a Floating Storage and Offloading Facility (the '**FSO**') called the 'Rubicon Vantage'. In 2014, it chartered the FSO to Kris Energy (Gulf of Thailand) Limited ('**Kegot**') for use on an oil field in Southeast Asia.

**The Guarantee**
Around the same time that the charter was agreed, Kegot's parent company Krisenergy Ltd ('**Krisenergy**') executed a 'Charterer Guarantee' (the '**Guarantee**') in favour of Rubicon. The Guarantee was governed by English law, and provided that:

- Where *'the amount(s) demanded under this Guarantee are not in dispute between [Kegot] and [Rubicon]'*, Krisenergy, as guarantor, is obliged to pay the amounts demanded within 48 hours from receipt of a demand (Clause 4).
- Where there is a dispute between Kegot and Rubicon *'as to [Kegot's] liability in respect of any amount(s) demanded under this Guarantee'*, Krisenergy is obliged to pay the amount demanded up to a maximum of USD 3m *'notwithstanding any dispute between [Kegot] and [Rubicon]'* (Clause 5). Clause 5 further stated that any sums demanded in excess of USD 3m may be withheld or deferred by Krisenergy until a final judgment or final non-appealable award was published (or an agreement reached between Kegot and Rubicon in relation to the dispute).
- A demand under this Guarantee must be in writing and must (amongst other things) be accompanied by a calculation of sums demanded together with *'any supporting documentation reasonably required to assess such demand'* (Clause 3).

**The Demand**
In 2015, Rubicon sent Kegot four invoices totalling a little in excess of USD 1.8 million, for works Rubicon had organised on the FSO pursuant to the terms of the charter. Kegot disputed that it was liable to pay these amounts under the charter, and legal proceedings were commenced between Kegot and Rubicon in relation to the dispute.

In the interim, Rubicon made a demand on Krisenergy under the Guarantee for the total sum outstanding under the four invoices. Krisenergy declined to pay. Its reasons included that:

- Krisenergy was only required to pay pursuant to Clause 5 where liability to pay sums had been admitted by Kegot (and only quantum remained in dispute). As liability had not been admitted, Krisenergy was not required to pay.
- In any event, the demand was not compliant with Clause 3 the Guarantee, and therefore, it did not trigger Krisenergy's payment obligation.

## Decision

The Commercial Court disagreed with Krisenergy's reasons and decided that the demand was valid, and that Krisenergy was obliged to pay the full sum demanded within 48 hours (as it did not exceed the USD 3m maximum sum payable on demand under Clause 5).

The Commercial Court's reasoning is detailed below.

**(1) Payment on Demand**
A so-called true guarantee typically imposes a secondary obligation on the guarantor to *'see-to-it'* that primary obligations under the relevant underlying contract are performed. The obligation on the guarantor to pay is therefore dependent on whether or not there has been a breach of an obligation under the underlying contract. Such instruments are typically issued by companies that have a commercial relationship with the primary obligor, such as parent companies. An on-demand bond, on the other hand, typically imposes an autonomous, primary obligation on the guarantor to pay on-demand (i.e. upon receipt of a demand for payment that is compliant with the terms of the bond), regardless of whether liability for breach of the underlying contract has been established. These are commonly issued by banks.

In English law, there is a presumption (the '**Marubeni presumption**' from the judgment in *Marubeni Hong Kong v Mongolian Government* [2005] EWCA Civ 395) against construing an instrument as an on-demand bond (rather than merely a see-to-it guarantee) if the party providing the instrument is not a bank or financier. Krisenergy accepted that Clause 5 made the Guarantee, at least in part, an on-demand instrument, so there was no need to apply the Marubeni presumption in order to establish whether Krisenergy had assumed autonomous on-demand liabilities.

However, Krisenergy sought to argue that:

- The Marubeni presumption should be applied *'by analogy'* when interpreting the scope of such autonomous on-demand liabilities in Clause 5.
- This should lead the court to construe Clause 5 restrictively, as Krisenergy was not a bank.
- The reference in Clause 5 to *'liability in respect of any amount(s)'* should therefore be narrowly construed to only trigger the payment obligation where liability to pay sums had been admitted by Kegot (and only quantum remains in dispute).
- As liability had not been admitted, Clause 5 did not apply.

The Commercial Court rejected this argument. It confirmed that the Marubeni presumption is directed to the question of whether a particular instrument is an on-demand bond or a see-to-it guarantee. Once the parties accepted that the Guarantee was (at least to an extent) an on-demand bond, that presumption was spent.

It then became necessary to interpret the scope of Clause 5 *'simply by considering the words the parties chose to use to record their agreement, free from any antecedent presumption as to what meaning they are likely to have, or as towards a wide or narrow construction'*.

Following this approach, the Commercial Court considered the words *'…where the amount(s) demanded are not in dispute'* in Clause 4 as clearly referring to disputes as to both liability and quantum. Further, that Clause 5 captured *'what is left over from Clause 4'*, so that it applied where Kegot disputed either liability to pay an amount, or where Kegot disputed the quantum demanded.

The Commercial Court's reasoning was not impacted by a provision in the charter stating that *'where an item billed is disputed in good faith, it is not payable until any dispute has been resolved'*. Just because this rule applied to Kegot did not mean this needed to apply to Krisenergy as well. In fact, the Commercial Court considered that it may well make commercial sense for a guarantor to be obliged to *'pay-now-argue-later'*, even if the party to the relevant underlying contract is not, on the basis that the guarantor has more cash and can more easily *'weather the cash flow strain'* of making an immediate payment.

**(2) Compliant Demand**

Krisenergy also argued that Clause 3 of the Guarantee, which required a demand to be accompanied by *'any supporting documents reasonably required to assess such demand'*, would naturally include any documents reasonably required to ascertain:

— What work had been done (so Krisenergy could assess whether that work was within the scope of works for which Kegot was liable under the charter); and

— whether the costs of that work were reasonably incurred, or were reasonable in amount.

It argued that since such documentation had not been provided, the demand was not compliant with the terms of the Guarantee, and that Rubicon had therefore not validly triggered Krisenergy's payment obligation meaning that Krisenergy was therefore not required to pay.

The Commercial Court disagreed. It considered that while Kegot would require the documents at (i) and (ii) above in order to assess the merits of the arguments against Kegot, such documents were not reasonably required by Krisenergy to assess the demand. Instead, all that Krisenergy reasonably required were documents from which Krisenergy could quickly find out whether (and to what extent) the underlying claim relating to the amounts demanded was admitted or disputed by Kegot.

Further, the Commercial Court was *'prepared to assume without deciding'* that Krisenergy also reasonably required documents *'sufficient to allow Krisenergy to form a provisional view as to whether or not the claims which give rise to the demands are bona fide and not fraudulent claims'*.

By providing 270 pages of supporting documents, including third party invoices, the Commercial Court decided that Rubicon had satisfied the requirements of Clause 3 and issued a valid demand.

## Comment

Parent company guarantees are a common feature in the oil and gas industry.

When drafting a guarantee, parties should carefully consider whether the guarantee is intended to operate as a true see-to-it guarantee, an on-demand instrument, or, as was unusually agreed in this case, both.



The key difference being:

- A guarantee usually creates a secondary obligation, under which the guarantor guarantees the performance of a primary obligation under the underlying contract (this is sometimes referred to as a see-to-it guarantee). The liability of the guarantor is therefore dependent on the performance of the primary obligation. Whilst *'primary obligor'* wording in such guarantees can result in the guarantor undertaking primary obligations, the guarantor's liability will remain dependent on whether or not there has been a breach of the underlying contract.
- An on-demand bond imposes a primary obligation on the guarantor to pay (the beneficiary of the bond) immediately upon receipt of a demand for payment. Payment by the guarantor is not contingent on performance of the underlying contract or proof of loss. Typically, but subject to the express requirements of the bond, a simple statement detailing that an obligation in the underlying contract has been breached and that loss has been suffered by the beneficiary is sufficient to trigger payment. There is no need to prove either breach or loss.

On-demand obligations are more typically assumed by banks or financiers. However, in this decision the Commercial Court has made clear that parent companies are able to give such *'on-demand'* bonds. Although there is a presumption against them doing so, that is merely a presumption that may be displaced by clear words in the instrument.

As such, it is important that parent companies consider, with care, whether they are seeking to give a typical parent company guarantee – or to go further and create an obligation to pay a sum on-demand without any need to first satisfy that the sum is contractually due under the underlying (guaranteed) obligation.

If a parent company chooses to assume such on-demand obligations then, as confirmed by this decision, there is no presumption that such rights should be interpreted narrowly or restrictively.

Although this was not an issue in the current case, parent companies wishing to assume on-demand obligations should also be mindful of any regulatory regimes that may apply. For example, in the UK, a guarantee that contains primary, on-demand, payment obligations and that is issued in exchange for payment of a premium may constitute a 'contract of insurance' under the Financial Services and Markets Act (Regulated Activities) Order 2001 (SI 2001/544). In such circumstances, if the guarantor is not duly authorised by the relevant authorities, it could be exposed to criminal liability.

**Judge:** Nicholas Vineall QC (sitting as Deputy High Court Judge)

# Drilling units and support vessels

The chartering of drilling units and support vessels represent significant financial commitments for many oil companies. As such ensuring that they are properly procured and of appropriate specification is key. Two recent decisions published in the last year will be of importance to oil companies in this regard.

— In *HPOR Servicos de Consultoria Ltda v Ocean Rig UDW Inc. and Another Company* [2018] EWHC 3451 (Comm), the Commercial Court affirmed that non-disclosure by an agent of previous corruption was a serious breach of the agent's obligations resulting in forfeiture of its agent's fees.

— In *Silverburn Shipping (IoM) Ltd v Ark Shipping Company LLC (the M/V 'Arctic')* [2019] EWHC 376 (Comm), the Court of Appeal overturned a decision of the Commercial Court and decided that an obligation in a charterparty to keep a vessel in class was an innominate term, not a condition, that did not necessarily allow termination for breach.

# Remedies against agent for corruption in winning drilling unit contracts

In *HPOR Servicos de Consultoria Ltda v Ocean Rig UDW Inc. and Another Company* [2018] EWHC 3451 (Comm), the Commercial Court was asked to deal with the consequences of and non-disclosure of past corruption by an agent in relation to subsequent contracts to act as an agent to secure drilling unit contracts. The Commercial Court affirmed that non-disclosure was a serious breach of the agent's obligations resulting in forfeiture of its agent's fees.

## Facts

The Claimant, HPOR Servicos de Consultoria Ltda ('**HPOR**'), was an SPV incorporated in Brazil and controlled by Mr Padilha. The Defendants were two companies incorporated in the Marshall Islands, the first Defendant was the shareholder of the second Defendant company, which provided services for offshore oil and gas exploration.

