Commodities

August 2014

COMMODITIES BULLETIN

Welcome to the August edition of our Commodities Bulletin.

In our first article this month, London Partner Damian Honey and Associate Michael Buffham consider issues arising from the current oversupply of iron ore to China and the legal implications for traders.

Next, Senior Associate Sarah Hunt from our Geneva office considers the implications for oil traders of the Iraqi-Kurdistani dispute, and the question of the legality of Kurdistan's sale of crude oil held in Ceyhan.

Our final article comes from Vincent Benezech, a Senior Associate in our Paris office. It reports on a recent case called United Miravallees, which marks a change in French law that will reassure commodity traders concerned about the impact on their trading caused by the blocking of cargo on board vessels as a knock-on effect of charter disputes.

This edition also contains information about our second London Calling Commodities Conference on 16 September, and the dates for our London and Hong Kong Commodities Breakfast Seminars in September and October.

Should you require any further information or assistance about any of the issues dealt with here, please do not hesitate to contact any of the contributors to this Bulletin, or your usual contact at HFW.

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Iron ore: soaring supply and dropping demand causing concerns for miners, investors and importers

Overwhelming supply and slowing demand has seen the price of iron ore drop 30% in 2014. This is causing major concerns for miners, investors and importers with fears that a prolonged decline in prices could cause mine closures and even threaten the solvency of some producers. This Briefing will consider the current position and some of the legal implications of this development.

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DAMIAN HONEY, PARTNER

Supply and demand

Demand for iron ore in the Chinese steelmaking industry prompted miners, particularly in Australia, to invest billions of dollars in new iron ore mines, greatly increasing supply of the product. However, with economic growth and construction in China slowing, this new supply now exceeds demand.

Barclays Bank estimates that, assuming Chinese steel production grows at 5.1% per annum, there will be a surplus of 79 million tonnes of seaborne iron ore this year and 67 million tonnes next year. UBS estimates a surplus of 74 million tonnes this year, with a possible oversupply of 267 million tonnes by 2016. In spite of these forecasts, Rio Tinto is still aiming to increase its Australian iron ore output by a further 20% to 350 million tonnes over the next two years.

Impact on pricing

As might be expected, this has led to an overall fall in the price of iron ore but there have been other effects on pricing too.

There is a widening differential between the benchmark price of iron ore and that of lower grade iron ore. Iron ore with a high-grade haematite (i.e. iron) content of 62% is favoured by Chinese buyers. Using this grade of material in steel production is more environmentally friendly and allows for better utilisation rates. Spot prices for the import of iron ore into China are based on a 62% iron content. Iron ore of 58% grade is now trading at a $17 discount to the spot price. Other contributing factors are the oversupply of lower grade iron ore and reduced supplies of high-grade Chinese concentrate product, which is blended with lower grade iron ore to increase its iron content.

Seaborne iron ore is also now trading at a $20 discount to local Chinese product. This represents a tenfold increase in the price difference over the last three years. As a result, miners importing products into China have reduced the price of lower grade iron ore.

Ramifications for miners and investors

In addition to reducing the price of lower grade iron ore, large miners have reacted to the current market by seeking to save costs and thereby preserve profits. BHP Billiton recently cut 100 jobs at its Perth headquarters and a further 170 jobs at its Mount Whaleback mine.

Smaller and high cost operators may face even greater difficulties. The fall in prices may cause smaller Chinese producers to exit the market. Cairn Hill, an Australian producer of 50% grade iron ore, was recently put into administration. With prices predicted to continue falling and amid reports that 90% of capacity to hold iron ore in Chinese ports is already full, ultimately it seems likely that production from outside China will have to be reduced if the market is to be rebalanced.

That said, there are some who remain optimistic. Rio Tinto appears to be confident that its Australian mines will continue to generate profits and that high cost mines in China are those most at risk from the downturn. Although some investors have been selling off shares in mining companies, there are still some brokers recommending the purchase of shares in major mining companies. Furthermore, BHP Billiton and Rio Tinto are both still planning to increase their dividends.



Recommendations

The situation is reminiscent of the problems encountered by those importing coal into China in 2012. It remains to be seen whether a crisis will develop. In the meantime, it is crucial that those involved in the import of iron ore into China, whether as miners, investors or importers, are aware of the issues and prepared to meet the challenges that the market is facing.

