



How to Stop the Lights Going Out – The Implications of Interruption to Fuel Supply

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COUNTRIES AFFECTED BY CRISIS





How to Stop the Lights Going Out: the Implications of Interruption to Fuel Supply

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Change Drives Disputes

- Change in profitability / economic balance of contracts has varied significantly over the last 18 months
- Volatile commodity prices
- Construction boom in the oil industry led to prices and terms dictated by EPC contractors
- Credit crunch
- Change in governmental behaviour – often driven by the economy



Tangible Effects of the Change

- Credit crunch:
 - Companies move into administration
 - Risks of insolvency increased
 - Projects under construction questioned by their lenders
- Change of government behaviours
 - Russia's demand for a more market-based pricing vis-à-vis Ukraine
 - Transit countries' insistence on higher transit fees, i.e. bigger cut of the overall profits



Ukraine vs Russia

Background

- Heavy dependence on gas as fuel for power generation in some other countries
- Critical importance of gas supply from Russia and vulnerability of central and eastern European countries to any interruption of supply
- Current pipeline network necessitates transit of gas destined for Europe through several countries



Ukraine vs Russia

Key ingredients of the conflict

- Below-market pricing of gas sold to some of Russia's neighbours (due to historical reasons) and Russia's desire to bring the price closer to market
- Ukraine's "counterclaim" – demand for higher (more adequate?) transit fees
- Outstanding bills



Ukraine vs Russia

Immediate results of the conflict

- Major shortage of gas in Hungary (supplies cut to power plants and large industrial users – alleged damage 0.02-0.04% GDP per day)
- Major disruption in eastern Ukraine (50% of the industry brought to a standstill with no supply of heat to many municipalities)
- 20% cut in gas supplies in Poland (with no major consequences as alternative routes of supply existed)



Ukraine vs Russia

Long-term consequences (and opportunities?)

- This has resulted in:
 - A fear of increased gas prices in future contracts
 - The need to re-open existing supply contracts with Russian suppliers
- But has also resulted in renewed focus on:
 - Alternative routes of gas delivery (South Stream, Nord Stream, Nabucco)
 - Gas storage
 - Nuclear, clean coal, renewables and other alternatives to gas fired power generation



Ukraine vs Russia

Lessons to be learned

- Politically sensitive crises cannot be avoided through the means available to private contracting parties
- Security of supply requires:
 - Investment programs
 - Political solutions
- Nevertheless, the possibility of future supply interruptions must be addressed:
 - Through technical solutions (alternative fuels, alternative supply routes)
 - Through proper risk allocation among all parties involved



Interruption in Fuel Supply (1)

Mitigation relating to electricity supply

- Generators have following options:
 - Source fuel from alternate suppliers
 - Claim force majeure with respect to supplies and (possibly) hardship with respect to replacement supplies
 - Reduce output
- However, the above may result in:
 - Breach of existing agreements
 - Default under credit facility agreements



Interruption in Fuel Supply (2)

Mitigation by contractual mechanisms

- The gas shortage issue from the generator's view point:
 - National gas supplier is usually well protected
 - Similar back-to-back protection should be provided in the generator's contracts with its off-takers. However:
 - It is hard to pass risk all the way upstream
 - Ultimate producers are unlikely to accept liability
 - Protection from the market balancing implications of the shortage may not always be achievable
- Ultimately the loss of revenues is likely to be borne by the generator



Interruption in Fuel Supply (3)

Mitigation and regulatory and other restrictions

- It is also necessary to consider parties' continuing obligations
- Whether there are protected customer priorities in times of contingency
 - What non-regulatory/civil contingency obligations?
 - Are there any preferred customers or does the generator have to pro-rate/allocate to its customers whatever power is available?



Growth in Other Disputes (1)

Volatile commodity prices

- Long-term contracts tend to have either a fixed price or price formula, often coupled with take-or-pay commitments
- Significant changes in market prices/demand create clear "winners" and "losers"
- The "loser" may seek to
 - Claim force majeure whenever possible – interrupting supply
 - Claim that the "winner" has committed a repudiatory breach and terminate the agreement – ceasing supply



Growth in Other Disputes (2)

Disputes beginning to arise

- The party whom the economic balance of the contract has swung against may “game” the contract
 - Price adaptation/hardship disputes
 - Force majeure disputes
 - Take-or-pay disputes
 - Applying the contract
 - Suspension of performance
 - Repudiatory breach / termination strategy disputes
 - Insolvency risk



Growth in Other Disputes (3)

Government action

- Budget deficits: Government tax receipts have fallen and social costs have risen
- NOC / State income from natural resource agreements have fallen with the oil price and demand
- Increased government action:
 - Nationalisation / expropriation
 - Indirect expropriation / fiscal raids
 - Enforced renegotiation

Conclusions

- Economic and political changes drive disputes
 - Prudent contractual drafting and structures can mitigate many (but not all) risks
 - However, contractual mechanisms cannot guard against all risks in this highly political international market