In 2011, the Defendants entered into an agency agreement with URCA Offshore Ltd ('**URCA**') to assist with two tenders for drillship contracts (the '**URCA Agency Agreement**'). URCA was controlled by a third party but acted at all material times in accordance with Mr Padilha's instructions. Under the URCA Agency Agreement 2% commission was to be paid by the Defendants to URCA in the event that a drilling contract was obtained. URCA would then pay the 2% commission to Mr Padilha.

In 2011, Petrobras confirmed the award of two three-year drilling contracts to the Defendants (these were later extended for another three years until 2018). Subsequently, the URCA Agency Agreement was terminated and the parties entered into two agency agreements that were re-structured to involve HPOR (together the '**New Agency Agreements**'). Pursuant to the New Agency Agreements, HPOR would receive 2% of the day rate Petrobras paid by way of hire. The commission payment would survive termination of the New Agency Agreements. At the time that the New Agency Agreements were entered into, the Defendants were aware that Mr Padilha was acting for other drilling companies. The Defendants were not informed that Mr Padilha had previously paid bribes to Petrobras executives to advance the commercial interests of two of the Defendants' competitors.

Between 2012 and 2015, the Defendants paid HPOR the fees agreed under the New Agency Agreements. The total paid for the two drilling rigs was over USD 16m. The Defendants stopped making payments to HPOR after April 2015.

When the major corruption investigation 'Operation Car Wash' began, the Defendants grew concerned about their position in Brazil. The Defendants provided Mr Padilha with a number of opportunities to disclose any corrupt activities. In July 2015, Mr Padilha confessed to one of his acts of corruption. However, HPOR failed to disclose to the Defendants that Mr Padilha had admitted to the Brazilian authorities his involvement in two corrupt deals. In September 2015, Mr Padilha's past corruption and association with Operation Car Wash led the Defendants to terminate the New Agency Agreements. Mr Padilha was subsequently found guilty of bribery and money laundering.

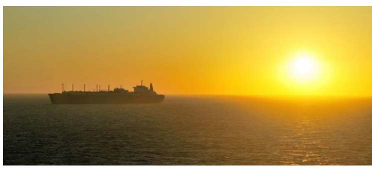
The Defendants commenced an arbitration to require HPOR to forfeit remuneration obtained before and after the termination of the New Agency Agreements.

## Arbitral Tribunal's Decision

The Defendants were successful in arguing it was appropriate to order that, by way of remedy for breach of fiduciary duty, HPOR, as agent, should forfeit and/or become liable to account for its own contractually earned/accrued remuneration.

The majority of the arbitral tribunal comprising Sir Bernard Eder, Sir Jeremy Cooke and Mr Richard Siberry QC, found (Mr Siberry QC dissenting) that HPOR was in deliberate breach of its fiduciary duties immediately upon entering the New Agency Agreements. In particular, the arbitral tribunal found that Mr Padilha's failure to disclose his corrupt relationships with Petrobras executives destroyed the relationship of trust and confidence between the Parties.

The majority of the arbitral tribunal considered the suggestion that Mr Padilha's past corruption was not related to the fiduciary relationship created by the New Agency Agreements to be *'unrealistic and unsustainable'*. Nevertheless, the majority also agreed that Mr Padilha worked *'actively, extensively and closely with [the Defendants] to secure the extension of the Drilling Contracts…'*. HPOR was therefore ordered to forfeit the remuneration it received for its services under the URCA Agency Agreement and the New Agency Agreements.



The transcript of the Commercial Court's decision provided details of the reasoning of Mr Siberry QC's dissenting judgment in the arbitration:

> *i. 'Mr Padilha could not have owed fiduciary duties to [the Defendants] prior to the conclusion of the Agency Contracts.*
>
> *ii. Once the Agency Contracts were concluded HPOR was in a fiduciary relationship with [the Defendants] and owed duties, including to inform [the Defendants] of [their] past misdeeds.*
>
> *iii. If the URCA Agreement had not been terminated [the Defendants] could not have terminated that contract on the basis of Mr Padilha's past misdeeds.*
>
> *iv. It was through Mr Padilha's efforts that a valuable extension of the Drilling Contracts was obtained and further assistance was provided.*
>
> *v. Upon signature of the Agency Contracts 'HPOR acquired an indefeasible right to commission at 2% on all day rate payments … a right which survives (lawful) termination of the Agency contracts by [the Defendants].*
>
> *vi. None of the authorities relied on by the majority in support of their conclusion that [the Defendants] were entitled to repayment of fees already paid support 'the proposition that a principal who agrees to pay an agent commission on receipts under a contract which is (or in this instance, must be taken to have been) procured by the honest endeavours of the agent, must repay the commission honestly earned with the full knowledge and consent of the principal because the agent, in breach of fiduciary duty has failed to disclose past misdeeds which may affect (and in this case did affect) the ongoing relationship between the principal and the third party and which justified termination of the agency contract.*
>
> *vii. He considered that 'to disallow HPOR's claims for commission due under the Agency Contracts and to allow [the Defendants'] counterclaim, would involve a significant and somewhat draconian extension of the law relating to remedies for breach of fiduciary duty'.*

## Commercial Court's Decision

HPOR appealed the award to the Commercial Court, arguing that there was a mistake of law made by the arbitral tribunal.

The Commercial Court started by addressing the basis upon which the majority had concluded that the Defendants were entitled to repayment of HPOR's fees. The Commercial Court concluded that the majority had erred because it based its reasoning on the conclusion that an account of profits was available. The remedy of account of profits was not relevant in this case because HPOR had not received sums which should have been paid to the Defendants nor had HPOR misused any of the Defendants' property. The Commercial Court referred to the case of *Murad v Al-Saraj* [2005] EWCA Civ 959 [2005] WTLR 1573, 85:

> *'an account of profits […] is a procedure to ensure the restitution of profits which ought to have been made for the beneficiary and not a procedure for the forfeiture of profits to which the defaulting trustee was always entitled for his own account. […] Equity does not take the view that simply because a profit was made as part of the same transaction the fiduciary must account for it'.*

The appeal succeeded to the extent that it challenged the grounds for the repayment. However, the issue in dispute concerned whether an agent was entitled to retain contractual remuneration and the remedy for this matter did not lie in an account of profits.

The Commercial Court also found that the remedy of forfeiture is applicable to an agent's remuneration regardless of whether a fee has already been paid, and it is available for all classes of breach. Commercial Court considered that HPOR committed breaches from the start of the relationship between the parties which went to the root of the contract. The fact that Mr Padilha had provided valuable services to the Defendants by obtaining the drilling contracts was irrelevant in considering whether the remedy of forfeiture was available because he had provided those services whilst committing a continuing breach of duty.

It was decided that HPOR's behaviour amounted to a serious breach of contract because Mr Padilha had concealed his breach of duty from the outset of the contractual relationship and precluded HPOR from providing disinterested advice. Therefore, the Commercial Court upheld the arbitral tribunal's award that the remuneration paid to HPOR and Mr Padilha be forfeited. Although it was found that the majority of the arbitral tribunal had erred in considering that the remedy of the account of profits was available, the same outcome was achieved by operation of the remedy of forfeiture.

## Comment

'Operation Car Wash' continues to result in a significant amount of arbitration and litigation as participants in the oil and gas industry seek to deal with its financial consequences.

In this case, an arbitral tribunal and the Commercial Court have clarified that non-disclosure of past-corruption is capable of amounting to a serious breach of an agent's fiduciary obligations, permitting termination of an agency contract for repudiatory breach.

Furthermore, in those circumstances, any fees paid to the agent may be recovered through the law of forfeiture.

The Commercial Court's decision serves as a reminder of the importance of an agent adhering to its fiduciary duties. In particular, and in the context of this judgment, full disclosure is required of any past admissions or allegations of corruption, secret commissions or bribes that might damage the principal. Failure to disclose such allegations would put the agent's interests in conflict with the principal's interests, and this would be a breach of fiduciary duty by the agent.

**Arbitral Tribunal:** Sir Bernard Eder; Sir Jeremy Cooke; and, Mr Richard Siberry QC

**Judge:** Cockerill J

# BARECON – The Importance of Class

In *Silverburn Shipping (IoM) Ltd v Ark Shipping Company LLC* (the M/V 'Arctic') [2019] EWHC 376 (Comm), the Court of Appeal overturned a decision of the Commercial Court and decided that an obligation in a charterparty to keep a vessel in class was an innominate term, not a condition, that did not necessarily allow termination for breach.

The form of contract being used was an amended version of the BIMCO Barecon '89. This is one of the most widely used industry standard form contracts, making this an important decision for ship owners, charterers and funders.

## The Facts

Under a charterparty dated 17 October 2012 (the '**Charterparty**'), Silverburn Shipping (IoM) Ltd (the '**Owners**') had chartered the anchor handling tug M/V ARCTIC (the '**Vessel**') to Ark Shipping Company LLC (the '**Charterers**') for a period of 15 years. Delivery took place on 18 October 2012.

Clause 9A of the Charterparty read:

> *'The Vessel shall during the charter period be in the full possession and at the absolute disposal for all purposes of the Charterers and under their complete control in every respect. The Charterers shall maintain the Vessel, her machinery, boilers, appurtenances and spare parts in a good state of repair, in efficient operating condition and in accordance with good commercial maintenance practice and they shall keep the Vessel with unexpired classification of the class indicated in Box 10 and with other required certificates in force at all times. The Charterers to take*

> *immediate steps to have the necessary repairs done within a reasonable time failing which the Owners shall have the right of withdrawing the Vessel from service of the Charterers without noting any protest and without prejudice to any claim the Owners may otherwise have against the Charterers under the Charter'.*

The Vessel arrived at the Caspian port of Astrakhan for repairs and maintenance on 31 October 2017. The Vessel's class certificates expired on 6 November 2017, which was before she had entered dry dock for repair work and some five years since the last special survey.

The Owners served notice on the Charterers on 7 December 2017 referring to unpaid hire, the poor condition of the Vessel and to the Charterer's breach of Clause 9A. In that notice, the Owners sought to terminate the Charterparty and demanded the return of the Vessel. The Charterers resisted that demand, stating that the Vessel had arrived at dock before her certificates expired and they would shortly be renewed. They argued that the *'reasonable time'* which applied to repairs also applied to renewal of certificates.

The matter was referred to arbitration and the arbitral tribunal awarded in favour of the Charterers.

The Owners appealed to the Commercial Court, leave to appeal being granted on the basis of two points of law being open to serious doubt as well as the matter being of general public importance.

The Commercial Court considered:

- Whether the Charterers' obligation under Clause 9A was an absolute obligation, or merely an obligation to reinstate expired class certificates *'within a reasonable time'*; and
- whether the classification obligation was a condition of the contract or an innominate term.

