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Negotiating Take or Pay clauses in long term contracts in Nigeria

Nigeria has predominantly been focused on the exploitation of its crude oil deposits inspite of its vast natural gas reserves. This trend is however fast changing, with the development of its gas resources a top priority, given its pivotal role in economic development. In developing and exploiting this abundant resource, Nigeria embarked on major gas utilisation projects such as Liquefied Natural Gas (LNG) in the 1990s and more recently with the liberalisation of its power sector, critical gas to power infrastructure projects such as gas gathering plants and long distance pipelines. For these projects to be bankable and attract the necessary funding for execution, they are hinged on longterm offtake contracts such as LNG Sales Contracts (LNG), Gas Sales and Purchase Agreements (GSPA), Gas Transportation Agreements (GTA) and Power Purchase Agreements (PPA).

At the heart of these longterm offtake agreements are take or pay provisions. Under these provisions, the parties agree that the buyer shall take a specified quantity of gas or power and will be required to make payment of the agreed contract price for such specified quantity of gas or power notwithstanding the buyer is unwilling or unable to offtake all or any portion of the specified quantity .

Similarly, in Gas Transportation Agreements (GTA) and Pipeline Capacity Agreements (PCA), send or pay clauses provide for the shipper to either use the pipeline or the capacity reserved in the pipeline to which the GTA or PCA relates or pay for same, even where the gas is not shipped and or the capacity reserved not used.

Both take or pay and send or pay clauses are risk allocation mechanisms used in safeguarding against risks such as market demand risk and price risk. As risk allocation mechanisms, these clauses allow project sponsors such as NLNG, Azura IPP, Gaslink, Seven Energy and Accugas in the case of Nigeria, secure funding for their various projects on a limited recourse basis, given the stream of revenue guaranteed by these provisions.

Given the importance of take or pay clauses to the bankability of long term energy projects, it is essential that care is taken when drafting such clauses to avoid the possibility of them being judicially misinterpreted and therefore declared unenforceable.

A typical take or pay clause requires the buyer to either take, or pay the contract price for a minimum contract quantity of the commodity (i.e. electricity or gas) each (usually referred to as the Take or Pay quantity 'TOP Quantity') or in the alternative, pay the applicable contract price for such TOP quantity if not taken in the applicable year.

It is important to stress that where the buyer fails to nominate or take delivery of the TOP quantity in an applicable year or where the shipper fails to send the nominated quantity or use the reserved capacity, it would not amount to a breach or default of the LNG, GSPA, PPA, GTA or CRA. So, under a long term contract, the buyer or shipper could in a given year nominate zero delivery and not be in breach of its obligations as the difference between the quantity not taken by the buyer or sent by the shipper in that year and the corresponding TOP quantity would form the deficiency quantity for which the buyer or shipper must make a take or pay payment to the Seller at the end of the year.

TOP Quantity is not fixed but is normally adjusted to take cognisance of various events that may occur in a given contract year. Such events include, under delivery by the seller; delivery by the seller of off specification gas that is rejected by the buyer; and force majeure events. These reductions reflect the basic principle that a buyer should not have to pay for a commodity that could not be delivered. The take-or-pay obligation only applies to commodity that meets the required specifications (or which the buyer accepts even though off-specification) and which is not affected by the applicability of force majeure to relieve a party of its obligations.

Most LNG contracts and GSPAs typically offer the buyer the right to receive “make-up” quantity of gas in later years (in some cases even during a brief period following the expiration of the contract term) which corresponds to the quantity for which a take-or-pay payment was made and not taken. This make-up gas can be taken only after the buyer has first taken the TOP Quantity for that year, which preserves the seller’s assured annual revenue thereby eliminating both demand and price risks earlier stated above. In addition, there are often restrictions over the period in which the buyer’s right to take make-up gas exists. It is important to note that make -up provisions are native to LNG contracts and GSPAs and do not feature in most other commodity take or pay contracts.

Take or pay distinguished from Take and pay

Take and pay clauses in contrast to take or pay clauses require that the buyer takes delivery and pays for the quantified goods. The buyer does not have the right to refuse to take the minimum contracted quantity of such goods and still make payment. The makeup principle also does not apply in take and pay circumstances. It therefore suffices to state that where a take and pay clause is applicable, the inability or refusal of the buyer to take delivery of the goods would amount to a breach of contract for which the seller could claim damages, so care must be taken to ensure the take or pay provision is not drafted in a manner in which it could be interpreted as a take and pay provision so that the clause is not deemed a penalty and rendered unenforceable.

Take-or-Pay Disputes

Take or pay clauses are often the subject of major disputes in long term energy contracts and the typical defence of buyers in such circumstances is that the clause amounts to an unenforceable penalty or that its underlying cause was a force majeure event. Most take or pay disputes in Nigeria have been the subject of arbitration as opposed to litigation (i.e. disputes between Gaslink Nigeria Limited and its customers) thereby limiting judicial precedent and pronouncements on whether a take or pay clause would under Nigerian law be deemed to be an unenforceable penalty. In the absence of such pronouncements, if the issue were to be the subject of litigation before Nigerian courts, reliance would have to be on decisions from other jurisdictions such as the English and U.S courts or decisions of courts of the other commonwealth countries.

US Courts have frequently held take or pay clauses as being enforceable. However, this was not always the case with the English courts as some of the court decisions created uncertainties as to whether take or pay clauses could be deemed to be unenforceable penalties. The issue has now been resolved by the English Supreme Court in the case of *Cavendish Square Holdings BV & Anor v Talal El Makdessi*ⁱ where Lord Neuberger and Lord Sumpton stated that the test for the applicability of the rule on penalties to take or pay or send or pay clauses is whether ***“the impugned provision is a secondary obligation which imposes a detriment on the contract breaker out of all proportion to any legitimate interest of the innocent party***

in the enforcement of the primary obligationⁱⁱⁱ In essence, where a take or pay payment becomes due upon the seller or transportation company making gas or electricity or pipeline capacity available, the rule on penalties would not apply, as no secondary obligation would have been created and the take or pay payment would not be deemed out of proportion given the seller's interest (i.e. repayment of its loan facility to its lenders for the energy project).

Effects of Force Majeure on a Take-or-Pay Obligation

In drafting take or pay clauses care has to be taken in ensuring that a buyer's ToP Quantity obligations in a contract year are not obliterated by the application of force majeure provisions which ordinarily prevents the buyer or seller from performance of their roles under the contract. In this instance, the makeup provisions should be drafted to ensure that once the force majeure event is resolved, the TOP quantity not taken in a given year can be taken in the future subject to the buyer meeting the TOP quantities in such subsequent years.

Seller's Obligations Regarding Delivery in a Take-or-Pay Contract

To limit the deductions from Take or pay payments, the seller and or transportation company must ensure that the buyer and shipper do not prevent delivery of the gas or electricity. Their transportation obligation should be deemed satisfied upon making available for delivery the agreed quantity of gas or the reserved capacity, as opposed to upon delivery.

Conclusion

It is important that parties seeking to enter into longterm energy contracts in Nigeria have an understanding of the key features of take or pay clauses and the impact of such clauses on their obligations under the contracts. Parties should be mindful of such clauses burdening the buyer or shipper with a minimum quantity offtake as opposed to the buyer or shipper having an option, and should seek the inclusion of makeup provisions and mechanisms for the handling of force majeure.

ⁱ [2015] UKSC 67

ⁱⁱ [2015] UKSC 67 [32] (Lord Neuberger and Lord Sumpton)