TWENTY ESSEX

# Take or pay: breach of capacity obligation causes no loss

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***British Gas Trading Limited v Shell Gas Trading Ltd and Esso Exploration & Productions UK Ltd* [2020] EWCA Civ 2349. Judgment of English Court of Appeal, 4 December 2020**

Take or pay provisions in long-term agreements for the sale of natural gas (including LNG) are ubiquitous. Such provisions oblige buyers to either accept delivery of a set volume of gas per period (usually a year), or to pay some minimum amount if delivery is not accepted. A buyers' annual take or pay quantity is frequently set by reference to the sellers' obligation to maintain a certain capacity to deliver gas. In *British Gas Trading Limited v Shell Gas Trading Ltd and Esso Exploration & Productions UK Ltd* [2020] the Court of Appeal held that although the sellers under a long-term contract for the sale of natural gas were in breach of their capacity obligation, that breach caused the buyers no loss. Caveat emptor, it seems, applies as much to quantity disputes arising under take or pay provisions as it does to quality disputes.

## Background

In 1988 Shell and Esso (as sellers) entered into two long-term contracts on materially identical terms (the Principal Agreements) for the sale to British Gas (as buyers) of natural gas from the Sole Pit Reservoirs in the North Sea (the Reservoirs). The Principal Agreements, which are due to run until at least 2025, include "take or pay" provisions providing for a minimum amount of gas that the buyers must either take delivery of, or pay for, every year. The quantity of gas which the buyers are required to take or pay for is fixed by reference to the "Total Reservoirs Daily Quantity" (TRDQ) which changed over the life of the contract, beginning with a "Run-In Period", increasing during a "Build-Up Period" followed by a "Minimum Plateau Period". After the expiry of the Minimum Plateau Period, the TRDQ remained constant until reduced (but never increased) pursuant to variation notices that the sellers had a right (but not a duty) to serve if they formed the opinion that they would be unable to maintain the TRDQ throughout a specified contract year.

The buyers had the right to nominate daily quantities of up to 130% of the TRDQ. Under clause 6.4(1) of the Principal Agreements, the sellers were obliged to maintain the capacity to deliver gas from the Reservoirs at the rate of 130% of the TRDQ.

In fact, the gas actually delivered to the buyers under the Principal Agreements did not consist of gas molecules exclusively produced from the Reservoirs. Instead, gas produced from a number of different reservoirs (including the Reservoirs) was commingled and processed at the Shell Sub-Terminal at Bacton. Processed gas was then redelivered to the producers on a broadly *pro rata* basis for delivery to the buyers. Provision for the latter was made in an agreement known as STACA which post-dated (but was envisaged in) the Principal Agreements to which producers from

other reservoirs are also parties.

STACA also required gas to be lent and borrowed between "User Groups" in certain circumstances up to fixed limits on terms that it will be repaid as soon as reasonably practicable. The limits on such lending and borrowing of gas do not apply on a "Restricted Day", defined as a day on which capacity within any part of the Bacton facilities for transporting, processing and delivering gas is restricted for any reason. Since many of the days on which lending under STACA occurred were Restricted Days, the limits on such lending did not apply on those days with the result that a substantial quantity of gas built up that is owed by other User Groups to the sellers.

Following the expiry of the Minimum Plateau Period, the sellers served several variation notices reducing the TRDQ in line the Reservoirs' declining production volumes. After 2009, however, the sellers did not serve any further variation notices to reduce the TRDQ. The sellers maintained that they were entitled to take account of gas from other reservoirs owed to them under STACA when determining the capacity "from the Reservoirs" they were obliged to maintain under clause 6.4(1) the Principal Agreements (i.e., 130% of TRDQ).

The buyers disputed that interpretation of clause 6.4(1) and contended that since production volumes of the Reservoirs were in decline, the sellers ought to have taken steps to reduce the quantities of gas that the buyers were obliged to nominate for delivery under the Principal Agreements by serving variation notices reducing the TRDQ. The buyers contended that had such reductions occurred, they would instead have bought gas in the market at a cheaper price (the market price having fallen below the price payable under the Principal Agreements) leading to a loss to the buyers of in excess of £60 million.

The buyers' claim relied on three propositions, which were the subject of a trial of preliminary issues, namely that:

1. The sellers' capacity obligation in clause 6.4(1) of the Principal Agreements required the sellers to maintain the capacity to deliver the required contractual quantities from the Reservoirs themselves, taking no account of gas which was owed to them in repayment of gas lent to other User Groups under STACA.

2. A term was to be implied into the Principal Agreements whereby the sellers' right to serve (or not to serve) a variation notice to reduce the TRDQ had to be exercised honestly and in good faith, and not arbitrarily, capriciously or irrationally.

3. Damages for breach of the capacity obligation in clause 6.4(1) are to be assessed on the basis that, in order to perform it, the sellers would have served variation notices that would have reduced the quantities which the buyers were required to take and pay for under the Principal Agreements.

Lionel Persey QC, sitting as a Deputy High Court Judge, rejected propositions (1) and (2) and therefore dismissed the buyers' claim. The buyers were granted permission to appeal the judge's decision on proposition (1), but not (2). Although proposition (3) did not require determination, the judge held that he would have determined it in the buyers' favour. The sellers cross-appealed the judge's decision on proposition (3).