## Commercial Court Decision

On the first point, the Commercial Court decided that the obligation was in fact an absolute one and the Charterers had to keep the Vessel with unexpired classification certificates at all times. The classification obligation was in essence a documentary one, and Charterers could therefore be in breach of their maintenance obligation without being in breach of the classification obligation. The two obligations are related but they are not 'part and parcel' of a single obligation (which is what the arbitral tribunal had considered them to be).

On the second point, the Commercial Court decided that the classification obligation should be construed as a condition of the Charterparty despite the fact that the parties had not expressly chosen to label it as such. A vessel is either in class or it is not. Breach of an obligation to maintain a vessel in class is likely to be serious; a charterer would be on notice of when a vessel's classification was due to expire and would have plenty of time to take the necessary steps to renew it.

The clear and absolute nature of the wording the parties chose, coupled with a fixed time limit (*'at all times'*), was redolent of a condition. The absence of a remedy – termination – does not mean that the obligation is not a condition; quite the opposite, in fact.

## Court of Appeal Decision

The Court of Appeal overturned the Commercial Court's decision and decided that the obligation to keep a vessel in class was an innominate term.

The question as to the classification of the term is clearly one of construction. On the question of ascertaining whether a Clause is a condition, the Court of Appeal reiterated that: (i) it is a matter of the intention of the parties on the true construction of the contract; (ii) where, upon the true construction of the contract, the parties have not made the term a condition, it will be innominate if a breach may result in trivial, minor or very grave consequences; (iii) unless it is clear that a term is intended to be a condition or (only) a warranty, it will be innominate.

The Court of Appeal came *'to the firm conclusion'* that the term was not a condition. That the term related to the vessel's classification status – important though classification status is – did not suffice to make it a condition. It reasoned, amongst other things, as follows:

- **Wording:** The term was not expressed to be a condition. This is in no way decisive; conditions may indeed be found where the word *'condition'* has not been used, or where the consequences of breach have not been spelt out. But it is a consideration of some significance, especially so, given that the BIMCO Barecon '89' is an industry standard after consideration by an industry drafting committee. Had the industry and the parties wished to make the position plain, they could have used the language of condition; they did not choose to do so.
- **Not a time clause:** The term is not a *'time clause'*.
- **No inter-dependence:** There was simply not the inter-dependence here on other terms that were conditions or conditions precedent.
- **Type of breach:** The term goes to the classification status of the vessel, the importance of which, at least in general, should not be minimised. Only one kind of breach of the term is possible: either the vessel is in class or she is not. This is a relevant factor. Of itself, it lends support to the conclusion

that the terms is a condition. However, it is outweighed by a plethora of other factors set out above and below.

- **Clause 9A as a whole:** Clause 9A, correctly analysed, places distinct obligations on Charterers, as to maintaining both the physical condition of the vessel and its class status. Plainly the Charterers' obligation as to the physical maintenance of the vessel is not a condition of the Charterparty; far from any breach of this obligation entitling Owners without more to treat the Charterparty as at an end, Charterers must take immediate steps to remedy the matter by completing the necessary repairs *'within a reasonable time'*. That is not the language or substance of a condition. The structure of Clause 9A, in an industry standard contract, strongly suggests that the term is not to be construed as a condition.
- ***'other required certificates…'* wording:** If the term contended is to be a condition, either only a part of the term is a condition (not including the *'other required certificates'* wording) or that Charterers' obligation as to *'other required certificates'* forms part of the condition. If the latter, it would mean, for instance, that this 15 years' charterparty could be terminated by Owners if Charterers committed any breach in respect of the certificates required under the BWM or AFS conventions. The Commercial Court declined to accept that such a construction could realistically accord with the intention of the parties.
- **The scheme of the Charterparty:** The gravamen of Owners' case is that a breach of the term potentially puts the vessel's insurance at risk and that the term should therefore be classified as a condition. However, that argument was unsustainable once it is appreciated that a breach of contract by Charterers which actually leaves the vessel without P&I cover does not, of itself, entitle Owners to terminate the Charterparty. If leaving the vessel uninsured does not constitute a breach of condition, the Commercial Court could not accept that putting the vessel at risk of being uninsured is or ought to be classified as a breach of condition.
- **The consequences of breach of the term:** Loss of class amounting to a breach of condition, at the very time the vessel was undergoing repairs under class supervision, is not a result to which the Commercial Court would accede unless driven to it.
- **A continuing obligation:** It is one thing to conclude that a statement as to the vessel's class at the commencement of the Charterparty is a condition or condition precedent; it is quite another to hold that a 15 years' warranty to maintain the vessel in class at all times is a condition. For all the reasons given, the Commercial Court was satisfied that the term was not a condition and is properly to be regarded as innominate. This conclusion best accorded with the language, structure and scheme of the Charterparty, together with business common sense. While the categories of conditions are not closed, the term simply lacked the hallmarks of a condition. The alternative, was to risk trivial breaches having disproportionate consequences destructive of a long-term contractual relationship.

## Comment

The BIMCO Barecon '89 (and its later forms) is one of the most commonly used bareboat charters, routinely relied upon across a range of circumstances.

From an owner's perspective, loss of class certification often triggers default under loan documents and will inevitably lead to loss of insurance. As such, this decision is of importance.

The oil and gas, and shipping, industries rely heavily on model form industry contracts. It is of interest that the Court of Appeal noted had the industry and the parties wished to make the position plain, they could have used the language of condition; they did not choose to do so. In doing so, the Court of Appeal has emphasised to contracting parties, and industry drafting committees, that the primary power to make a term a condition is in their hands as drafters of contractual terms, conditions and warranties.

Absent classification by the parties or in the relevant industry model form, English law will seek to ascertain the true construction by reference to interpreting the contract as a whole against its commercial background. In many circumstances, such as here, that will result in the term being analysed being an innominate term rather than a condition.

Owners should also take note: the impact on loan documents and insurance of loss of class may be serious. Consideration should be given to whether the current BIMCO Barecon '89 satisfactorily addresses this risk as concerns the liability of the Charterer.

**Judge:** Carr J

**Court of Appeal Judges:** Gross LJ; McCombe LJ; Leggatt LJ

# Commodity sales

Challenging conditions in commodity markets continues to give court guidance on drafting hydrocarbons commodity sales agreements in the oil and gas sector.

— In *Cockett Marine Oil DMCC v Ing Bank NV & Anor* [2019] EWHC 1533 (Comm) the Commercial Court dealt with the latest round of the OW Bunker saga that has raised some interesting issues as to whether bunker sales are 'sales' contracts.

— In *Classic Maritime Inc v Limbungan Makmur SDN BHD* [2019] EWCA Civ 1102 the Court of Appeal decided on the extent to which a force majeure clause requires a party to prove that it would otherwise have performed its obligations in the absence of any force majeure event.

## Bunker Supply Contracts Revisited

In *Cockett Marine Oil DMCC v Ing Bank NV & Anor* [2019] EWHC 1533 (Comm) the Commercial Court dealt with the latest round of the OW Bunker saga. The Commercial Court was asked to decide whether an assignment under contracts *'relating to the sale of oil products'* was sufficiently wide to include bunker supply contracts, notwithstanding the fact that such contracts are not contracts relating to the sale of goods / products (within the meaning of the Sale of Goods Act 1979). Also, whether the seller's standard terms and conditions were incorporated into the contract through the parties' negotiations.

## Facts

Two companies in the Cockett group of companies ('**Cockett Marine Oil**') agreed to purchase bunkers (i.e. fuel oils) from two companies in the OW Bunker group of companies ('**OW Bunker**'), one for supply to the mv ZIEMIA CIESZYNSKA (a bulk carrier) and the other for supply to the mv MANIFESTO (an LPG tanker). In both cases, OW Bunker 'subcontracted' the supply of the bunkers to third parties.

The bunkers were supplied by the third parties in October 2014. The following then happened:

— In early November 2014, OW Bunker collapsed. Pursuant to a security agreement, OW Bunker's contractual rights under contracts *'relating to the sale of oil products'* were assigned to ING Bank N.V. ('**ING**').

— Cockett Marine Oil did not pay OW Bunker / ING for the bunkers. The matter was referred to arbitration, and an award was issued determining that Cockett Marine Oil was contractually liable to pay OW Bunker / ING.

Cockett Marine Oil challenged the award under section 67 of the Arbitration Act, on the basis that the arbitral tribunal had no jurisdiction. Its arguments for challenging the award included the following:

— The alleged agreement to refer disputes to arbitration in London was contained in a clause of OW Bunker's standard terms and conditions (the '**T&Cs**'). However, Cockett Marine Oil argued that OW Bunker's T&Cs were not incorporated into, and did not form part of, the relevant bunker supply contracts. As such, the parties had not agreed to London arbitration.

— In light of the Supreme Court judgment in *PST Energy 7 Shipping LLC & Anor v OW Bunker Malta Ltd & Anor* [2016] UKSC 23 ('***PST Energy***'), an assignment of rights under contracts *'relating to the sale of oil products'* did not capture bunker supply agreements, which were not contracts relating to the sale of goods / products (within the meaning of the Sale of Goods Act 1979).

## Decision

As detailed below, the Commercial Court rejected both arguments and dismissed Cockett Marine Oil's challenge to the arbitral tribunal's jurisdiction.

**Incorporation of Standard Terms & Conditions**
As is not uncommon, the relevant bunker supply contracts were made by way of an exchange of emails / by telephone and instant messaging.

In relation to both vessels, Cockett Marine Oil communicated a desire to purchase bunkers of a certain quantity and quality. OW Bunker replied with a proposed price for the supply of those bunkers, and Cockett Marine Oil accepted the proposal. Cockett Marine Oil subsequently issued its nominations, which included provisions on payment, bunker delivery receipts, sanctions, and a request to be sent a copy of OW Bunker's latest terms and conditions of sale. OW Bunker's reply / sales order confirmation acknowledged the nominations and stated that the delivery of the bunkers was subject to OW Bunker's T&Cs.

Cockett Marine Oil argued that a legally binding contract was formed in both cases when it accepted OW Bunker's quotation, as this constituted 'acceptance' of OW Bunker's 'offer' to supply bunkers at a specified price. As OW Bunker's communications referring to its T&Cs were issued after the contracts were formed, these T&Cs were not incorporated into the contracts.

The Commercial Court was not sympathetic to this view. It could not overlook the fact that after Cockett Marine Oil confirmed their order, they added additional terms and requested a copy of OW Bunker's T&Cs. This, the Commercial Court considered, strongly suggested that Cockett Marine Oil did not think a binding agreement had already been reached. On that basis, it concluded that although Cockett Marine Oil's communication was expressed as confirmation of an order and therefore perhaps appeared to reflect the reaching of some kind of agreement, it was actually, strictly speaking, a counter-offer. Further, by sharing its T&Cs, OW Bunker identified the conduct which would amount to acceptance (namely, the acceptance of the bunkers by the vessel), and Cockett Marine Oil, by accepting the bunkers without objection, accepted OW Bunker's T&Cs.

