

Floods in Australia: what legal implications for Commodity Traders?

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Australia has endured one of the wettest spring seasons in its recorded history. Heavy rain in November and December in eastern Australia caused river levels to rise and flood plains to become saturated. This led to widespread localised flooding and to the severe floods reported by the global media over the New Year period.

The most severely affected area covers a wide swathe of the middle part of Queensland State. At least seven major rivers in the area are reported to have flooded. At the time of writing the water levels are still high; states of emergency are in effect across many local authorities in the affected area. Water levels are expected to recede in the coming days but not to return to normal levels for weeks to come.

Affected commodities

Beyond the damage to life, property and infrastructure, the severe rain has impacted Australia's important commodities exporting business. Wheat and sugar trades are amongst those affected. Damage to crops and inland transportation problems have led to fewer stocks being available for export and a consequential rise in market prices. US Wheat futures were reported to be trading at a five-month high this week following concerns about damage to Australian (the world's fourth largest wheat exporter) crops. Australian sugar export forecasts for this year are reported to have been cut by 25%, exacerbating demand pressure and contributing to raw sugar prices reaching a 30 year high. Conversely, dry bulk freight prices have been forced down by the reduction in cargoes available for seaborne carriage. The Baltic Exchange's dry bulk freight index reached a 20 month low this week.

The most seriously affected trade is coal. Coal is Australia's biggest export business, accounting for approximately a quarter of Australia's total goods and services exports over recent years.

Australia is the largest exporter of coal in the world, exporting 28% of the world total in 2008-2009, with exporting capacity increasing since then.

Australia produces both thermal coal (used in the power generating industry) and metallurgical "coking" coal (used in the production of steel). All of Australia's export output of both types of coal is mined in Queensland and New South Wales in eastern Australia, with Queensland producing the greater quantity. The majority of Queensland's coal is coking coal. Its coking coal exports account for approximately two thirds of world trade. The vast majority of Australian coal imported into China, India and Europe is coking coal. Significant quantities are also exported to Japan, Korea and Taiwan.

With demand still strong in China and India in particular and disruptions prevalent elsewhere in the major producing areas (Columbia - heavy rains; Russia - severe drought and now severe cold) analysts are busy speculating on the effect the disruptions to the world's coking coal supply will have on prices of coal and steel, which relies on coking coal availability. Prices of both types of coal have already risen to recent highs and many predict further increases into 2011.

Our concern in this article is with the legal implications of the supply disruptions for trading contracts. An English law application is assumed but many of the legal principles will be similar under Australian law governed contracts.

Force Majeure?

The flooding has affected coal exports in three ways: (1) disruption to production due to flooding at producing mines; (2) disruption to the transportation of coal from mines to export terminals; (3) disruption to loading operations at export terminals.

It has been widely reported that many of the major coal producers operating in the area have "declared force majeure" in order to protect themselves from defaulting on contractual obligations to supply coal from mines affected by the flooding. The mine operators reported to have done so include BHP Billiton, Rio Tinto, Anglo American, Xstrata, Peabody Energy, Macarthur Coal, Aquila Resources - Vale, Cockatoo Coal and Wesfarmers. In total the mines affected are estimated to produce over a third of Australia's annual production of coal.

Coal is transported from the mines primarily by rail. The rail network is among the busiest for freight traffic in the world with trains of between 1 and 2 kilometres in length carrying 8,000-

10,000 tonnes of coal operating 24 hours a day. The main rail operator in the area, QR National has been forced to close parts of three of the four major coal transport lines in the area (Blackwater, Moura, Goonyella) due to the floods. Those closures have restricted or stopped completely the supply of coal to export terminals.

Four export terminals are reported to have been affected: Abbot Point, Dalrymple Bay, Hay Point and RG Tanna (Gladstone). At the time of writing supplies of thermal coal to the major thermal coal export terminal at Newcastle in New South Wales do not appear to have been severely affected. At the affected terminals shortages of coal have been reported due to the lack of stock arriving on the rail system and stockpiles being depleted. RG Tanna terminal announced that it would operate at 50% capacity last week. As at the time of writing, the terminal is reporting that coal stocks are "extremely low" with no more coal expected on the Moura rail system until the end of next week. 18 vessels are waiting at the port with a further 12 expected over the next week. Dalrymple Bay is said to have been operating at 60-70% of capacity since 1 January, with stocks due to run out this weekend. Of those stocks that are available for export issues may arise in relation to the condition and specification of the "wet" coal.

Who can rely on force majeure?

Force Majeure is a concept of French law. It is similar to the English law doctrine of frustration of contract (events arising subsequent to the execution of the contract that, without fault of either party, render performance of the contract impossible or radically different from that which was envisaged). Force Majeure is relevant to English law contracts only insofar as the concept of an agreed and permitted excuse for failure to perform is written into such contracts. English law commodity trading contracts invariably do so and adopt the term "force majeure" to refer to the permitted excuses.

