Commodities

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COMMODITIES BULLETIN

Liquefaction of dry bulk cargoes – a phenomenon that continues to haunt the seas between Indonesia and China

In recent years, the carriage of nickel ore by sea has posed a deadly threat. Apart from the human cost, the financial cost has run into hundreds of millions of dollars. The capsize of the bulk carrier "HARITA BAUXITE" on 17 February 2013 whilst en route from Indonesia to China, with the loss of 15 lives, is a recent tragic example.

During the carriage of nickel ore by sea, the weight of the cargo, coupled with vibration caused by the engines or the motion of the vessel, can lead the whole cargo to behave as a liquid. A liquid cargo can destabilise the vessel, causing listing and ultimately, capsizing and sinking.

Since 1 January 2011, it has been mandatory for shippers who trade mineral bulk cargoes to comply with the International Maritime Solid Bulk Cargoes (IMSBC) Code, which provides for the safe carriage of solid bulk cargoes. If a cargo that may liquefy has a moisture content that exceeds the transportable moisture limit, it should not be loaded on to ordinary bulk carriers. To ensure the safety of vessel, cargo and crew, IMSBC Code requirements should be closely observed.

Under English law, the consequence of the strict liability regime for shipment of dangerous goods is that shippers or receivers can face exposure to significant claims from the carrier under a contract of carriage if cargo is shipped in breach of the IMSBC Code. If the Hague or Hague-Visby rules are incorporated into the relevant bill of lading or charterparty, the carrier is likely to be in a strong position. Article IV Rule 6 entitles him to recover all losses directly or indirectly resulting from the shipment of the dangerous cargo.

The risks associated with the carriage of nickel ore are particularly high in the growing trade between Indonesia and China. 5 bulk carriers carrying nickel ore have been lost within the past two and a half years. Each vessel was travelling from Indonesia to China. The related death toll now stands at more than 80.

Shipments of nickel ore are increasing due to sustained demand from China. In the last three years, this demand has made it commercially viable for Chinese companies to source nickel ore from remote mines and previously unexploited and inaccessible locations in Indonesia. Infrastructure at load ports is largely rudimentary. Most mines are located far from suitable test facilities where moisture content and transportable moisture limit can be accurately determined.

In addition, Indonesian nickel ore typically contains substantial moisture content. The ore is open-cast mined and stored in areas prone to heavy rains prior to shipment, allowing moisture to accumulate.

Last year, the Indonesian government imposed a ban on the export of unprocessed nickel (Regulation No 7/2012). The implementation of the ban on 6 May 2012 led to a significant drop in the trade of Indonesian nickel ore to China.

The ban was lifted in November 2012 following a decision of the Indonesian Supreme Court and export volumes are now surging again.

The Indonesian government, keen to encourage the processing and smelting of ores within Indonesia, has announced its intention to impose a full ban on exports of unprocessed mineral ores in 2014, despite the Supreme Court's decision. However, such a ban may be difficult to implement and is likely to face substantial resistance from the Indonesian mining community.

Worldwide, casualties continue to occur as a consequence of bulk cargo liquefaction. There appears to be both a lack of understanding of the problem by shippers and operators and a lack of clarity in the regulations, which are not consistently implemented in load port countries. As new unsophisticated mines open in remote regions of the world and China's appetite for mineral ore cargoes continues, the problem will persist.

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Traders in commodities susceptible to liquefaction who are acting as charterers should pay careful attention to the precise terms on which they charter vessels to perform their sale contracts. The provisions of the IMSBC Code are likely be incorporated into charterparties. It is of utmost importance that shippers comply strictly with those provisions in the sampling, testing and loading of such commodities.

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Who bears the cost of delay in unloading in CFR contracts – a Singapore decision

How should demurrage be calculated as between seller and buyer in a CFR sale contract where laytime is interrupted during unloading and neither party is at fault? This was the key issue before the Singapore High Court in *Profindo Pte Ltd v Abani Trading Ltd* (14 January 2013).

Profindo agreed to sell 2,750 mt of cement to Abani on a CFR basis. The cargo was to be loaded in China and delivered to a port in Madagascar. The sale contract contained a provision allowing Abani to discharge the goods within the allowable laytime of 2.75 days. Profindo chartered a vessel, the cargo was loaded and on arrival at the discharge port in Madagascar, discharge commenced.