The T&Cs were therefore held to be incorporated into the bunker supply contracts, and, accordingly, the arbitral tribunal was held to have had jurisdiction.

**Assignment of Rights**
Cockett Marine Oil then argued that the assignment in favour of ING was not sufficiently broad to transfer OW Bunker's cause of action under the bunker supply contracts to ING, so that ING had no right to refer this dispute to arbitration, and that the arbitral tribunal therefore did not have jurisdiction.

Cockett Marine Oil's argument may be summarised as follows:

— OW Bunker only assigned rights un*der contracts 'relating to the sale of oil products'* to ING in accordance with the relevant security agreement.

— The Supreme Court confirmed in *PST Energy* that Bunker supply contracts are not contracts relating to the sale of goods / products (within the meaning of the Sale of Goods Act 1979) – see above.

— Therefore, the wording of the assignment did not capture bunker supply contracts.

The Commercial Court considered that, while this argument had the *'attraction of beguiling simplicity'*, it could not be right. First, it would have meant that ING had no security attaching the sums due to OW Bunker under its many bunker supply contracts, which would be a surprising and unlikely result. Second, there was *'nothing incongruous'* about a security agreement describing bunker supply contracts as *'contracts for sale'*. It concluded that:

> *'…in commercial terms [bunker supply contracts] had many of the features or characteristics of a sale, notwithstanding the fact that they were not contracts of sale within the meaning of the Sale of Goods Act because they did not envisage the passing of property before payment was due'.*

Therefore, OW Bunker's rights under the bunker supply contracts were validly assigned to ING, ING was entitled to refer this dispute to arbitration, and the arbitral tribunal therefore had jurisdiction.

## Comment

This judgment aptly identifies the risks associated with making legally binding agreements by exchanging a series of messages. It also indicates ways in which such risks may be mitigated. Key to the mitigation of risk in this case was the provision by OW Bunker of its standard T&Cs.

However, it is easy to see how things could have turned out differently. For example, if Cockett Marine Oil had not continued to negotiate, had not suggested further terms, had not requested a copy of the supplier's terms and conditions, or had expressly rejected or objected to provisions in the supplier's terms and conditions when it received these, the case may have been decided differently.

As such, the key 'take-away' is the importance of establishing the framework under which the parties are negotiating price, quantity and quality. This might be done in several ways, such as: (i) a master sales/framework agreement between the parties governing all sales leaving key price, quantity and quality terms to be decided on each trade; or (ii) standard template wording to be used in any offer that state that the relevant party's standard terms and conditions apply.

That said, the practical reality is that in the context of supplying bunkers, it is common practice for the sellers' terms and conditions to apply to the supply contracts at each stage of the contractual chain. It is therefore perhaps not surprising that Cockett Marine Oil requested a copy of OW Bunker's T&Cs in its nomination, and not surprising that the Commercial Court considered these T&Cs to apply.

With regards to the assignment of rights to ING, this judgment clarifies the reach of the Supreme Court Judgment in *PST Energy*. Just because a bunker supply contract does not constitute a contract relating to the sale of goods within the meaning of the Sale of Goods Act 1979, as was decided in that case, this does not mean that bunker supply contracts cannot be described, in commercial terms, as a contract relating to the sale of certain goods for other purposes.

**Judge:** Teare J

# Force majeure clauses and causation: Court of Appeal guidance

In *Classic Maritime Inc v Limbungan Makmur SDN BHD* [2019] EWCA Civ 1102 the Court of Appeal decided on the extent to which a force majeure clause requires a party to prove that it would otherwise have performed its obligations in the absence of any force majeure event. In dismissing the appeal and upholding such a requirement, known as the 'but for' test, the Court of Appeal emphasized the importance of the terms of the clause over the use of general categorisations. The decision provides helpful guidance as to the types of language more likely to lead to such a result. It may signal an increase in requests for claiming parties to demonstrate their ability to perform in the absence of any force majeure event.

## Facts

Classic Maritime Inc ('**Classic**'), a ship owner, entered into a long term contract of affreightment with Limbungan Makmur SDN BHD ('**Limbungan**') for the carriage of iron ore pellets from Brazil to Malaysia. Limbungan intended to make shipments under the contract using iron ore pellets obtained from an iron ore mine in Brazil. On 5 November 2015 a tailings dam forming part of the mine burst, leading to the cessation of production.

Classic sued Limbungan for failing to make shipments under the contract. As the freight rates were agreed prior to the collapse in demand for steel in 2009, they were more than seven times the market rate at the time the dam burst, giving a sizeable claim for damages.

Limbungan defended the claim on the basis of a force majeure clause in the contract providing that: *'… the Charterers … shall [not] be Responsible for loss of or damage to, or failure to supply, load, discharge or deliver the cargo resulting from: … accidents at the mine or Production facility… always provided that such events directly affect the performance of either party under this Charter Party…'.*

Both parties accepted that an *'accident at the mine'* had occurred. However, Classic argued that due to the collapse in demand for steel, Limbungan would not have been in a position to meet the required shipments under the contract even if the dam had not burst. On the facts, the Commercial Court agreed with Classic and found that Limbungan would not have made the shipments regardless of the production stoppage. This raised an issue as to whether the force majeure clause applied in such circumstances.

Limbungan relied on a previous line of English cases (including a decision of the House of Lords) deciding that force majeure clauses which reflect the common law doctrine of frustration and provide for the immediate termination of a contract (referred to as 'contractual frustration clauses') do not require the 'but for' test for causation to be satisfied. This mirrors how the doctrine of frustration operates at common law.

Although acknowledging the similarity between the clauses considered by these cases and the clause relied on by Limbungan, the Commercial Court emphasised that the clause fell to be considered on its own terms. The cases relied upon were in any event limited to contractual frustration clauses which brought about the immediate termination of a contract. The clause under consideration was not a contractual frustration clause and the application of the 'but for' test was indicated by references to a failure to supply *'resulting from'* events which *'directly affect the performance of either party'*. Somewhat paradoxically, however, the Commercial Court only awarded Classic nominal damages on the basis that if Limbungan had been ready, willing and able to make the shipments, it would have been excused from liability under the force majeure clause, meaning that Classic would never have earned the freight.

## Court of Appeal Decision

Appeals were brought by both parties as to the causation and quantum aspects of the Commercial Court's decision respectively. As regards causation, the Court of Appeal agreed with the Commercial Court and eschewed the use of categorisation as an aid to interpretation:

> *'in deciding whether the charterer can rely on clause 32 in circumstances where it would not have performed its obligation anyway, what matters is not whether the clause is labelled a contractual frustration clause, a force majeure clause or an exceptions clause, but the language of the clause. As with most things, what matters is not the label but the content of the tin'.*

The Court of Appeal also found it difficult to say that either party's interpretation was more or less commercial than the other's. Accordingly, the Court of Appeal approached the interpretation of the clause *'without any predisposition as to the construction which should be adopted and without any need to avoid what are said to be the unfair consequences of adopting one or other of the rival constructions. It is simply a matter of construing the words of the clause'.*

In considering the language of the clause, the Court of Appeal agreed that use of the phrases *'resulting from'* and *'directly affect the performance of either party'* were supportive of the 'but for' test. The Court of Appeal identified four other aspects of the clause which also supported this conclusion:

- The reference to a *'failure to supply'* was to be read consistently with other failures covered by the clause i.e. failures to *'load, discharge or deliver the cargo'*. These other failures can only have referred to cargo which, but for the event in question, would actually have been loaded, discharged or delivered.
- The clause contained a large list of force majeure events and it was apparent that some of them were only consistent with the application of the 'but for' test such as *'seizure under legal process' and 'accidents of navigation'*.
- The events were referred to within the clause as *'causes'* which supported the impression given from the phrases *'resulting from'* and *'directly affect the performance of either party'* that the 'but for' test was to apply.
- The clause also provided (after the passage quoted above) that if *'any time is lost due to such events or causes'*, it would not count as laytime or demurrage. Previous cases had held that time would not be *'lost'* in such circumstances unless the party in question would have performed in the absence of such an event. This supported the application of the 'but for' test to the clause as a whole, as it would be illogical for this part of the clause to provide for a different causation criterion to the rest of the clause.

In relation to quantum, the Court of Appeal overturned the Commercial Court's decision. The Court of Appeal reached the view:

> *'Although the judge described his approach as an application of the compensatory principle which was realistic because it took account of the reason why the charterer was in breach of its duty to supply the cargoes, this was in my judgment an irrelevant consideration in the assessment of damages. There is no case, or at any rate none which was cited to us, in which the reason why a party is in breach of contract has been held to justify, let alone require, a different approach to the compensatory principle'.*

## Comment

The Court of Appeal's decision provides authoritative guidance as to the interpretation of force majeure clauses and is likely to have an impact on the drafting of force majeure clauses in the future. The reversal of the Commercial Court's findings as to quantum means that the application of the 'but for' test to such clauses will be of considerable significance. In the result, Classic was awarded damages of just under USD 20m in circumstances where Limbungan would have otherwise been excused from performance due to the dam failure had it been ready, willing and able to perform.

The Court of Appeal's decision provides a number of drafting observations which are likely to carry over to other clauses. The phrases *'resulting from'* and *'directly affecting performance'* are commonly used in force majeure clauses and are now likely to point toward the application of the 'but for' test. So will references to *'causes'* or *'time lost'* and the enumeration of events or circumstances which are only consistent with the application of the 'but for' test. Parties intending a broader application of such clauses will need to pay careful attention their drafting.

The case may also result in greater scrutiny of force majeure claims by parties looking to excuse non-performance. Where the 'but for' test is likely to apply, claiming parties may now be faced with early requests to show that absent the force majeure event relied upon, they would have otherwise been ready, willing and able to perform.

Whilst the Court of Appeal's emphasis on the wording of individual clauses is clear, a question may remain as to the correct approach to hybrid clauses which allow a party to terminate a contract due to a force majeure event (whether immediately or after a period of time) in addition to being relieved of liability or the obligation to perform.

Many force majeure clauses will fulfil both purposes of exempting or suspending performance and providing for the termination of the contract (typically if the force majeure event persists for a certain period of time). The FIDIC form of contract is one such example and is widely used on international oil and gas construction and engineering projects. The Crine LOGIC form is another and is widely used in the international oil and gas market. As an approach to interpretation is needed for such clauses regardless of whether the exemption/suspension or termination provisions are relied on, an interesting question arises as to which of the competing approaches discussed above ought to apply.