No party will have a right to rely on "force majeure" to excuse his performance of any contractual obligation unless: (1) there is a clause in the contract that clearly covers the situation that has in fact occurred or there is wording that excuses performance where any other unspecified events outside that party's control occur; (2) there is a causative link between the events that have occurred and the party's inability to perform its obligations; and (3) the procedure specified in the clause is followed. If all three requirements are satisfied then the party claiming force majeure is entitled only to do what the clause permits. Often clauses permit suspension of obligations for a

period of time but they differ about if and when a party is entitled to cancel the contract or whether performance must be made once the FM ceases.

Regarding point (1), clauses frequently refer to "floods" but that may not be enough on its own. For example, mine production may not be directly affected by flood water but may be halted because of lack of transportation available due to the closure of rail systems following the floods. Regarding point (2) some clauses require that the FM events must have "prevented" a party from performing its obligations. Others state that it is enough for the events to "hinder" performance for a party to be excused. Often it is difficult to prove that a particular event has prevented a party from performing because it may be able to perform by means other than those anticipated at the time of contracting. Regarding point (3), where both points (1) and (2) are satisfied a party will then need to ensure that it complies with the procedural requirements of the clause regarding, for example, giving notice of the force majeure event to contractual counterparties. Consistent with the law's approach of holding parties to their contracts, a party may be prevented from relying on a force majeure clause unless it has complied with the requirements of the force majeure clause strictly. For more detail on what a force majeure clause should say and how to comply with it in a "force majeure" situation, see our previous [alert number 06-045](#).

Those companies who have **contracts with one of the coal producers** that has declared force majeure should review their contracts and consider whether the relevant producer is actually excused from performance or not - either because the events do not fall within the clause or because the party invoking force majeure has not complied with the procedural requirements of the clause. A general force majeure declaration is of no legal significance unless it triggers the operation of a specific clause in a contract.

It is to be expected that **traders that have bought coal from one of the producers** that have declared force majeure for onward sale will seek to pass on that declaration to their customers and rely on it. Whether they are entitled to do so and thereby avoid their obligation to deliver to their buyer will, again, depend on the precise wording of the FM clause in their contracts. Where the coal to be delivered is stated to be coal produced from specific mines affected by the floods then sellers may have good grounds for arguing that they are prevented from delivering the coal. Where no origin of the coal is specified then sellers will be in a more difficult position, since the law regards their intended source of supply as irrelevant when assessing whether they are able

to deliver coal to a buyer. If coal is available elsewhere (albeit at a much higher price) then a seller may be obliged to buy coal from that alternative source or risk being held in default and liable to pay the difference between the contract price and the relevant market price plus any additional freight costs incurred by a buyer. By way of example, the SCoTA contract incorporates this principle at clause 17.8, which states expressly that a failure by the seller's supplier to deliver coal will not constitute a force majeure event.

Where under **contracts for the sale of commodities FOB at one of the affected export terminals** sellers are unable to deliver within agreed loading windows because of reduced operations at the port or a lack of coal available because of rail disruptions, there are stronger grounds for a seller relying on usual force majeure language. If a seller is unable to buy coal already available at the port or already shipped by another party within the loading window save at an exorbitant price then it may well have grounds for arguing that it has been prevented from delivering coal by the consequences of the floods. The point to remember is that (unless permitted to do so by the relevant contract) a seller cannot safely sit back and expect that he will be excused by the restricted flow of coal to and from the port arising because of the floods. The prudent seller will do all that he can to try to source a cargo to perform the contract or risk being held in default.

Parties that have chartered vessels to load coal from one of the affected coal terminals may find themselves facing large demurrage liabilities or cancellations of vessels that do not load their cargoes within agreed laycans. It is less usual for charterparties to include force majeure clauses, though some of the less commonly used forms do. The Gencon form for example provides no means for a charterer to avoid obligations because of disruptions of the like experienced in Australia at present. The COAL-OREVOY form, in contrast, does include a force majeure clause. Of course a clause may be agreed as part of the additional terms that invariably supplement the standard Gencon form. The major suppliers tend to operate on their own standard terms and shipments under a COA may be governed by more apposite wording. As ever, it has to be borne in mind that a force majeure clause will not apply to interrupt the running of laytime or demurrage unless it specifically so provides. In relation to time charterparties charterers should consider whether "Exceptions" clauses provide them with a means of avoiding hire payments but often they will not.

Conclusion

The severe flooding in eastern Australia will have a major impact on individuals, businesses and the Australian state for weeks to come. It is to be hoped that the rain will subside and the water levels will dissipate quickly. Given Queensland is such a large exporter of commodities, the effect on contracts in an already high/volatile priced market is likely to be dramatic. Of all commodities it is coal which is likely to be most significantly affected given the volume of the world's coking coal exports that are mined in the affected area of Queensland.

Weather-related interruption of supply seems to have been a feature for world commodities in 2010. If one believes what one reads in the press La Niña's effect will continue well into this year. Events in Australia provide a timely reminder for all those with existing contracts to carefully review the force majeure language in their sale/purchase and shipping contracts so they can act appropriately to protect themselves from delay, disruption and loss adverse weather might cause. When preparing new contracts make it a new year's resolution to pay special attention to the inclusion of tailored FM type language in sale/purchase and shipping contracts to minimise exposure to the supply disruption.

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