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WHAT HAPPENS WHEN THE WHEELS COME OFF IN A COMMODITIES SUPERCYCLE?

The press is full of speculation as to whether we are entering a commodities "supercycle", a period when the market sees prices rise higher than the long-term trend for more than ten years, followed by a downturn of similar length as supply catches up with demand.

Demand for commodities is certainly high and in some markets, supply is not able to keep pace. For example, there are concerns about the availability of a number of metals due to insufficient investment in the mining sector. This has the potential to impact global sustainability targets if the materials required to make the transition to battery-powered electric vehicles are not available.

From a legal perspective, a sustained period of high demand, limited supply and rising prices will have an impact on the respective negotiating power of the parties in commodities trading, which will affect the contracts agreed and in turn have a knock-on effect on the type and outcome of disputes that arise.

The boom period of a supercycle will favour sellers, who will be able to negotiate favourable contractual terms, potentially locking buyers in at a higher price, for a longer period and on shorter payment terms than in normal circumstances. In addition, for FOB buyers, freight rates will be high, due to increased demand.

When prices begin to fall, this can create significant financial pressures for a buyer. Despite the momentum and the limited room for manoeuvre that can be generated by a booming market, we recommend that where possible, buyers exercise particular caution in relation to price and payment terms. In longer term contracts, aim to link pricing to a benchmark index, so that it tracks the movement of the market more closely. Consider proposing a price review clause, triggered in the event that prices fall by a particular margin. Aim to avoid very short payment periods, particularly if you are not able to pass these on to your purchaser down the chain. Any flexibility you can negotiate in the event of late payment could prove invaluable at a later stage.

Sellers will naturally want to negotiate terms as much in their own favour as possible. However, this can create unwelcome difficulties when markets fall: an insolvent buyer can leave a seller exposed and unable to recover its losses in practice - even after obtaining a favourable judgment or award. Build in flexibility where you can. The right to require security can offer valuable protection. The right to terminate in the event of default is a useful tool, but keeping it as an option can be preferable to an automatic early termination provision. It allows the seller to retain control and take stock of the overall impact of triggering an event of default clause, particularly in relation to long-term trading partners. Having the option to negotiate and give your buyer some flexibility can save both a transaction and a valuable relationship.

It is also worth remembering that default clauses typically work both ways and in markets where the possibility of shortages is a genuine prospect because of problems with supply, sellers might find themselves unable to perform their own fundamental obligation to deliver the goods.

Sellers should be mindful that if contracts become commercially unappealing, buyers will often respond by scrutinising contractual terms to identify possible ways out. Sellers should therefore ensure their contractual performance is thorough, to avoid their counterparty seizing an opportunity to terminate. And force majeure clauses should be drafted with particular care. Whilst the English courts are typically alive to the reality that parties sometimes seek an escape route from an unprofitable contract by claiming force majeure, such disputes can be lengthy, time-consuming and costly. It is always preferable to avoid them, even if an opponent's case is weak.

For both parties to a sale and purchase contract, it is prudent to aim always to be "back-to-back" with counterparties up and down the contractual chain.

Whilst the debate as to whether we are riding a supercycle continues, trading parties can be taking steps now to ensure that if and when the wheels come off, the landing is not too bumpy.

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