**Judge:** Teare J

**Court of Appeal Judges:** LJ Haddon-Cave, LJ Males and LJ Rose

# Arbitration

Any oil and gas contract or investment is only as effective as the parties' ability to enforce it. Whether by arbitration agreement in the contract, or by offer to arbitrate in an Investment Treaty, arbitration remains the most popular method of enforcement. In the past twelve months there have been some important developments:

- In *Fleetwood Wanderers Limited (t/a Fleetwood Town Football Club) v AFC Fylde Limited* [2018] EWHC 3318 (Comm) the Commercial Court remitted an award to the arbitrator for reconsideration on the basis of serious irregularity after the arbitrator sought the opinion of a third party and conducted his own research without notifying the parties.
- The German Federal Court of Justice set aside the award obtained by the Dutch investor Achmea against the Slovakian Republic in a manner that will have profound implications for investor protection through arbitration under investment treaties within the European Union.
- In *ZCCM Investments Holdings v Kanasanshi Holdings Plc & another* [2019] EWHC 1285 (Comm), the Commercial Court decided that a procedural ruling made in an arbitration was not an award, and therefore not capable of giving rise to a challenge under section 68 of the Arbitration Act.

# Arbitrator breached duty to act fairly by seeking an opinion from a third party and conducting his own research

In *Fleetwood Wanderers Limited (t/a Fleetwood Town Football Club) v AFC Fylde Limited* [2018] EWHC 3318 (Comm) the Commercial Court remitted an award to the arbitrator for reconsideration on the basis of serious irregularity after the arbitrator sought the opinion of a third party and conducted his own research without notifying the parties.

## Facts

The dispute arose out of the transfer of a professional footballer. It was alleged that Fleetwood Wanderers Limited ('**Fleetwood**') had procured a repudiatory breach of the player's contract with AFC Fylde Limited ('**Fylde**'). Fylde commenced an arbitration against Fleetwood under the Football Association Rules and FIFA's Regulations on the Status and Transfer of Players ('**RSTP**'). A question arose as to whether the RSTP was binding in domestic disputes between clubs. The arbitrator sought the opinion of the Football Association's ('**FA**') judicial services manager on this issue before rendering his award. He neither notified the parties of this approach nor gave them any opportunity to make submissions on the opinion once it was received. Based partly on this opinion and on research he had carried out himself on the internet, the arbitrator found that Fleetwood was liable to pay compensation to Fylde.

Fleetwood challenged the award under section 68(2)(a) of the Arbitration Act 1996 on the grounds that the arbitrator had failed to comply with his general duty under section 33(1) to *'act fairly and impartially as between the parties, giving each party a reasonable opportunity of putting his case'* and that this had caused substantial injustice to Fleetwood.

## Decision

### Duty to act fairly and impartially

The Commercial Court reiterated that an arbitral tribunal should give the parties an opportunity to make submissions on any issue that may be relied upon by it as the basis of its award. The parties are entitled to assume that the arbitral tribunal will base its decision solely on the evidence and arguments presented by them prior to the making of the award. The acts of the arbitrator in seeking an opinion from the FA and conducting his own research without notifying the parties constituted a breach of his general duty under Section 33(1) and thus a serious irregularity under Section 68(2)(a).

### Substantial injustice

The Commercial Court followed the test in *Alfred Uwe Maass v Musion Events Limited* [2015] EWHC 1346: *'there is substantial injustice if it can be shown that the irregularity in the procedure caused the arbitrators to reach a conclusion which, but for the irregularity, they might not have reached, as long as the alternative was reasonably arguable'*. On the facts of this case, the Commercial Court found that it was very likely that if the arbitrator had raised the question of obtaining a further opinion on the status of the RSTP, Fleetwood would have made further submissions, leading to a real prospect that the arbitrator would have concluded that the RSTP did not apply.

### Setting aside versus remitting

Instead of setting aside the award, the Commercial Court remitted it to the arbitrator for reconsideration, based on the following reasons:

- Section 68(3) provides that the Court must not set aside the award unless satisfied that it would be inappropriate to remit it to the arbitrator.
- Remitting the award for reconsideration of the part relating to the RSTP only would avoid reopening the rest of the award and thus save costs.
- The irregularity, although material, was within a narrow compass. The parties would be able to make submissions and provide evidence on the questions raised by the arbitrator with the FA.
- There was no suggestion of bias, nor any good reason to challenge the arbitrator's professionalism. There was no reason to believe that if the award was remitted, this would compromise his future conduct of the reference.

## Comment

This case sends a clear message to arbitrators regarding the interpretation of the general duty to act fairly and impartially under Section 33(1) of the Arbitration Act. Although the duty may appear simple, the conduct of the arbitration must be approached with great care, since any lack of transparency, such as independent enquiries to elicit opinions or information without notice to the parties, may amount to a breach of the duty, and thus to a serious irregularity.

As Sections 33 and 68 are mandatory provisions of the Arbitration Act 1996, they will apply whenever the chosen seat of arbitration is in England and Wales. In choosing England and Wales as an arbitral seat, the parties can be assured that these minimum protections are afforded by law.

**Judge:** Halliwell J

# The German Federal Court of Justice rules in Achmea – entry into the EU renders Slovakia's offer for Intra-EU arbitration inapplicable

In its recent decision (I ZB 2/15), the German Federal Court of Justice ('**BGH**') set aside the award obtained by the Dutch investor Achmea against the Slovakian Republic. The BGH's decision came down on 31 October 2018 and was not unexpected given that the German court had issued a reference for a preliminary ruling by the Court of Justice of the European Union ('**CJEU**') that led to the CJEU's 6 March 2018 decision (C-284/16), which found that the arbitration clause referred to by Achmea was incompatible with EU law.

Although the BGH had indicated a different view in its preliminary-ruling reference, the BGH in its final decision followed the CJEU, ruling that there was no arbitration agreement between Achmea and Slovakia. The BGH decided that when Slovakia joined the EU on 1 May 2004 – and thus before Achmea initiated arbitration proceedings in 2008 – the state's offer to investors to conduct arbitration proceedings became inapplicable. As a result, there was no valid offer for Achmea to accept, when Achmea commenced arbitration against Slovakia.

## Facts

The issue related to proceedings between the Slovak Republic and Achmea BV concerning an arbitral award of 7 December 2012 made by the arbitral tribunal provided for by the Agreement on encouragement and reciprocal protection of investments between the Kingdom of the Netherlands and the Czech and Slovak Federative Republic (the '**BIT**').

The BIT, concluded in 1991, entered into force on 1 January 1992. On 1 May 2004 it acceded to the European Union.

In the arbitration proceedings the Slovak Republic raised an objection of lack of jurisdiction of the arbitral tribunal. It submitted in that respect, as a result of its accession to the European Union, recourse to an arbitral tribunal provided for in Article 8(2) of the BIT was incompatible with EU law. By an interlocutory arbitral award of 26 October 2010, the arbitral tribunal dismissed the objection. The applications for that award to be set aside brought by the Slovak Republic before the German courts were unsuccessful at first instance and on appeal.

By arbitral award of 7 December 2012, the arbitral tribunal ordered the Slovak Republic to pay Achmea damages in the principal amount of EUR 22.1m. The Slovak Republic brought an action to set aside that arbitral award before the Oberlandesgericht Frankfurt am Main (Higher Regional Court, Frankfurt am Main, Germany). When that court dismissed the action, the Slovak Republic appealed on a point of law against the dismissal to the BGH. The BGH decided to stay the proceedings and to refer the following questions to the CJEU for a preliminary ruling:

> *'(1) Does Article 344 TFEU preclude the application of a provision in a bilateral investment protection agreement between Member States of the European Union (a so-called intra-EU BIT) under which an investor of a Contracting State, in the event of a dispute concerning investments in the other Contracting State, may bring proceedings against the latter State before an arbitral tribunal where the investment protection agreement was concluded before one of the Contracting States acceded to the European Union but the arbitral proceedings are not to be brought until after that date?*
>
> *If Question 1 is to be answered in the negative:*
>
> *(2) Does Article 267 TFEU preclude the application of such a provision?*
>
> *If Questions 1 and 2 are to be answered in the negative:*
>
> *(3) Does the first paragraph of Article 18 TFEU preclude the application of such a provision under the circumstances described in Question 1?'.*

## Court of Justice of the European Union Decision

The CJEU considered that it must be ascertained, first, whether the disputes which the arbitral tribunal, mentioned in Article 8 of the BIT, is called on to resolve are liable to relate to the interpretation or application of EU law.

Even if, as Achmea in particular contends, that arbitral tribunal, despite the very broad wording of Article 8(1) of the BIT, was called on to rule only on possible infringements of the BIT, the fact remains that in order to do so it must, in accordance with Article 8(6) of the BIT, take account in particular of the law in force of the contracting party concerned and other relevant agreements between the contracting parties.

In the present case, the arbitral tribunal chose to sit in Frankfurt, which made German law applicable to the procedure governing judicial review of the validity of the arbitral award. It was thus that choice which enabled the Slovak Republic, as a party to the dispute, to seek judicial review of the arbitral award, in accordance with German law, by bringing proceedings to that end before the competent German court.

By concluding the BIT, the Member States party to it established a mechanism for settling disputes between an investor and a Member State which could prevent those disputes from being resolved in a manner that ensures the full effectiveness of EU law, even though they might concern the interpretation or application of that law.

Article 8 of the BIT was such as to call into question not only the principle of mutual trust between the Member States but also the preservation of the particular nature of the law established by the Treaties, ensured by the preliminary ruling procedure provided for in Article 267 TFEU, and is not therefore compatible with the principle of sincere cooperation. In those circumstances, Article 8 of the BIT had an adverse effect on the autonomy of EU law.

Consequently, the answer to Questions 1 and 2 is that Articles 267 and 344 TFEU must be interpreted as precluding a provision in an international agreement concluded between Member States, such as Article 8 of the BIT, under which an investor from one of those Member States may, in the event of a dispute concerning investments in the other Member State, bring proceedings against the latter Member State before an arbitral tribunal whose jurisdiction that Member State has undertaken to accept. In view of the answer to Questions 1 and 2, there was no need to answer Question 3.

## BGH Decision

The BGH set aside the award obtained by the Dutch investor Achmea against the Slovakian Republic. The BGH's decision was not unexpected given that the German court had issued a reference for a preliminary ruling by the CJEU.

Although the BGH had indicated a different view in its preliminary-ruling reference, the BGH in its final decision followed the CJEU, ruling that there was no arbitration agreement between Achmea and Slovakia. The BGH decided that when Slovakia joined the EU on 1 May 2004 – and thus before Achmea initiated arbitration proceedings in 2008 – the state's offer to investors to conduct arbitration proceedings became inapplicable. As a result, there was no valid offer for Achmea to accept when Achmea commenced arbitration against Slovakia.

The BGH made its finding on the basis of the German Arbitration Law, which states that an invalid arbitration agreement between parties constitutes grounds for setting aside an arbitral award. The BGH found that a non-existing arbitration agreement is equivalent to an invalid agreement.