## The Court of Appeal's judgment

### Proposition 1: The Construction of the Capacity Obligation

The Court of Appeal allowed the buyers' appeal on the construction of the capacity obligation. The Court began with the language of clause 6.4(1) and concluded its plain meaning was that it was concerned only with capacity to supply gas from the Reservoirs and not gas from other sources. The sellers' argument that gas to be repaid under STACA had to be treated "as if" it were gas produced from the Reservoirs was rejected because it sought to read words into clause 6.4(1) that were not there.

Next, the Court of Appeal analysed other provisions in the Principal Agreements which, it held, served to confirm its provisional conclusion based on the language of clause 6.4(1). In particular, other provisions made it clear that the TRDQ was based upon the physical production capacity of the Reservoirs alone.

The Court of Appeal next considered whether STACA, with which the Principal Agreements had to be read, affected that conclusion and held that it did not. On the contrary, since the STACA contemplated that lending and borrowing of gas would be temporary only, its provisions were inconsistent with bringing such gas into consideration when setting the TRDQ.

Finally, the Court of Appeal considered "commercial common sense", which it doubted had much of a role to play in the construction of detailed and expertly drafted contracts such as the Principal Agreements, and concluded that since the purpose of clause 6.4(1) was to ensure security of supply of gas from the Reservoirs, there was no reason why the possible availability of gas from other sources had to be taken into account.

### Proposition 3: Assessment of Damages

The Court of Appeal also allowed the sellers' cross-appeal on the assessment of damages. For the purposes of that cross-appeal it had to be assumed that the sellers were in breach of the

capacity obligation in clause 6.4(1) for a considerable period (up to ten years). Despite that, the Court of Appeal held that the buyers suffered no loss because although the sellers failed to maintain the capacity to deliver 130% of the TRDQ from the Reservoirs, they were able to meet the buyers' delivery nominations utilising gas owed to them by other User Groups.

Damages for breach of contract were to be assessed on the basis that the party in breach had performed its obligation and, on that basis, the buyers suffered no loss. Although the sellers could have avoided their breach of the capacity obligation by issuing variation notices to reduce the TRDQ in line with declining Reservoir production, damages were not to be assessed on the basis that the party in breach would have taken steps to avoid being in breach in the first place.

**Comment**

The Court of Appeal's approach to the construction of the capacity obligation was a textbook application of the approach to construction of commercial contracts as re-stated in *Arnold v Britton* [2015] UKSC 36 and *Wood v Capita Insurance Services Ltd* [2017] UKSC 24. It is also a striking example of how difficult it can be to displace a provisional view reached focusing exclusively on the parties' language. The interpretation of contracts is an iterative process. But where a complex and professionally drafted contract is being construed, the language is often the beginning and the end of analysis, particularly where the contract is a long-term contract construed in circumstances that are unlikely to have been foreseen. The parties' language is then often all the court has to work with and notions of "commercial common sense" (and other cross checks) are unlikely to prove decisive.

The Court of Appeal's conclusion that the buyers suffered no loss as a result of the sellers' assumed breach of the capacity obligation is, at first blush, counter intuitive. As Peter Jackson LJ commented (at [102]) it "runs contrary to the conventional expectation that parties who breach contracts should face consequences" and that expectation is "harder to shake off where the defaulting party had the power to alter the contractual obligation so as to avoid being in breach". As noted above, the sellers did have the right to reduce the TRDQ by issuing a variation notice and did, in that sense, have a choice as to how they performed the contract.

The fact is, however, that the sellers did not exercise their option to reduce the TRDQ (and thereby avoid breaching their capacity obligations). The sellers had a single obligation to maintain the capacity to deliver gas from the Reservoirs at 130% of the TRDQ. On the assumption that they were in breach of that obligation, the buyers were entitled to be put into the position they would have been if the sellers had maintained that capacity and, on that basis, they suffered no loss.

In reality, the buyers' damages claim was not one for breach of the capacity obligation, but rather for a failure by the sellers to exercise their discretion to serve variation notices reducing the TRDQ in line with declining Reservoir production. That being the case, it was unfortunate that the buyers were refused permission to appeal against the judge's decision on proposition (2) (the implied term). The circumstances where the courts will imply a term to limit the scope of a discretion conferred upon one of the parties (a so-called "Braganza" implied term following the Supreme Court's judgment in *Braganza v BP Shipping Limited* [2015] UKSC 17) is a developing area of law: see *TAQA Bratani Ltd v Rockrose* [2020] EWHC 58 (Comm) at [44]-[53] and *Cathay Pacific Airways Ltd v Lufthansa Technik AG* [2020] EWHC 1789 (Ch) at [150]-[183]. The Court of Appeal's assessment of damages demonstrates the extent to which the sellers' right to issue variation notices affected both parties' rights under the Principal Agreements. As Peter Jackson LJ commented (at [107]) the contract was unusual "in giving one party the prerogative to set the parameters of an obligation that binds both parties". At the very least the implication of a term requiring that prerogative to be exercised in good faith might have mitigated against what the Court of Appeal itself described as the "counter-intuitive" and "surprising" result it reached on damages.

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Malcolm specialises in commercial disputes arising in a variety of sectors including energy and natural resources, international trade and shipping and offshore construction.

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