

The Risks and Benefits of Blending on Board – Are You Getting the Right Mix?

Author: [Paul Skeet](#), Counsel, London

Author: [Kyri Evagora](#), Partner, London

Author: [Frances Callanan](#), Associate, London

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Introduction

For logistical and economic reasons, which are considered below, there is an increasing trend (especially in the oil trade) for blending, doping and dyeing cargoes on board vessels.

This client alert:

- looks at the practice of blending, doping and dyeing cargoes on board vessels; and
- sets out some tips for best practice in documenting the indemnities that are commonly required to be given by Buyers to Sellers in CIF, CFR and DES/ DAP sales transactions in connection with such operations.

Blending on board - who, what, why?

Blending is the commingling of two or more products into a single cargo. In the commodities market, blending represents a quick and economical means of producing a variety of products at short notice, using existing inventory or component products that are cheaply and/or readily available.

Blending might be carried out to:

- alter existing stock so that it meets the specifications in a new contract;
- make a completely new product to meet demand in the market; or
- decontaminate an existing product.

Alternatively or in addition, a cargo may be "doped" with additives to modify its performance (either for economic or for legal/ regulatory compliance purposes) and cargoes may be dyed to comply with local laws and regulations.

From a supplier's point of view, blending, doping and dyeing on board (as opposed to upstream or in shore tanks) has a number of advantages.

First, in order to blend, etc. upstream or onshore, a supplier must invest in or lease appropriate blending equipment and/or storage tanks. This not only represents an upfront cost but can cause logistical issues if demand for storage and blending facilities exceeds capacity.

Second, creating a cargo on board allows a supplier to source product from a wider geographical area and at shorter notice. For example if a supplier needs two products to produce the cargo it requires, it does not have to wait until both products are available at the same loadport or send its vessel to a port where the two components are available at the same time. Instead, it can load the first product and direct the vessel to the source of the second. This saves time (and potentially storage and transport costs) and therefore allows suppliers to respond promptly to demand, blending new cargoes en route to the Buyer.

Legal Issues

Blending, doping or dyeing on board gives rise to a number of legal and practical issues, two of the most important of which are considered below.

Cargo Homogeny

By blending or doping a cargo on board a vessel, the supplier relies on the loading process, assisted by the ship's systems and the natural motion of the vessel at sea, to blend the cargo and ensure cargo homogeny.

If blending is not effective, samples drawn at discharge may not be representative and, if the sample does not meet contractual specifications, the cargo might be rejected and/or the subject of a claim. As a consequence, the supplier might find itself in breach of its contractual obligations and/or local laws and regulations.

Indemnities

Blending, doping or dyeing a cargo clearly changes the composition of the cargo. As a consequence, the cargo that is delivered to the Buyer may not correspond to the description of the cargo stated on bills of lading issued upon shipment. If the goods discharged are no longer as described on the bills of lading, the shipowner might be exposed to significant liability. Shipowners will therefore usually request a letter

of indemnity from the charterer before agreeing to the blending, doping or dyeing of a cargo on board a vessel.

In CIF, CFR and DES/DAP sale contracts, therefore, it has become increasingly common for a Seller to request a corresponding letter of indemnity from its Buyer where the Buyer requests or requires blending, doping or dyeing of the cargo to take place on board the vessel. For example, under Shell's General Terms and Conditions for Sales and Purchases of Crude Oil (2010 edition), a Buyer that requires a cargo to be commingled, blended, doped, dyed or otherwise altered on board the vessel must indemnify the Seller in respect of all liabilities and losses the Seller may suffer as a result of such a request - and the Buyer's indemnity will be no less wide in scope than the indemnity the Seller is required to give the vessel owner. The usual exclusion of "consequential" losses is also expressly stated not to apply to the Buyer's indemnity to the Seller in this context.

Below, we will look at the giving and receiving of such indemnities from the point of view of both Sellers and Buyers in CIF, CFR and DES/DAP sale transactions.

Best Practice for CIF, CFR and DES/ DAP Sellers

Avoid express obligations to blend, dye and/or dope

So far as possible, Sellers should seek to avoid agreeing in the CIF, CFR or DES/DAP sales contracts to an express obligation to blend, dope or dye the cargo on board the vessel at the Buyer's request prior to discharge. In a particular case, any of these activities might be impossible, impracticable or expose a Seller to onerous liabilities that the Seller may not wish to assume (especially if the Buyer is not considered creditworthy for any indemnity - as to which see below).

Alternatively, if there is to be an express obligation to consent to these operations prior to discharge, the sale contract might be drafted so that any such obligation is subject to the consent of the shipowner and the provision by the Buyer of appropriate indemnities.

Seek a right to be indemnified by the Buyer

For the reasons set out above, shipowners are likely to require a letter of indemnity if the Seller/charterer wishes to blend, dope or dye the cargo. If blending, doping and/or dyeing is carried out at the Buyer's request, the Seller should have a corresponding right in the sale contract to an indemnity from the Buyer before going ahead.

Remember, a letter of indemnity is only as good as the creditworthiness of the party providing the indemnity. Consider the value of the Buyer's letter of indemnity: does it offer adequate protection if given by a Buyer that is already at the limit of its credit with the Seller? Should the Seller have a contractual right to insist that the Buyer's indemnity be countersigned by a first class bank approved by the Seller or that some other form of security be provided in the Seller's discretion?

Agree appropriate amendments to the sale contract

Before taking steps which could alter the cargo's composition, the prudent Seller will obtain the Buyer's clear written agreement that any blending, doping and/or dyeing has been carried out at the Buyer's request (or with its consent) and that the Seller will have satisfied its delivery obligations by delivering the altered cargo.

Best Practice for CIF, CFR and DES/DAP Buyers

Include an express right to require on-board blending, doping or dyeing in the sale contract

For a variety of reasons, a Buyer might ask a Seller to blend, dope or dye a cargo on board the vessel, to comply with local laws and regulations for instance or because a sub-buyer's requirements have changed. It is therefore in the Buyer's interests for the sale contract to include an express obligation on the Seller to procure that the vessel will allow the blending, doping or dyeing of the cargo on board the vessel at the Buyer's request. If the sale contract is silent on this point, the Buyer will be in a much weaker position when seeking the Seller's consent to such operations.

Limit the scope of any indemnity provided to the Seller

If the Buyer provides the Seller with a letter of indemnity, it should limit its scope as far as possible. It should be no wider, for example, than the indemnity the Seller has given the shipowner. So far as possible Buyers should also try to exclude liability for special or consequential losses.

Make sure you know what you are getting

Blending, doping and dyeing processes are not always carried out at the Buyer's request. In order to manage its delivery obligations a DES/ DAP Seller might blend and/or dope a cargo on board the vessel in order to meet contractual specifications at short notice.

The Buyer will not want to discharge a product which is later revealed to contain additives that are not permitted under local law and regulations. However, the Buyer will not necessarily know that the

composition of the cargo has been altered on board (or how it has been altered) after the bills of lading were issued. To avoid the problems which might arise as a consequence, a Buyer could insist on a provision in the sale contract which requires the supplier to give written notice of any blending, doping and/or dyeing which occurs on board the vessel and/or to disclose any letters of indemnity which are provided to shipowners in this respect before the vessel arrives.

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