The BGH noted that, in principle, an arbitration agreement between the parties could have been concluded through the commencement of arbitration proceedings by Achmea. By initiating arbitration proceedings, the investor usually accepts the offer made by a state in a BIT to conduct arbitration proceedings with investors from another state.

In this specific case, however, there was no valid Slovakian offer at the time the arbitration proceedings were initiated. A respective offer was originally provided for in Article 8(2) of the Netherlands-Slovakia BIT. Once Slovakia joined the EU, however, the offer became inapplicable because – according to the CJEU ruling, rendered as a result of the BGH's reference – Article 8 of the Netherlands-Slovakia BIT is not compatible with the principle of sincere cooperation among EU member states (Article 344 TFEU) and the autonomy of EU law ensured by the preliminary ruling procedure (Article 267 TFEU).

The BGH clarified that EU law became part of the applicable law to the dispute under Article 8(6) of the Netherlands-Slovakia BIT when Slovakia joined the EU on 1 May 2004. As of that moment, the treaty became an Intra-EU BIT and Article 8(2) was no longer applicable in light of the CJEU declaring the arbitration offer incompatible with EU law.

The BGH recognised that Article 8 of the Netherlands-Slovakia BIT is contained in a treaty that is generally binding only on the Netherlands and Slovakia. The provision's inapplicability, however, caused Slovakia's offer to conduct arbitration proceedings with Dutch investors to lapse. In short, there was no longer a corresponding Slovakian offer that Achmea could have accepted by initiating arbitration proceedings. In this way, the BIT is inseparably linked to the arbitration agreement.

## Comment

**Fate of other Intra-EU arbitral awards**
The ground to set aside an arbitral award due to the invalidity or the lack of an arbitration agreement under German Arbitration Law is based upon the UNCITRAL Model Law and therefore also part of numerous other arbitration regimes. The ground also corresponds to one of the grounds for non-recognition of an arbitral award under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Hence, other intra-EU awards that are subject to enforcement in Germany or other EU member states could also suffer the same fate as the Achmea award.

The crucial question will be whether the CJEU's ruling on Article 8(2) of the Netherlands-Slovakia BIT also applies to the arbitration offers contained in other Intra-EU BITs. While the operative part of the CJEU's ruling is formulated in rather general terms and could thus be considered transferable to other BITs, the CJEU's underlying reasoning deals with some specific aspects of Article 8 which cannot be found in the dispute settlement clauses of other BITs. This applies in particular to Article 8(6), which explicitly provides for the applicability of Slovakian law (and by extension EU law) to the dispute. This leaves room for a different interpretation of other BITs.

Furthermore, it must be taken into account that the grounds for setting aside an award under German Arbitration Law are not applicable to arbitral awards rendered under the ICSID Convention. ICSID arbitral awards are subject to a particular enforcement regime, which does not allow for a review of the arbitration agreement by national courts. This also applies to the *Vattenfall v Germany* (ICSID Case No. ARB/12/12) arbitration, in which the arbitral tribunal recently confirmed its jurisdiction despite the Achmea judgment. The Vattenfall decision concerned the arbitration offer contained in the Energy Charter Treaty ('**ECT**').

**EU Member States adopt declaration on the termination of all bilateral investment treaties**
On 15 January 2019, representatives of EU Member States made the first formal step towards ending bilateral investment protection treaties signed between EU Member States ('**intra-EU BITs**') when they signed the Declaration of the Representatives of the Governments of the Member States on the Legal Consequences of the Judgment of the CJEU in Achmea and on investment protection in the EU (the

'**Declaration**'). By this step, Member States have confirmed full respect for the Court's ruling in the Case C-284/16 Achmea.

Twenty-two of the twenty-eight EU Member States (Belgium, Bulgaria, Czech Republic, Denmark, Germany, Estonia, Ireland, Greece, Spain, France, Croatia, Italy, Cyprus, Latvia, Lithuania, the Netherlands, Austria, Poland, Portugal, Romania, Slovakia and the UK), have now committed to take all necessary steps to formally terminate intra-EU BITs and will not conclude any new ones. They have also pledged to notify arbitral tribunals of the non-arbitrability of claims arising from or in connection with such BITs and Energy Charter Treaty claims; and to request to set-aside related intra-EU awards. Nonetheless, although general media assign much higher importance to the Declaration, from the perspective of public international law, the Declaration has no direct legal power and did not and cannot terminate or modify the existing intra-EU BITs. The Declaration is simply an expression of the intention of the Member States to terminate these treaties in the future. In addition, with regard to the ECT, the Member States are still to form a joint position on the consequences of the Achmea judgment.

The Declaration complements the earlier Commission Communication on the protection of cross-border investments within the Capital Markets Union, issued on 19 July 2018, confirming that investors from EU Member States are fully protected in the Single Market by EU law and the protection of these rights is ensured by the EU national Courts and the European Court of Justice. The Declaration does not change the legal situation for intra-EU investment disputes for now. On the other hand, the Member States' aim is to deter investors from bringing new investment claims by announcing that their home states will challenge the relevant proceedings. This will, amongst other things, increase the potential costs of arbitral proceedings until the stage of enforcement, thereby rendering intra-EU arbitrations unattractive. Interestingly, Member States implicitly recognise that a functioning system is being abolished without equivalent legal protection – in particular with regard to judicial protection – being put in place. On this basis they have announced the intention to discuss and possibly create new mechanisms for intra-EU investment protection. Whether, when or how this will happen is still unclear.

The Czech Ministry of Foreign Affairs confirmed that the signing of the Declaration is a confirmation of a long-standing position of the Czech Republic, which has firmly maintained there is no space for intra-EU BITs in the EU Single Market. A different position has been taken by Hungary, which has adopted a separate version of the Declaration regarding the effect of the Achmea case on the investor-State arbitration clause contained in the ECT, which may be fuelled by pending disputes. Also, other states including Finland, Luxembourg, Malta, Slovenia and Sweden, jointly signed a separate version of the Declaration departing from the majority on the same issue concerning the impact of the Achmea judgment on the applicability of the ECT arbitration clause. The different views on the extent of the applicability of the Achmea case may potentially result in investors seeking more arbitration friendly jurisdictions in the future, however for now the Declaration might be considered as an inappropriate measure of the European Commission and the respective Member States and interfere with ongoing arbitral proceedings.

**Impact on energy investments**

The impact of the Achmea judgment on existing and future energy investments within the EU remains unclear. It appears to be settled policy of the European Commission, and some Member States, to end any protection of EU nationals investing in other Member States under the terms of BITs and the ECT. As a consequence, in structuring investments in the EU, oil and gas companies should consider whether there are advantages of using investment vehicles domiciled, as nationals, outside the EU. In respect of the ECT this might result in limited options.

It remains to be seen whether Brexit, and any associated future arrangements between the UK and the EU, will open up new horizons on investment protection. It also remains to be ascertained whether the UK's membership of the EU has the effect of permanently revoking any offer to arbitrate in a UK/EU Member State BIT – or whether the offer to arbitrate remains live.

**Judges:** E. Juhász, A. Borg Barthet, J.-C. Bonichot, F. Biltgen, K. Jürimäe, C. Lycourgos, M. Vilaras and E. Regan

# Is an interim decision by an arbitral tribunal capable of giving rise to a challenge?

In *ZCCM Investments Holdings v Kanasanshi Holdings Plc & another* [2019] EWHC 1285 (Comm), the Commercial Court decided that a procedural ruling made in an arbitration was not an award, and therefore not capable of giving rise to a challenge under Section 68 of the Arbitration Act 1996 (the '**Act**').

## Facts

ZCCM Investments Holdings ('**ZCCM**'), a Zambian investment entity, applied to the tribunal for permission to pursue a derivative claim in the name of a company, Kanasanshi Holdings Plc ('**KHL**'), in which it was a shareholder. The arbitral tribunal refused permission, finding that ZCCM had failed to make a *prima facie* case.

ZCCM applied under Section 68 of the Arbitration Act 1996 to challenge the decision on the grounds of serious irregularity or lack of fairness. This required the Commercial Court to examine whether the decision constituted an award, since only an award can be challenged under Section 68.

ZCCM suggested that the test was whether or not the decision finally determined a particular issue or claim. Since the arbitral tribunal's ruling brought ZCCM's claim to an end, it constituted an award. In addition, the ruling had several formal attributes that suggested it was an award, including that it had been signed by all three arbitrators and specified the location of the seat.

KHL argued that the application for permission was an intrinsically procedural device; the cause of action belonged to KHL and was not brought to an end by the ruling. In addition, at the end of the hearing KHL had expressly asked the arbitral tribunal to make an award rather than a procedural ruling, and the arbitral tribunal had declined.

## Decision

The Commercial Court noted that the authorities on the subject were highly fact-specific and did not establish any clear set of principles by which to make this determination.

However, the Commercial Court set out the following criteria:

— The Court will give weight to the substance of the decision and not merely its form.

— A decision dealing purely with procedural issues is unlikely to be an award.

— If the decision deals with substantive rights and liabilities, it is more likely to be an award.

— If the decision finally disposes of an issue or claim, that is a factor pointing to the decision being an award.

— The arbitral tribunal's own description of the decision is relevant, but not conclusive.

— It may be relevant to consider how a reasonable recipient of the decision would have viewed it. In this regard:

  - A reasonable recipient is likely to consider objective attributes such as the arbitral tribunal's description of the decision, the formality of the language and the level of detail of the reasoning.
  - A reasonable recipient will also consider whether the decision complies with any formal requirements for an award under the applicable rules.
  - The reasonable recipient should be taken to have all the information that was available to the parties and the arbitral tribunal, including the procedural context.

Applying these principles to the facts, the Commercial Court concluded that the decision in this case was an interim ruling and not an award. It was in essence procedural and did not bring the arbitration to an end, since KHL could pursue the claim if it wished. At 22 pages, it was shorter than would be expected for a final award in a multi-million-pound claim and dealt with the issues in a 'compressed' form that was more suitable to a procedural ruling.

The Commercial Court therefore dismissed ZCCM's challenge.

## Comment

This case will be useful both to arbitrators and to arbitration practitioners, given that it appears to provide for the first time a coherent set of criteria for determining whether a decision is an interim ruling or a final award that can be the subject of a Section 68 challenge. It emphasises the limited scope of challenge concerning acts of an arbitral tribunal, which may be reassuring the parties that are concerned with the potential for continued court interference.

**Judge:** Cockerill J

# REMIT: Regulatory

Regulation (EU) No. 1227/2011 on wholesale energy market integrity and transparency ('**REMIT**') prohibits market abuse in relation to wholesale energy products. As European energy markets have liberalised, National Regulatory Authorities ('**NRA**') in the energy sector are significantly stepping up investigations and fines pursuant to REMIT across Europe.

— The disciplinary tribunal of the French Regulatory Commission fined VITOL S.A for engaging in market manipulation on the French Southern virtual Gas Trading Point.

