Oil and Gas insight

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Fair exchange is no robbery

A look at the 'Take-or-pay' clause in energy sector contracts

The Government of Ghana has begun engaging players in the energy sector to renegotiate all take-or-pay contracts in the sector to take-and-pay contracts.

This decision was made on the back of increased demands for a more robust procurement system and efficient management of the nation's resources.

This article examines the take-or-pay clause in energy sector contracts and discusses alternative contract clauses available when negotiating contracts.

Origins

Take-or-pay contracts have been used perhaps since the inception of the Natural Gas trade. It was popular in the 1960s in Europe and USA and remains a commonly used clause in long term energy contracts.

The original purpose of the take-or-pay clause was to balance the interests of both the buyer and seller by providing an assurance of a guaranteed revenue stream to the seller; and providing supply security and price flexibility to the buyer.

What is a take-or-pay clause?

A take-or-pay contract clause obligates a buyer to pay for a contracted quantity of a commodity, regardless of whether the buyer takes the entire quantity agreed or not. In some instances, the buyer may pay an agreed lower price for the quantity not taken. There are also make-up rights associated with such contracts, which allow a buyer to claim any quantities that it paid for but did not take during the applicable measurement period.

In practice, buyers are able to negotiate lower prices in take-or-pay contracts in order to compensate for the guaranteed quantities to the seller.

In long term energy contracts, sellers are typically concerned with quantity and price risks. A take-or-pay contract clause places the full quantity risk on the buyer because the buyer pays for the quantity regardless of demand during the period. This leaves the seller with only the price risk to manage.

A take-or-pay clause assures the seller and its financier of a return on the significant capital investment necessary to generate the agreed quantities of the commodity. The seller in turn, assures the availability of the pre-agreed quantities of the commodity.

Certain events may result in a downward adjustment of the contracted quantity for a measurement period. These events include inability of the seller to make the quantities available for delivery; quantities which do not conform to quality specifications; and force majeure. In such instances, the buyer does not pay for quantities that were not available or suitable for delivery.

Although, the take-or-pay clause is not usually accepted outside the oil and gas industry, it is a common practice within the industry.

Disputes

The take-or-pay clause in contracts has been a source of many legal disputes.

For instance, if a buyer is delayed in commissioning facilities needed to receive and use the commodity, the take-or-pay obligation will start to accrue at the agreed delivery start date, regardless. The seller becomes entitled to receive payments from the buyer if it can be demonstrated that the commodity was available for delivery.

Furthermore, if the seller is able to sell the quantities not taken by the agreed/contracted buyer to another buyer, the seller is not required to account to the contracted buyer for these proceeds. Depending on the terms of the agreement, the contracted buyer may still be obligated to pay for the contracted quantities.

However, if the buyer can show that the quantity was not available for delivery, then the take-or-pay obligation may be eliminated.

It is advisable that a buyer avoids the take-or-pay contract clause if it is apparent that it may not be in a position to take delivery of the contracted quantities at the agreed delivery dates.

Distinguishing features between the 'take-and-pay' and 'take-or-pay' clauses

The take-and-pay clause, also known as the firm off-take contract, obligates the buyer to take and pay for a minimum quantity of commodity in each measurement period. Each time the buyer fails to take the minimum contract quantity in any period, it will be in breach of the contract and become liable to the seller for damages. Unlike the take-or-pay clause, the buyer cannot subsequently claim any quantities that it paid for but did not take during a particular measurement period.

Another key distinguishing feature is that the seller is required to take all reasonable steps to mitigate its losses, including reselling the quantities not taken by the buyer. The proceeds of such sales are then offset against the claims receivable from the buyer.

A third major point of difference is that, with a take-and-pay contract, the seller must bring a damage claim for each occurrence of the breach. Depending on the contract terms, the seller may have to provide evidence of actual loss as well as evidence of its efforts to mitigate such loss. Clearly, this could be time consuming and lead to unending legal tussles. A take-and-pay seller may therefore find that revenue is not as guaranteed under this clause as with the take-or-pay clause.

Are there alternatives to these clauses?

Yes. There are alternatives, two of which are discussed below, although not commonly used in the industry.

Requirements contracts

A requirements contract obligates the buyer to take all its demand for a commodity from the seller. There is no pre-determined quantity. It is worth noting that the quantity required by the buyer may be less than what the seller produces hence the seller may need to find ways of selling the excess supply. The commodity prices under requirements contracts are therefore higher than what would be paid under the take-or-pay and take-and-pay contract clauses to reflect the increased risk to the seller.

This type of contract may be most favourable to buyers in an uncertain market because there is no commitment to purchase quantities that may not be required. However, it is not commonly used because it does not assure a revenue stream for the seller, increasing the seller's difficulty in obtaining external debt financing.

Take-or-cancel contracts

Under this type of contract, the buyer may take less than the contracted quantity, provided it gives the seller reasonable notice and pays a cancellation fee. The cancellation fee must adequately compensate the seller for the fixed and unavoidable costs incurred in generating the agreed quantities.

Similar to the take-or-pay contract, the seller is assured of cash flow regularity. The seller receives enough notice to make alternative arrangements and is entitled to the cancellation fee. However, because the cancellation right gives the buyer a high level of quantity flexibility, it is important for the seller to manage the potential for cancellations by the buyer. To mitigate the impact of such cancellations, sellers endeavour to set an appropriate advance notice period during the contract negotiation stage.

It is better to prevent than to heal

Our experience in the industry has shown that, regardless of the clause that parties use, the challenge often arises in the manner in which these clauses are drafted.

Parties entering into long-term energy contracts should be aware of the essential features and limitations of these basic contract clauses.

Additionally, attention should be paid to other aspects of long-term contracts such as force majeure, pricing, quality, billing and timing, even if these appear to be boilerplate.

A properly drafted clause can provide significant comfort to sellers, lenders and buyers. What we see often is that issues are missed or not given enough attention in the rush to conclude a deal.

Concluding remarks

Parties should not feel limited to these clauses discussed but should explore arrangements that balance their interests and risks. The consequences of a poorly negotiated long-term contract may be felt for several years in the future.

Parties should also be mindful of the implications of their chosen contract type on financial reporting as each clause has different financial reporting requirements.

Take precautions and pay attention to avoid yesterday's errors from holding your tomorrow hostage.

Want to know more? Let's talk.

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