Before discharge could be completed, the port authorities unexpectedly required the vessel to leave the berth and move to anchorage. This caused a delay of about two days. The vessel owners imposed demurrage charges on Profindo, who sought to recover them from Abani, alleging that pursuant to the terms of the sale contract, responsibility for delay was to be borne by Abani, as laytime continued to run regardless of whether the vessel was in berth or not. Abani countered, arguing that laytime was suspended when the vessel left the berth.

In addition, Profindo claimed for loss of earnings, on the basis that the shipowners had blacklisted Profindo for late payment of demurrage, leaving them unable to charter a vessel in fulfilment of a contract with another customer.

At first instance, the District Judge rejected Profindo's claims and also upheld Abani's counterclaim against

Profindo for a shortfall in the quantity of cement delivered. Profindo appealed.

The following key issues were considered by the Appeal Judge:

1. Did the first instance judge err in holding that Abani was not liable for Profindo's claim for demurrage because laytime was suspended when the vessel was not berthed?
2. Did the first instance judge err in holding that even if laytime was not suspended, Abani could not be responsible for Profindo's loss of earnings?
3. Did the first instance judge err in holding that Profindo was liable for Abani's counterclaim for shortfall of cement?

Issue 1

As a matter of contractual construction, the burden lay with Abani to convince the Court that the suspension of laytime could be read into the sale contract. The Appeal Judge reasoned that since in CFR contracts, the seller is not under any duty to ensure that the goods are actually physically delivered at the port of discharge, there was no reason to hold that the risk of delay in unloading the goods after laytime had commenced was to be borne by the seller.

Abani had not satisfied the burden of proof in convincing the Court that a suspension of laytime could be read into the agreement, as Abani's obligation to pay demurrage had not been qualified anywhere in the sale contract.

In light of the above, laytime continued to run during the interrupted discharge operations, as no express or implied term providing otherwise was included in the contract.

Issue 2

In respect of Profindo's claim for loss of earnings (allegedly as a result of being blacklisted by the shipowners), the Court agreed with the first instance judge and held that Profindo had failed to satisfy the legal requirements of remoteness and mitigation. Profindo were "authors of their own misfortune" in that the alleged loss of earnings was one which could easily have been mitigated and was not.

Issue 3

Profindo was not liable for the missing cement: Profindo's delivery obligations were discharged at the port of loading, rather than at the port of discharge (as had been held by the first instance judge).

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Abani had not satisfied the burden of proof in convincing the Court that a suspension of laytime could be read into the agreement as Abani's obligation to pay demurrage had not been qualified anywhere in the sale contract.

Australia implements G-20 OTC derivative reforms

The Corporations Legislation Amendment (Derivative Transactions) Act 2012 (Cth) (the Act) came into effect on 3 January 2013. Its purpose is to provide a legislative framework to implement Australia's commitment at the 2009 G-20 Summit regarding 'over the counter' (OTC) derivatives reforms.

That commitment was to introduce substantial reforms to improve transparency and reduce systemic risk in markets for OTC derivative products. Three areas were identified for reform:

- Reporting all OTC derivatives to trade repositories.
- Clearing all standardised OTC derivatives through central counterparties.
- Executing all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.

This marks a significant shift in the regulation of OTC derivatives, but Australians and Australian companies trading OTC derivatives woke up on 4 January 2013 to a world substantially unchanged by the Act.

The Act does not itself introduce any trade reporting, central clearing or execution obligations. Rather, it provides a framework enabling the relevant Minister to determine whether certain classes of OTC derivatives should be subject to more stringent regulation. It also provides for regulations (derivative transaction rules or DTRs) to be implemented by the Australian Securities and Investments Commission (ASIC) for any class of OTC derivatives prescribed by the Minister.

The Act also provides a basic framework for licensing trade repositories – which until now have had little relevance in the Australian financial services landscape.

First Stages

On 12 December 2012, the Treasury released a proposals paper entitled "Implementation of Australia's G-20 over-the-counter derivatives commitments" (Proposals Paper).