— In December 2018 it was announced that the Spanish NRA, Comisión Nacional de los Mercados y la Competencia fined Galp Gas Natural S.A. and Multienergía Verde, S.L.U for market manipulation and Energitilsynet, the Danish NRA, issued a fine to Energi Danmark A/S for 10 counts of market manipulation.

## French regulator imposes EUR 5m for market manipulation

The disciplinary tribunal ('**CoRDiS**') of the French Regulatory Commission ('**CRE**') fined VITOL S.A ('**VITOL**') for engaging in market manipulation on the French Southern virtual Gas Trading Point. This fine results from an investigation opened in April 2014, which found the energy and commodities company's behaviour breached Article 5 of REMIT, which prohibits any engagement in, or attempt to engage in, market manipulation on wholesale energy markets.

### Facts

Between 1 June 2013 and 31 March 2014, in relation to the French Southern virtual Gas Trading Point, VITOL:

— Issued multiple sell orders, at the beginning of the trading day when liquidity was low;

— as the day moved along, it issued sell orders at gradually decreasing prices and with decreasing frequency after 4 a.m. during the more liquid period of the day;



— once the gas prices had decreased, VITOL would engage in gas purchases; and

— following these purchases, VITOL would cancel its sell orders to finish the day as a net buyer.

## Regulator's Decision

The investigation found that VITOL had engaged in market manipulation in relation to the French Southern virtual Gas Trading Point.

CoRDIS found that VITOL engaged in such behaviour in 65 cases spread over 54 trading days. It was held that this activity was likely to give the wider energy market misleading signals as to the gas supply or demand on the French Southern virtual Gas Trading Point, which amounted to market manipulation. As a result, it imposed a EUR 5m fine on VITOL.

## Comment

In response, in its 9 October 2018 press release, VITOL rejected the findings, and announced that it would be appealing the decision. It maintains that its trading strategies were appropriate to physical energy markets and were in accordance with the applicable market regulations. Furthermore, VITOL has stated that CoRDiS did not follow due process and that had it done so, the result of the investigation would have been different.

This was the first fine levied by an NRA under REMIT in relation to the gas market. It also comes as a timely reminder to market participants that historic activity will be actively pursued by NRAs.

Although there are other prohibitions/obligations set out in REMIT (e.g. relating to the use of inside information), it is worth highlighting that a breach of Article 5 (i.e. breaching the prohibition on market manipulation) does not necessarily require that there is an intention to do so; a market participant may be found as having manipulated the market in breach of REMIT if it enters into any transaction or issues an order to trade that gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of wholesale energy products. Further, given that the definition of market manipulation in REMIT is very broad, Agency of the Cooperation of Energy Regulators ('**ACER**') has stated that it should be read together with the further detail provided in its guidance on REMIT.

Lastly, as markets continue to liberalise in Europe, there is likely to be greater regulatory scrutiny of issues concerning market manipulation and use of inside information. Experiences elsewhere in the world suggest that liberalising and liberalised energy markets are prone to manipulation and abuse. REMIT sets rules prohibiting certain trading practices and requiring specified steps to be taken concerning inside information. However, the scope of REMIT continues to lack clarity. For example, with markets that continue to contain a mixture of traded and long-term gas sales agreements there is little official guidance on practices such as a market participant trading around its own day-ahead nominations, not necessarily known to the market, under big legacy pipeline contracts the might impact the volume of gas in the market the next day.

# More fines imposed under REMIT

In December 2018 it was announced that: the Spanish NRA, Comisión Nacional de los Mercados y la Competencia ('**CNMC**') fined Galp Gas Natural S.A. ('**Galp**') and Multienergía Verde, S.L.U ('**Multienergía**') for market manipulation; and Energitilsynet, the Danish NRA, issued a fine to Energi Danmark A/S for 10 counts of market manipulation, in each case for breaches of REMIT.

## Spain

Spanish NRA, CNMC published a press release announcing its decision to fine Galp and Multienergía EUR 80,000 and EUR 120,000 respectively for market manipulation under REMIT. CNMC determined that from 12 to 20 January 2017 and on 17 January 2017, Multienergía and Galp respectively secured or attempted to secure the price of several natural gas wholesale products for delivery in Spain, traded at an artificial level. Multienergía sold MIBGas for next day delivery at an artificially high level in the final seconds before market close breaching Article 5 of REMIT that prohibits market manipulation. Similarly, Galp secured the prices of the natural gas day-ahead product for delivery in Spain at an artificial level.

## Denmark

Energitilsynet, the Danish NRA, issued a fine to Energi Danmark A/S of approx. EUR 100,000 and, in addition, the Danish State Prosecutor for Serious Economic and International Crime has confiscated the revenue of EUR 47,000 obtained through the 10 counts of market manipulation. It was reported that according to Energitilsynet, Energi Danmark A/S breached the prohibition on market manipulation set out in Article 5 of REMIT by capacity hoarding. In a published ACER guidance note, capacity hoarding is described as the act of acquiring all or part of the available transmission capacity without using it or without using it effectively. Energi Danmark A/S hoarded capacity on the electricity interconnectors by trading with itself managing to exclude third party traders and thereby hinder competition. These trades led to or could have potentially led to the creation of misleading or artificial prices on the intraday wholesale market for electricity.

## Comment

Evidence suggests that NRAs have been increasingly exercising their authority to monitor, investigate and enforce breaches of REMIT. Over the course of 2018, there have been five main instances when fines have been issued under REMIT by NRAs, the first three being:

- In April 2018, the Spanish NRA, CNMC, fined five companies a total of EUR 10,200 for a breach of their obligation to register as market participants under REMIT;
- in May 2018 the Hungarian NRA, Magyar Energetikai és Közmű-szabályozási Hivatal sanctioned an organised market place with a fine of approximately EUR 40,000 for a breach of reporting obligations under REMIT; and
- in October 2018, the disciplinary tribunal of the French Regulatory Commission fined VITOL S.A EUR 5m for engaging in market manipulation on the French Southern virtual Gas Trading Point (see above).

To the extent that recent activity is a guide to the future, these developments suggest that energy companies should prepare for more assertive policing by NRAs in respect of their REMIT compliance.

Due to the liberalisation of the European energy markets, there is less scope for abusive monopolistic behaviours to emerge. Nevertheless, there has been a corresponding increase in fines that NRAs are issuing under REMIT relating to market participants seeking to allegedly manipulate markets to make wrongful commercial gains.

Energy companies can expect increased scrutiny from NRAs. The experience from the United States suggests that liberalised energy markets are prone to manipulation and energy regulators, over time, step up investigations and fines into such perceived activities.

# UK Oil and Gas Industry Regulation 2019

## The Oil And Gas Authority

The Oil and Gas Authority's ('**OGA**') principle objective, as determined by statute, is 'MER UK' – that is, maximising the economic recovery of oil and gas from the UK Continental Shelf ('**UKCS**'). In its first two years of operation, the OGA has focused on establishing an outline and structure for its activities and helping the industry understand what 'business as usual' might look like under the MER UK regime, both through its approach to discussions with companies and through the production of a series of guidance notes covering most of the OGA's focus areas.

In 2018–2019, the OGA's third year, it has continued to work to improve the quality and quantity of data and information available to the industry to support an ongoing focus on exploration. It has built on the foundations laid in previous years and begun to place more emphasis on its regulatory powers. The OGA has articulated its intention to be more transparent in its regulatory work, on the basis that such openness will support MER UK. Of course, there is still a balance to be struck between that transparency and the need to preserve the confidentiality of sensitive commercial matters to ensure the confidence of the industry in its regulator.

In addition, the OGA has highlighted its role in the Energy Transition. Alongside this, the regulator has made awards under the 31st and 31st Supplementary Offshore Licensing Rounds as well as awarding its first carbon dioxide appraisal and storage licence.

Further details of some key developments since our 2018 Annual Review are set out below.

### Licensing

The OGA has powers to award licences and consent to licence assignments under the Petroleum Act 1998 and has held two licensing rounds in the last year. The 31st Offshore Licensing Round, in accordance with the OGA's policy of alternating licensing rounds between frontier and mature areas, focused on blocks in frontier areas of the UKCS in the Faroe-Shetland Basin, Moray Firth, East Irish Sea, East Shetland Platform, Mid North Sea High and English Channel. The OGA offered for award 37 licence areas covering 141 blocks, or part blocks. Those awards were made to 30 companies, ranging from well-known super-majors to new UKCS entrants acquiring licence interests for the first time. The awards were encouraging in terms of prospects for future activity on the UKCS, particularly in relation to exploration and production opportunities in never-before licensed areas.

The 31st Supplementary Offshore Licensing Round, which focused on the Greater Buchan Area, was the first time the OGA had linked a licence round offer with an Area Plan. The application process required applicants to demonstrate their wider area plan development concepts and to seek to collaborate with other area licensees and applicants. The round offered blocks under flexible terms, enabling applicants to define a licence duration and phasing that would allow them to execute the optimal MER UK work programme. The OGA offered for award four licences, covering five blocks, to three companies.

The OGA also announced the award of its first carbon dioxide appraisal and storage licence. The award was made to Pale Blue Dot Energy for the Acorn Carbon Capture and Storage Project. This followed an announcement from the government of its 'UK carbon capture usage and storage ('**CCUS**') deployment pathway' action plan. That plan set out the next steps government and industry ought to take in order to have the option of deploying large-scale CCUS from 2030 (subject to costs coming down sufficiently).

The 32nd Licensing Round was launched on 10 July 2019 and offers 768 blocks or part-blocks across the main producing areas of the UKCS. The closing date for applications is 12 November 2019 and decisions are expected to be made in the second quarter of 2020.

## Information, Data and Digitisation

In its first two years, the OGA focused on making the best use of the vast quantity of information held across the industry. It had a number of aims: to ensure that, as a regulator, it had available to it sufficient accurate and detailed information to carry out its role effectively; to improve the quality and accuracy of the data and information held; and to improve access to that information, with a view to ensuring that the industry gained full value from it. The OGA has continued that work over the last year, finalising guidance aimed at the ingathering of information and taking considerable steps to enhance access to existing data, primarily through the new National Data Repository.

