Commodities

October 2013

COMMODITIES BULLETIN

Recaps, contract formation, description and quality

In *Proton Energy Group SA v Orlen Lietuva* (24 September 2013), an interesting case for commodity traders, the English High Court ruled on the question of whether a contract had been formed by the exchange of recap messages between traders.

The Court reaffirmed that the formation of a binding contract depends upon an objective assessment of the agreed terms – and whether they include sufficient terms that the law regards as essential for the formation of legally binding relations.

The judgment also provides a useful reminder of the important distinction between the description of goods and terms relating to their quality.

Facts

By an email dated 14 June 2012, Proton made a 'firm offer' to sell Orlen 25,000MT Crude Oil Mix CN27090090, +/-10% at Seller's option, European origin as per an attached specification, CIF Butinge, Lithuania, price based on five quotations after the bill of lading date.

The parties continued to email throughout the course of the day, with Orlen finally stating *"confirmed"* in a one word email following an email recap of the key terms from Proton.

At this juncture, there was still a question mark over the documents that would need to be provided by Proton to obtain payment under a documentary letter of credit.

On 29 June 2012, Orlen wrote to Proton, stating that it was withdrawing from negotiations, did not accept the cargo and would not be opening any letter of credit. The parties did not agree on whether they were bound to the terms of the recap.

Contract formation

The basic requirements for the formation of a contract include agreement of all the core terms, otherwise the contract will be void for uncertainty. However, that does not mean that every major term must be decided before the parties are legally bound.

Relying on the UK Supreme Court's statement in *RTS Flexible Systems Ltd v Molkerei Alois Mueller GmbH & Co* (10 March 2010) that *"there is no legal obstacle which stands in the way of the parties agreeing to be bound now while deferring important matters to be agreed later,"* the Court held that the language of Orlen's agent, *"confirmed'*, constituted an acceptance of Proton's offer. On an objective appraisal of the conduct of the parties, notwithstanding that certain contractual terms of significance were yet to be agreed, an enforceable contract had been created following the confirmation of the recap on 14 June 2012.

Orlen argued that, while this might be true in most circumstances, the oil industry was different and that people within it would recognise that a contract had not in fact been formed. The Court disagreed.

Misdescription

Orlen also argued that they would have been entitled to set aside the contract for misdescription under the condition implied by s13 of the Sale of Goods Act 1979, which gives a party the right to terminate a contract if goods do not match their description. They argued that the quality of the oil was not the same as had been stated in the loading inspection report and that the contents of that report, incorporated into the contract by a clause headed *"Quality"*, was the description of the product.

Proton argued that the description of the product was not the same as its quality. The Court agreed. It found that the contract described the oil in a clause headed *"Product"* and that the oil matched that description. A difference in the quality only allowed Orlen to claim damages, not to terminate the contract. The Court noted that *"The parties are always free to make the quality a condition of the deal but, unlike description, it is not implied by statute."*

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SARAH HUNT

This case is a useful reminder of some of the basic contractual principles to remember when negotiating spot transactions in the oil (or general trading) industry. An agreed recap is likely to be considered as the acceptance required for the formation of a contract and provides the objective evidence required to satisfy the court. Further, if a buyer wants the right to terminate in the event that the quality of a product is incorrect, that must be made an express condition of the contract.

HFW represented the successful claimants, Proton Energy Group SA, in this case.

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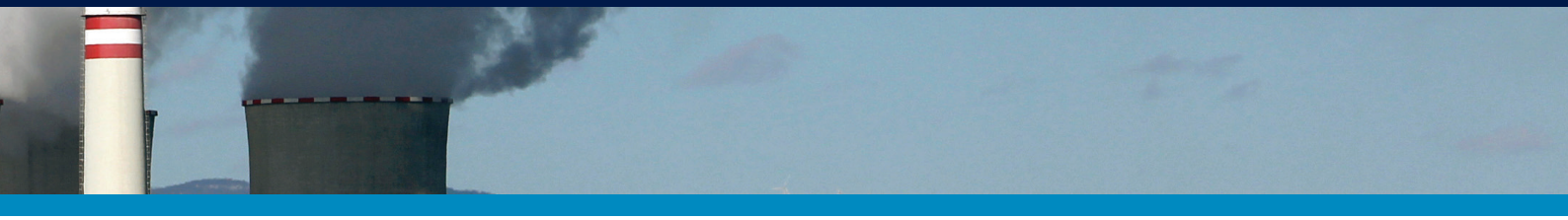
India's coal industry – developments and implications

By 2014, India is expected to overtake Japan as the second largest importer of thermal coal in the world. Shortly thereafter, it is expected to overtake China as the largest importer of thermal coal in the world. This seems counterintuitive given that India also has the fifth largest global reserves of coal.

This article considers some of the reasons behind India's increasing reliance on thermal coal imports, some of the consequences of that reliance and new measures implemented or contemplated by the Government of India (GOI) to reduce it, which have implications for the mining and power supply industries in India and for companies trading coal into India.

India's coal imports phenomenon

India is a net importer of thermal coal, its domestic production being insufficient to meet demand. The power sector accounts for around 80% of that demand, the other main users being the cement, direct reduced iron and brick manufacturing industries.