The Proposals Paper recommended that no decision be taken on mandatory clearing obligations or trade execution requirements prior to further regulatory reviews. However, it is only a matter of time before such regulations are implemented in Australia and in February 2013, both the Australian Securities Exchange and LCH Clearnet announced an intention to provide a clearing service for certain OTC derivatives in Australia.

The more immediate focus is on introducing mandatory reporting obligations.

The Proposal Paper recommends a wide ranging determination by the responsible Minister in the first quarter of 2013, requiring the mandatory reporting of trades in five derivative classes (interest rate, foreign exchange, credit, equity and commodity) to a licensed trade repository. This is broadly consistent with the approach being taken in a number of other jurisdictions, including Brazil, the EU, India, Korea and the US.

Prior to implementing the Act, there was a consultation process (the consultation). Stakeholders argued that using OTC derivatives to hedge business risk in ascertained areas (as opposed to engaging in speculative investments) does not pose (and presumably cannot even aggregate to) any systemic risk. Considering the volumes, values and nature of transactions within the regulatory overview of ASIC, this is a valid observation.

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Participants in the National Electricity Market (NEM) were particularly vocal, claiming that mandatory reporting of OTC electricity derivative transactions – used almost exclusively by NEM participants to hedge risks associated with physical electricity trading – would lead to a 10-15% increase in the price of electricity. The Treasury has recommended that no decision be made on the mandatory reporting of OTC electricity derivatives pending further reviews. Its response to other stakeholder feedback is eagerly awaited, but it appears that other OTC commodity derivatives are unlikely to be spared from the mandatory reporting regime.

On 28 March 2013, ASIC proposed draft rules on the anticipated mandatory reporting obligations, for comment by 1 May 2013. The rules are intended to comply with internationally agreed standards on transaction reporting, stipulating which institutions must report, the information required for each derivative class and when the obligation will start for different classes of reporting entities.

Under ASIC's draft proposal, reporting obligations would be phased in as follows:

- **First Phase** – major financial institutions (with at least $50 billion of notional outstanding positions in OTC derivatives on 30 September 2013) from 31 December 2013 (for credit derivatives/interest rate derivatives) and from 30 June 2014 (for other derivative classes).
- **Second Phase** – other financial institutions from 30 June 2014 (for credit derivatives/interest rate derivatives) and 31 December 2014 (for other derivative classes).
- **Third Phase** – all other entities trading in OTC derivatives from 31 December 2014 (credit derivatives/ interest rate derivatives) and 30 June 2015 (other derivative classes).

During the consultation process, stakeholders raised concerns that additional costs and compliance obligations associated with reporting could make using flexible OTC instruments like forward exchange contracts and cross currency swaps administratively unworkable for smaller players. In a welcome development, ASIC has confirmed it will undertake further consultation on a possible de minimis threshold in relation to the Third Phase in the second half of 2013.

Whilst there would be no obligation to report until a licensed repository is available, it is anticipated that a number of trade repositories currently operating in other jurisdictions will apply for Australian licences in 2013. ASIC has taken steps to facilitate this and in March, it proposed draft rules and regulatory guidance to establish a trade repository regime.

What you need to do

Participants in Australia's OTC derivative markets will need to familiarise themselves with the new regime.

Recognising the true driver behind the regime will help businesses understand how to work within it. In brief, the driver is that any domestic Australian regime must be sufficiently equivalent to the regimes in place in major overseas jurisdictions like the EU and USA.

Carve-outs implemented in other G-20 jurisdictions that become generally accepted are likely to be repeated in Australia.

Market participants should monitor developments closely: implementation is likely to be rapid and in response to global developments. The first challenge will be to establish internal processes to manage the mandatory reporting obligations when they begin. At a minimum, this will involve reviewing standard documents and training staff in relation to ongoing compliance requirements.

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Conferences & Events

Energy and Resources Seminar
HFW Perth (15 May 2013)
Presenting: Hazel Brewer, Cheryl Edwardes, James Donoghue, Julian Sher

GAFTA Trade and Trends Conference and annual GAFTA dinner
Geneva (15–17 May 2013)
Attending: Brian Perrott, Chris Swart, Katie Pritchard and John Rollason

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