All those involved in iron ore trading should make preparations but those with longer term contracts are most likely to be affected. They may find counterparties either refusing to perform or concocting reasons not to do so. There may also be an increase in disputes as to quality proceeding to litigation or arbitration which, in a better market, might have settled on commercial terms.

A number of steps can be taken to protect against default. For example,

- Contract terms should be evidenced in writing.
- Correspondence with a counterparty relating to a contract (including emails, instant messaging and other electronic communications) should be collected and stored to record what has been agreed. Parties should also consider recording telephone conversations during which contract terms are agreed.
- Contracts should be "stress tested" to identify areas of weakness that a reluctant counterparty may try to exploit.
- Strict compliance with contractual terms is essential to avoid a counterparty seizing an opportunity to terminate the contract.

If a default occurs:

- Any additional time or other concessions granted to a counterparty should be carefully recorded in writing.
- Any commercial settlement negotiations should be conducted on a "without prejudice" basis alongside open messages holding the counterparty in breach. This is to ensure that should the negotiations fail, the innocent party remains in a position to rely on its contractual rights.
- Care should be taken not to act on a breach of contract too quickly, leaving an innocent party itself open to an allegation of breach on the grounds of premature termination. It is often prudent to write to a counterparty allowing an opportunity for it to cure any breach, failing which termination will occur.
- Any contractual notice requirements, including as to form, address and timing must be strictly observed.

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The Iraq-Turkey pipeline dispute and the future of Kurdish crude

Oil traders with an interest in the region should be aware of developments in a dispute between Iraq's Ministry of Oil (represented by the State Oil Marketing Organisation, SOMO) and Turkey and BOTAS (Turkey's state owned pipeline operator). On 23 May 2014, SOMO filed an arbitration claim with the International Chamber of Commerce (ICC) claiming, *"by transporting and storing crude oil from Kurdistan, and by loading that crude oil onto a tanker in Ceyhan, all without the authorisation of the Iraqi Ministry of Oil, Turkey and BOTAS have breached their obligations under the Iraq-Turkey Pipeline Agreement."*

The Kurdish Regional Government (KRG) maintains that it is entitled to export oil through the Iraq-Turkey Pipeline (ITP) and that the federal government does not have exclusive exporting authority under the Iraq Constitution. SOMO argues that under Article 111 of the Iraq Constitution: *"Oil and gas are the ownership of all the people of Iraq in all the regions and governorates"*.

The KRG alleges that it has authority under Articles 112 and 115 of the Iraq Constitution to manage oil and gas in the Kurdistan Region extracted from fields that were not in production in 2005, the year the Constitution was adopted by referendum.

The KRG argues that because Article 112 provides that the central government may *"undertake the management of oil and gas extracted from present fields"*, with the logical meaning of the term 'present fields' being those fields under production at the date of the entry into force of the



Iraq Constitution, oil and gas extracted from fields coming into production after that date can be managed by the KRG. In addition, Article 115 states *"All powers not stipulated in the exclusive powers of the federal government belong to the authorities of the regions and governorates that are not organised in a region."* The KRG says that as relevant powers are not otherwise stipulated in the Constitution, it has the authority to sell and receive revenue from its oil and gas exports. Further, the Constitution provides that, should a dispute arise, priority shall be given to the law of the regions and governorates.

The case will shed interesting light on the interpretation of the 40-year old ITP Agreement, originally signed in 1973 and last amended in 2010, and demonstrates the growing importance of ICC arbitration in resolving inter-state disputes. The Tribunal will need to rule on Iraqi constitutional law questions significant to the future of the independent export of Kurdistani crude.

This dispute has implications for oil traders operating in the region. SOMO has threatened to sue any buyer who lifts Kurdish crude, insisting that it holds rightful title to all Iraqi oil and gas under the Iraq Constitution. To date, no cargoes have been arrested. To succeed in an arrest, SOMO would need to show it has title to the crude and is entitled to either the proceeds of the sale or the crude itself.

Any defence to such an arrest would depend on the governing law of the contract, as this would affect whether or not title passes following a sale where title is disputed. It would also involve consideration of the Iraqi constitutional position outlined above.

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SARAH HUNT, SENIOR ASSOCIATE

Arrest of bunkers blocking vessel and cargo onboard: good news for commodity traders

On 18 April 2014, the Court of Appeal of Douai in France rendered a decision which marks a change in French law that will give reassurance to commodity traders. The Court accepted that the security required in order to lift an arrest of bunkers could be limited to the value of the bunkers, as opposed to the position previously adopted by French courts requiring full security to the amount of the claim to be provided.