### Guidance on reporting and disclosure of information and samples

The OGA's 'Guidance on Reporting and Disclosure of Information and Samples' set out:

> *'i. requirements for compliance with the Oil and Gas Authority (Offshore Petroleum) (Retention of Information and Samples) Regulations 2018 (the '**Retention Regulations**'). Information must be retained, as it may be required to be reported to the OGA in accordance with a notice issued under s.34 of the Energy Act 2016 (the '**2016 Act**'). A s.34 notice may cover routine reporting of information submitted to the OGA as part of its normal regulatory activities, or 'one off' notices for specified items, samples, or datasets. The Retention Regulations set out what samples are required to be reported to the OGA, either on a 'routine' or 'standalone' basis, including in relation to an agreed Information and Samples Plan or in response to a request for disposal of the samples in question. The Guidance summarises the samples to be reported, the form and manner, where and when they should be reported, and whether reporting is routine or in response to a standalone s.34 notice; and*
>
> *ii. how the OGA will implement the Oil and Gas Authority (Offshore Petroleum) (Disclosure of Protected Material after Specified Period) Regulations 2018 (the '**Disclosure Regulations**'), which cover the OGA's power to disclose information and samples after varying specified periods'.*

### The OGA's Statutory Notice on Meetings

On 7 November 2018, the OGA updated its 'Meetings Statutory Notice', amending the list of meetings that fall within the notification requirements in Part 2, Chapter 4, of the 2016 Act to reflect its latest set of priorities. Previous Statutory Notices identified meetings to which the obligation to notify applies (specifically in relation to Operating Committee Meetings and Technical Committee Meetings) by listing assets which reflected the OGA's 'Opportunity Matrix'. However, the Opportunity Matrix is no longer used for this purpose, and so this latest Notice reflects the assets identified in connection with the OGA's Priority Area Plans.

### National Data Repository

On the 25 March 2019, the OGA launched the UK Oil and Gas National Data Repository ('**NDR**') which is said to be one of the largest ever single open releases of data. The NDR is an online platform, freely available to all, containing 130 terabytes of well, geophysical, field and infrastructure data, covering more than 12,500 wellbores, 5,000 seismic surveys, and 3,000 pipelines.

The aim of the NDR is to support MER UK and the realisation of the estimated 20 billion barrels of oil and gas that remain. It seeks to unlock new investment and technology and to support more exploration activity. In addition, it is said that the NDR will play an important role in the energy transition, including, for example, enabling future CCUS projects.

### UKCS Technology portal

On 17 May 2019, the OGA announced the launch of a UKCS technology portal. The portal is based on information provided by operators through the OGA's Stewardship Survey and other sources. The portal is designed to enable operators to access information and lessons learned on technology deployment, and to promote engagement with the supply chain, the Oil and Gas Technology Centre and other providers to address technology needs in the industry. The goal is to provide visibility on technologies currently available to the industry as well as enabling the identification of research and development opportunities for future technologies.

## Regulatory approach

**Enquiry Guidance**

The OGA published its Enquiry Guidance on 15 May 2019. This guidance on the handling of enquiries carried out pursuant to the 2016 Act sets out the process the OGA will 'normally' adopt when carrying out an enquiry – though the guidance is to be applied 'flexibly' and the regulator may adopt a different approach, should the facts of a particular matter justify it. In determining the outcome of an enquiry, the OGA intends to adopt principles of fairness, proportionality, and transparency (subject to considerations of commercial confidentiality).

The enquiry process is intended to enable the OGA to assess the most appropriate course of action, taking into account the full range of regulatory powers available to it. It is important to note that enquiries will not automatically result in the application of any formal procedure, but if the enquiry indicates that there may have been a breach of MER UK the OGA may launch an investigation with a view to possible imposition of sanctions. Conversely, however, it should be borne in mind that the OGA may proceed directly to an investigation without first carrying out an enquiry. The OGA's previously published Dispute Resolution Guidance and Sanction Procedure are helpful to consider alongside the Enquiry Guidance for a fuller overview of the procedures the OGA will follow in relation to investigations and sanctions.

**The OGA's open letter to industry outlining the next stage of its regulatory approach**

On 4 June 2019, the OGA's Director of Regulation, wrote to all licensees and infrastructure owners regarding the next stage of its regulatory approach.

The letter stated that, while the OGA has seen an impressive rejuvenation of the UKCS since it came into operation, it is still seeing a number of examples of behaviour threatening MER UK or indicating a lack of awareness of the obligations imposed by the MER UK Strategy.

The OGA highlighted that its approach to date has been incremental, through its 'measured escalation' process, whereby it gradually increases the intensity and seriousness of interventions as issues become critical or continue for too long. According to the OGA's statistics, it has intervened to resolve 56 cases since the start of 2017. The OGA states that the majority of operators, licensees and infrastructure owners have responded well to its approach to date and have made changes to their businesses to align with the requirements of MER UK. However, the OGA considers that challenges remain and that many issues are taking too long to resolve, threatening MER UK. Accordingly, the OGA intends to progressively be more proactive in the use of its powers. Though it states the change will not be dramatic, the OGA does intend to take on more cases and to be more transparent about the work it is doing in this regard.

**Investigation: Cygnus and Pegasus**

On 25 June 2019, the OGA opened a non-binding dispute resolution investigation into the prioritisation of access to Cygnus capacity in relation to transportation and processing services for gas from the Pegasus field. It is notable that the OGA named the parties to the investigation which, prior to the publication of its Enquiry Guidance in May 2019, it did not generally do. The OGA has said it will provide updates as the investigation progresses.

**Revised Stewardship Expectations**

The OGA, in consultation with industry, published a revised set of stewardship expectations on 19 July 2019. The OGA's original stewardship expectations were published in 2016. The revised set contain two new expectations: (1) well activity performance; and (2) commercial alignment and delivery. There are ten stewardship expectations in total, each directly linked to the MER UK Strategy and seeking to provide clarity on behaviours and good practices to the industry.

The expectations are not intended to have binding legal effect. However, the OGA will use them to measure the performance of parties and, if necessary, seek to improve performance. If an expectation has not been achieved, the OGA may deem the party to be failing to comply with the MER UK Strategy.

## The Energy Transition

The UK Government's announcement of binding 'net zero emissions' legislation on 27 June 2019 attracted much media attention. The obvious question that follows is: how is that to be achieved? It is an issue that many industries, including the oil and gas sector, have been considering for some time but perhaps unsurprisingly, it has become a key focus for the OGA over the last year or so. In response, the OGA has now published its policy position on its role in the energy transition.

The OGA has continually expressed its support in the transition to a low carbon economy, and this was identified as a thematic priority in the OGA Corporate Plan for 2019–2024. While the energy transition is sometimes seen as a risk to the UK oil and gas industry, the OGA's intention appears to be to focus the industry generally on the opportunities it may present.



The objectives of OGA's policy are stated to be:

- To support fully the UK's transition to a low carbon economy;
- to have regard to minimising carbon emissions from the UK offshore oil and gas sector;
- to use skills and expertise to work with government, industry and other relevant stakeholders to support wider energy transition initiatives; and
- to engage fully with the energy transition to support MER UK by creating further efficiencies and to contribute to the industry's continued licence to operate.

## Looking forward

On 25 April 2019, the OGA published its Corporate Plan. This Plan set out the priorities for 2019–2024. It considers the OGA 'way forward' framework under the headings of seven OGA themes, and sets new priorities and KPIs for the next five years. In addition, the Plan describes budgets and forecasts for the coming years and, finally, sets out the OGA project activities for 2019.

The OGA's 'way forward' framework was first captured in its inaugural Corporate Plan in 2015. This described seven OGA themes and how they would be pursued in light of the OGA's overall ambition, purpose, and values. The framework and themes defined in 2015 remain consistent in the new Plan, being to: (1) revitalise exploration; (2) improve asset stewardship; (3) drive regional development; (4) improve decommissioning efficiency; (5) leverage technology and data; (6) create the right conditions; and (7) develop people, processes and systems. However, the priorities, methods of delivery, and KPIs associated with the themes have been updated.

The Plan also places a firm focus on progress towards Vision 2035, asking industry leaders to work towards this future. It calls for inclusion, workforce engagement, and collaborative partnerships and business models which can deliver value at pace. Vision 2035 is about extending the life of the UKCS by at least a generation, and doubling supply chain opportunities to deliver jobs, security of supply chain and, through the energy transition, a lower carbon future.

# Index of cases

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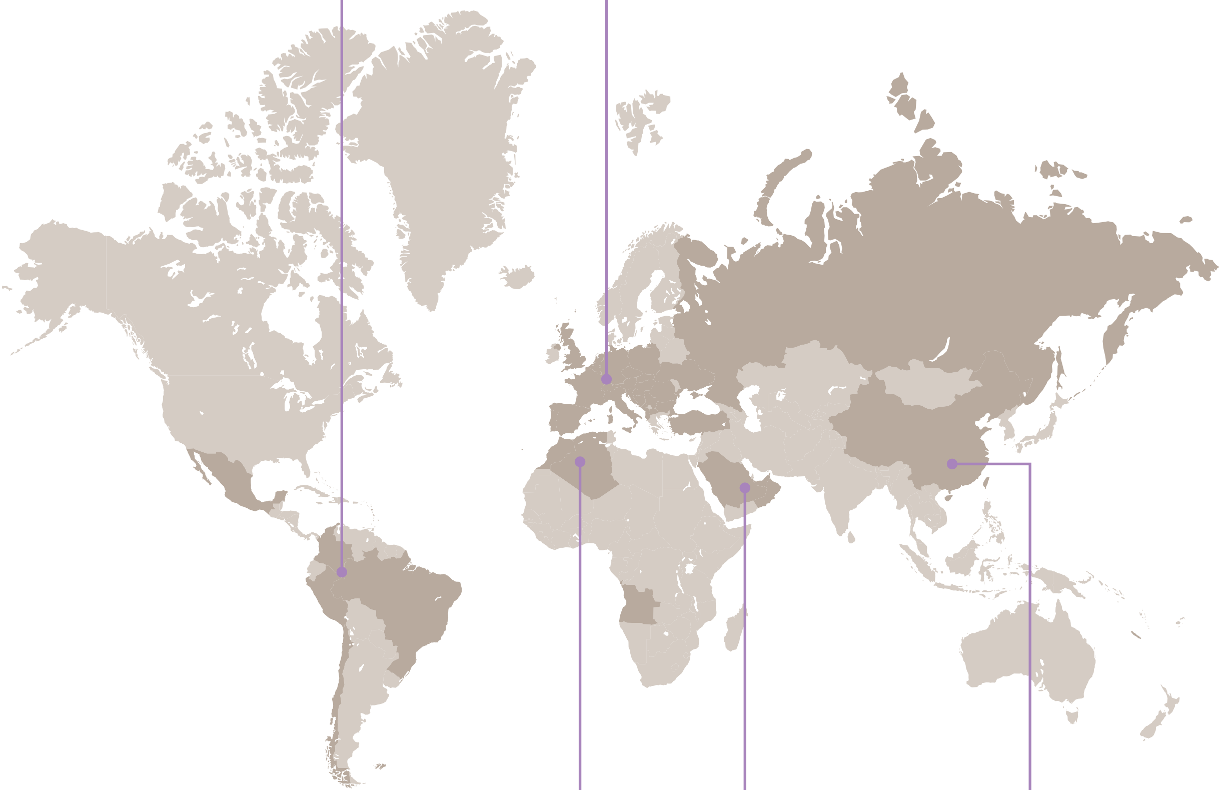

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