Imports of thermal coal into India have grown at a staggering compound annual growth rate (CAGR) of 32%, from 39 million tonnes (MT) in 2008/2009 to 118 MT in 2012/13. If imports in June 2013 alone are annualised, they would equate to 144 MT for the fiscal year ending 31 March 2014.

Domestic coal supplies

India faces a number of challenges on the domestic coal supply side:

- Production at a number of large coal mines has either stopped due to technical problems or declined due to them reaching maturity.
- The development of new mines has encountered delays relating to land acquisition or environmental concerns. In some cases, development has been deferred due to the current low coal price.
- Many coal mines are underground, making them more expensive and more technically challenging to operate than open-cut mines.
- Indian coal generally has a high ash content (resulting in lower heating values).

The Indian coal supply deficit was around 70 MT in 2012 and is likely to increase substantially: demand for thermal coal in India is expected to rise 43% to 730 MT in 2017, while supply from domestic sources is expected to rise only 38% in the same period.

Natural gas, an alternative fuel for power generation, cannot offer an immediate solution, even though it is already being consumed by Indians at the fastest rate in Asia. The share of gas-fired generation capacity in India is expected to fall to just 3% in 2030, from 9% in the fiscal year ended 31 March 2013.

Consequences

India's reliance on coal imports has a number of significant consequences:

- The current low value of the Indian rupee makes imported coal significantly more expensive than domestic coal.
- Projected Indian coal demand could limit coal supplies in the Asia-Pacific region generally, giving foreign producers the power to increase prices.
- Increased imported coal prices will mean more expensive electricity for customers in India and have an adverse effect on India's current account deficit.
- Increased imports will put additional strain on India's already struggling ports and transport infrastructure.
- Increased imports will result in new generating capacity being constructed close to India's ports in order to reduce logistics costs.

The Government of India's response

The GOI has taken a number of steps in response to the coal supply challenges which India faces. These could impact both the mining and power industries in India, as well as those trading coal into India.

In June 2013, the GOI announced plans to allow power companies to pass on the full cost of using imported coal to consumers, which was previously not allowed. The move is directed at ensuring adequate coal supplies to power plants (many of which are running at 50% capacity) and encouraging additional investment in power generation capacity.

The GOI is also proposing measures to augment domestic coal production, including:

- Permitting excess coal from 'captive mines' (mines allocated to a specific use) to be sold to Coal India Limited (CIL).
- Enabling private companies to partner with CIL in PPPs or joint ventures.
- Allowing CIL to outsource more of its mines for development by private companies.
- Requiring CIL to supply 65% of power project coal from domestic sources, increasing to 75% in 2016/2017.

If implemented, these measures would have a significant impact on India's lucrative domestic coal industry, opening it up and offering an unprecedented opportunity for private investment. Nevertheless, it seems likely that India will continue to rely on thermal coal imports to plug the supply deficit for many years to come.

(A version of this article also appeared in HFW's India Bulletin, October 2013).

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JAMES DONOGHUE

FOSFA Default clause

In the March 2013 edition of our Bulletin, we reported on the English High Court's decision in *Novasen v Alimenta* (27 February 2013). In that judgment, the Court considered the application of common law principles to the assessment of damages for breach of contract under the FOSFA Default clause. It concluded that a buyer's damages against a non-performing seller may be assessed very differently depending on whether or not it buys substitute goods.

The Court said that damages should be assessed on two different bases under the FOSFA Default clause, depending on whether or not the "innocent" party chose either (1) to buy substitute goods (or sell to a substitute buyer if the "innocent" party is the seller); or (2) simply to claim damages without entering into a substitute contract.

If the "innocent" party did buy/sell against the defaulter, then the common law position would be modified by the clause and the "innocent" party would be entitled to compensation irrespective of subsequent events and the effect which they might have had on the contract if it had remained in force.

However, if the "innocent" party did not buy/sell against the defaulter, then the common law position would not be modified by the clause. The "innocent" party's entitlement to compensation would be the common law measure, with subsequent events taken into account where relevant for the purposes of assessing compensation.

This decision caused concern to the "innocent" party, and at the time, we reported that it would be appealed, along with a decision on the GAFTA prohibition clause in *Bunge S.A. v Nidera B.V.* (29 January 2013).

The decision in Bunge v Nidera is due to come before the Court of Appeal in November this year. However, we now understand that the appeal in Novasen v Alimenta will not go ahead. This means that the law on the application of the FOSFA Default clause will remain as set out by the Court in the first instance decision.

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Conferences and Events

HFW Singapore Commodities Breakfast Briefing
HFW Singapore
30 October 2013

GTSA Dinner
Geneva
4 November 2013
Attending: Jeremy Davies, Damian Honey and Sarah Hunt

Geneva Commodities Week
Geneva
4–6 November 2013
Attending: Jeremy Davies, Damian Honey and Sarah Hunt

globalCOAL SCoTA Crash Course
London
6 November 2013
Presenting: Rebecca Lindsey

The Sugar Association of London Newcomers Seminar
London
22 November 2013
Presenting: Judith Prior

HFW Singapore Commodities Breakfast Briefing
HFW Singapore
27 November 2013

IECA Winter Seminar
Geneva
28 November 2013
Presenting: Robert Finney

For more information about any of these events, please contact events@hfw.com

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