COMMODITIES | JUNE 2021

COMMON ISSUES IN OIL TRADING CONTRACTS: RECOVERABILITY OF HEDGING LOSSES

This is the fourth instalment in our series of articles looking at common issues in oil trading contracts.

Hedging is now typically an everyday part of the oil trading business. But does that mean that hedging losses suffered on account of a counterparty's breach are recoverable?

The law on hedging losses

Since the decision of *Addax Ltd v Arcadia Petroleum Ltd*[1], the English courts' former reluctance to find hedging losses recoverable has steadily been eroding[2]. That said, each case must still be assessed on its own facts, with a particular focus on core English law principles relating to the recoverability of damages, namely causation and foreseeability.

Causation

A party claiming damages must show that the breach was causative of the resulting loss. A clear link must therefore be established between breach of the physical sale contract and the resulting hedging loss. This may not be straightforward.

Where a hedge is entered into to mitigate the risk in a specific trade, it should be relatively simple to demonstrate the link. However, it is often the case that traders will aggregate hedges in their books and it may not be clear which paper trades relate to which physical ones. In these circumstances, it may be more difficult for a claimant to show that the relevant hedging losses flow directly from the defendant's breach of contract.

Remoteness

The claiming party will also need to demonstrate that its hedging losses are not too remote. The test is one of foreseeability: a loss will only be recoverable where it flows from the ordinary course of things or where it is in the contemplation of the parties at the time of contracting.

In the oil trading industry, where hedging is commonplace, especially amongst more sophisticated traders, the test of foreseeability will be more straightforward to satisfy. However, it may not be so simple in relation to contracts between less sophisticated traders or with other parties, such as shipowners.

The challenges can be illustrated by way of a case study.

Case study

Seller sells Buyer 30,000 MT of crude oil for delivery DAP ARA. The parties agree that the price will be calculated using Platt's quotations for the five consecutive days after the date on which the vessel tenders NOR, plus a premium. The delivery period is 9 November to 16 November.

The vessel loads in Houston and sets sail, giving an ETA of 9 November. Buyer must declare the precise discharge port at latest 10 days after the vessel sails. However, the market starts to rise sharply after loading and Buyer,

---

[1] [2000] 1 Lloyd's rep 493

[2] See for example Choil Trading SA v Sahara Energy Resources Limited [2010] EWHC 374 (Comm)

realising the trade will no longer be economical, does not declare the final discharge port within the time required by the contract or at all. From 8 November, Buyer stops responding to Seller's communications.

On 17 November, Seller orders the vessel to proceed to Rotterdam where she tenders NOR. Buyer does not take physical delivery of the cargo and Seller has no choice but to discharge it onto a floating storage tanker until it can sell to another buyer.

On realising that Buyer would not be taking delivery of the cargo within the delivery period and that it would be exposed to a loss if the market prices dropped, from 17 November Seller begins hedging to protect itself from price fluctuations.

Notwithstanding the rising market, Seller incurs significant losses on account of Buyer's breach of contract, including storage costs, demurrage claims from the vessel owners and losses on the hedges it had put in place as part of its mitigation efforts. On the other hand, on account of the rising market, Seller makes a small profit on the physical transaction when it resells the cargo.

Are Seller's hedging losses recoverable?

Whilst the precise facts of the case would need to be carefully assessed, on a preliminary view, Seller has good grounds to claim its hedging losses from Buyer, assuming (a) the hedges put in place can be clearly linked to the underlying trade and (b) both Seller and Buyer are sophisticated operators in the oil trading business who would therefore expect hedging to be part of the trading process.

However, as established in *Choil Trading SA v Sahara Energy Resource Limited*[3], in which HFW acted for the successful claimant, the gains made by Seller on the physical trade will have to be taken into account in the overall assessment of damages and deducted accordingly.

Alternative scenario: What if Buyer declares the discharge port in time but the vessel is severely delayed due to a breach of contract by the shipowner, resulting in Buyer terminating the contract? Seller hedges to protect itself from price fluctuations. Would any hedging losses incurred in this scenario be recoverable from the shipowner?

In this scenario, any hedging losses that Seller may have suffered would likely not be recoverable from the shipowner. This is in light of the decision in *Trafigura Beheer BV v Mediterranean Shipping Co.*[4], where there was found to be no evidence that a shipowner would reasonably foresee that a misdelivery of cargo would result in a shipper hedging against possible price fluctuations, with the consequent possibility of hedging losses. Except in very particular circumstances, we would expect this to be the position held by a court more generally with respect to the recoverability of hedging losses from shipowners.

Practical tips for presenting hedging claims

Claiming hedging losses is not straightforward. Here are some practical tips to improve the likelihood of bringing a successful claim:

1. **Make an early record of what happened.** Memories fade and given the highly complex and fact specific nature of hedging, the relevant details should be established at the earliest possible opportunity. The person in the company who best understands (a) the hedging book and (b) the hedging process should, at the outset of the dispute, set out clearly exactly what steps were taken in relation to hedging. This may need to be in the form of a witness statement.
2. **Gather evidence.** You need to be able to substantiate your hedging claim. Evidence should be collated demonstrating that the hedges were entered into (i) specifically in relation to a physical trade and/or (ii) to mitigate your losses as a result of a counterparty's breach. You should also be able to show that the losses were suffered as a result of the hedging. Gathering evidence at the outset of the claim will also help to assess the merits of your claim properly from the beginning.

[3] [2010] EWHC 374 (Comm)

[4] [2007] CLC 594

3. **General principles still apply.** Remember to apply the general principals of causation and remoteness when considering your claim; if these elements are established, you are likely to be in a stronger position to recover your hedging losses.
4. **Mitigate**. Although the burden to mitigate is not a heavy one[5], you should seek to mitigate any hedging losses. For example, consider whether it is appropriate to close out any hedging positions following a counterparty's default.[6]

HFW Comment

The current trend indicates more willingness on the part of the English courts to award hedging losses. However, each situation must be examined on its own facts and when claiming hedging losses, always ensure that causation and foreseeability are at the forefront of your analysis.

For further information, see our "Practical guide to hedging"

Other articles in this series are:

Potential pitfalls in contract formation

Time for delivery and laycan

Demurrage in sales contracts

For more information, please contact the author(s) of this alert

SARAH HUNT
Partner, Geneva
T +41 (0)22 322 4816
E sarah.hunt@hfw.com

ANNE-MARIE PEARCE
Associate, Geneva
T +41 (0)22 322 4831
E anne-marie.pearce@hfw.com

AMANDA RATHBONE
Professional Support Lawyer, London
T +44 (0)20 7264 8397
E amanda.rathbone@hfw.com

[5] Transpetrol Maritime Services Ltd v SJB (Marine Energy) BV (the "Rowan") [2011] 2 Lloyd's Rep 331

[6] Glencore Energy UK Ltd v Transworld Oil Ltd [2010] 1 CLC 284