Contractual Commitments and Consequences for Energy Business Interruption Losses

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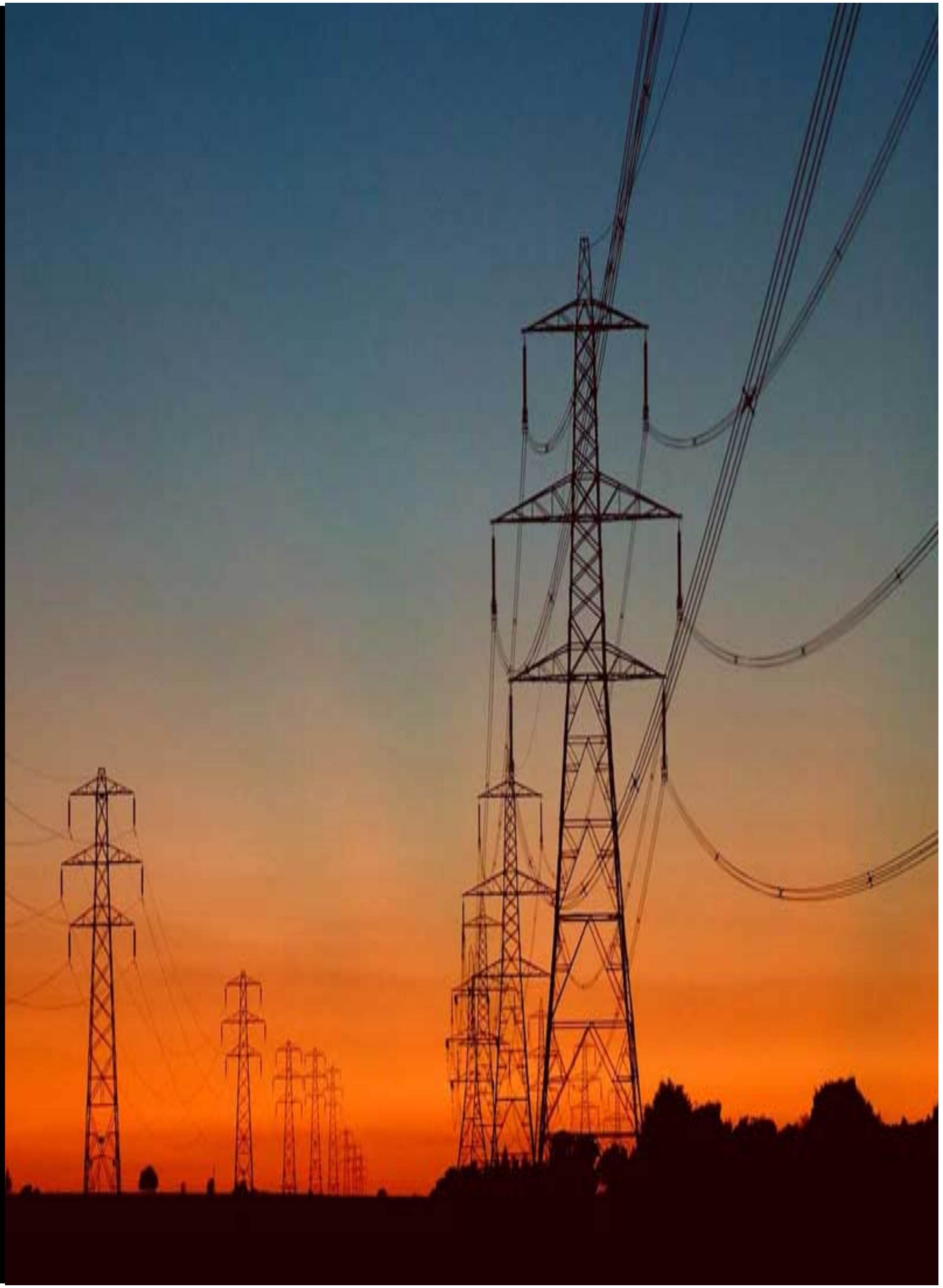
bakertilly
now, for tomorrow.



CONTRACTUAL COMMITMENTS AND BUSINESS INTERRUPTION

- Contractual commitments are common in energy / petrochemical industries

- Ensures continuity of:
  - Supply for buyers
  - Revenue for sellers

- May be required by providers of finance

- Contractual commitments may significantly impact a Business Interruption loss:
  - Raw materials
  - Sales commitments

- All behaviour governed by contract – insured has to work within restrictions of contract

1 Raw Materials

FEEDSTOCK / RAW MATERIALS – QUANTITIES

- Common contract types:
  - Take-or-pay contracts:
    - Long-term minimum take agreed
    - Buyer must pay even if minimum take not made
  - Contracts with rolling orders:
    - Buyer sets out requirement for a defined period, often rolling
    - Shorter-term commitment on take