This case involved a cargo of 50,000 MT of wheat which was due to be carried from France (Rouen and Dunkirk) to Yemen. During loading at Dunkirk, six creditors of the ultimate time charterer arrested the bunkers of the vessel as security for their debts. The debts amounted to some USD 4 million and the value of the bunkers was around USD 365,000. The cargo was blocked for several weeks as a result of the arrest, giving rise to the risk of both deterioration in the quality of the wheat and late delivery.

The French courts confirmed the validity of the arrest, leaving no other solution than putting up security to obtain the release of the vessel and her cargo. The issue was the amount of the security required.

An intermediate time charterer offered to put up security in the amount of the value of the bunkers (USD 365,000) but the creditors refused and required full security to the value of their claims to be provided.

The dispute was brought before the French courts as a matter of urgency *(référé d'heure à heure)*.

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VINCENT BENEZECH, SENIOR ASSOCIATE

At first instance, the application filed by the intermediate time charterer to order the release of the arrest in exchange for a security amounting to the value of the bunkers (USD 365,000) was rejected.

This decision reflected the position previously adopted by French courts (in particular the Court of Appeal of Rouen in 1986), which was favourable to the interests of creditors but gave serious cause for concern to commodity traders who had no interest in the debts of the owner of the bunkers but who wanted the cargo to be delivered on time.

It was mainly based on the view that the arrest of an asset was not only designed to secure a claim but also to exercise pressure on the debtor to pay the full amount of the debt. Consequently, the debtor should not be allowed to obtain the lifting of the arrest in exchange for security amounting to the value of the asset attached where that was less than the full amount of the debt.

This view was open to criticism since if they enforced their claim against the attached bunkers, the creditors would recover not more than the amount resulting from the judicial sale of the bunkers, less the costs of arranging the judicial sale. It was even more questionable in circumstances where the pressure to pay was being exerted on parties other than the debtor (vessel and cargo interests).

An appeal was lodged and the Court of Appeal of Douai required the creditors to lift the arrest against the provision of security amounting to the value of the bunkers, such sum to be placed in escrow for the benefit of all creditors.

Even where a decision rendered by a French Court of Appeal is not a binding precedent, it is to be hoped that this decision will now act as a reference for any similar dispute. Commodity traders will be in a better position to avoid an arrest of bunkers delaying delivery of their cargo.

HFW (Chris Swart, Katie Pritchard, Tim Clemens-Jones, Vincent Benezech) represented the voyage charterers in this matter.

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News

Commodity Breakfast Seminars

Our Autumn series of London Commodities Breakfast Seminars will take place on 30 September, 14 and 28 October 2014. We shall also be holding a Commodities Seminar in Hong Kong on 18 September 2014. The seminars will cover issues of interest to those involved in commodity trading. If you would like to attend, please contact events@hfw.com.

London Calling – Getting Energised

Our second London Calling Commodities Conference will take place at HFW's London office on 16 September 2014. This year, the focus will be on the future of the energy market. We are delighted to have a number of eminent guest speakers joining us, including Fabio Gabrieli, Head of Coal Market Intelligence at Mercuria; Jeffrey Evans, Chairman of Maritime London and Managing Director of Gas at Clarksons; Simon Rainey QC of Quadrant Chambers; David Cherrett, Chief Commodity Strategist, Noble; and Bruce Holcombe, Commercial Director of Media & Crisis Management Ltd. HFW Partners Brian Perrott and Sarah Taylor will also be presenting. For further information, please contact events@hfw.com.


Conferences and events

National AIE Energy Conference: Incorporating 14th Energy in Western Australia Conference
Perth
27 and 28 August 2014
Attending: Simon Adams

Global Commodity Trade Finance Conference
Lugano
16 September 2014
Attending: Spencer Gold

London Calling Commodities Conference – Getting Energised
HFW Friary Court, London
16 September 2014
Presenting: Brian Perrott, Sarah Taylor

Capital Link – 6th Annual Commodities Energy & Freight Forum
New York
17 September 2014
Presenting: Brian Perrott

International Trade and Commodities Seminar
Hong Kong
18 September 2014

HFW Commodities Breakfast Seminars
HFW Friary Court, London
30 September, 14 and 28 October 2014

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