CONTRACTUAL COST

- If agreed / minimum quantity not taken, could result in cost to the buyer
- Occasions when potentially no cost, when buyer cannot take:
  - Make up clause allowing catch up in later months / years (if applicable)
  - Force majeure (if applicable)
- Contractual clause may restrict the buyer's ability to consume at alternative locations or sell on the product
- Basis of cost depends on the contract but may be in the form of:
  - Cost of distressed sale, i.e. selling costs and lost sales value;
  - Value of shortfall against commitment
  - % of minimum take

IMPACT ON CLAIM

- Incident may result in lower feedstock requirements
- Contractual commitment to pay supplier
- Loss included within business interruption claim…

VARIABLE COSTS RELATING TO FEEDSTOCK CONTRACTS

- Claim for contractual costs on feedstock contracts quite common

- Raw materials / feedstocks = usually uninsured costs per the policy:
  - Purchases assume to vary directly with sales
  - Therefore costs “saved” if sales reduce

- With contractual commitment, if purchases are below minimum take, cost will not vary with sales/production

- Part of the cost is in fact “fixed”

- May not be indemnifiable as part of the loss of gross profit…

EXAMPLE OF FEEDSTOCK CONTRACTUAL COST

- Long term crude oil supply agreement – 150,000 barrels per day
- Monthly rolling plan for 3 months ahead
- Fire leads to a 75 day outage – buyer cannot take supply
- 60 day waiting period
- Seller has the *'right to sell the Crude oil in private sale'* due to failure of buyer to take delivery. Proceeds of sale shall first be credited against *'reasonable expenses incurred'* before purchase price owed by buyer.

Description	Unit	Cost
Barrels per day	BBL	150,000
Days outage	Days	15
Contract price	US$/BBL	70
Contract cost	US$	157,500,000
Difference in net sales proceeds	%	20%
Loss	US$	31,500,000

Contractual cost can have a significant impact on total loss

FEEDSTOCK 'LOSS' FREQUENTLY CLAIMED AS AN INCREASED COSTS OF WORKING

- BUT:
  - is it *"…necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in turnover……*
  - *…..but not exceeding the sum produced by applying the Rate of Gross Profit to the amount of the reduction thereby avoided"?*

    i.e. is the cost incurred economic?

ADDITIONAL INCREASED COST OF WORKING

- Is there Additional Increased Cost of Working or Extra Expense cover?
  - This extension frequently requires the expense to "*protect turnover*" (but is not subject to the economic limit)
  - some wordings may say *"…resuming or maintaining normal business operations."*
- Are purchases to meet contractual commitments the type of cost the AICW / EE is intended for?
- Is the AICW or EE cover sub-limited?
  - Given the size of the potential cost, sub-limits can be reached over a short period
- Even with AICW / EE cover, does an Insured have to declare FM to mitigate its loss?

2 Sales Commitments

SALES COMMITMENTS - VOLUMES

- It is not unusual for an Insured to have supply agreements on the sales side

- These may be for a:
  - Limited monthly or annual volume
  - Some regulated markets the volume may be unspecified, but the contract simply says ‘market demand’
  - A forward sales commitment

- If the above contractual conditions cannot be satisfied the options include:
  - Suffer the contractual penalties
  - Outsourcing - purchase in third party product
  - Declaration of *‘force majeure’*

INCREASED COST OF WORKING – SALES COMMITMENTS

- Purchase in final product to meet supply obligations
- Likely to mitigate a loss of turnover….
- However, does it mitigate a loss of gross profit?
  - On a MT:MT basis?
    - Purchased in final product likely to be more expensive than production
    - Often will not be economic as buying in at selling price + transport
  - Within the Maximum indemnity period?

INCREASED COST OF WORKING – SALES COMMITMENTS (CONT.)

Description	But for US$ per BBL	Actual US$ per BBL
Selling price of final product	70	70
Production cost	(60)	
Import – purchase cost		(70)
Import – transport cost		(5)
Gross margin	10	(5)

Additional cost: split by?	15
Economic	10
Uneconomic	5

3 Other Considerations

SUMS INSURED AND AVERAGE

- Feedstock costs often declared as uninsured costs:
  - Therefore, may not form part of BI Sums Insured
- However, portion of costs are in fact fixed, if purchases are below minimum take
- May result in underinsurance and application of average…

DEMURRAGE

- Due to an incident, buyer may not be able to immediately consume / store product
- Consequently, demurrage is incurred
- Does the policy cover demurrage? Is it a penalty?
- On occasion, the vessel transporting product could be considered a ‘floating warehouse’ mitigating the loss of a warehouse
- Results in additional demurrage cost
- Cost ‘akin’ to an additional storage cost
  - May need to split the cost between that mitigating the loss and that flowing from a contractual commitment
  - Policy may include a sub-limited cover for this expenditure

‘FORCE MAJEURE’ (“FM”) CLAUSE

- Frequently included in contracts
- Essentially frees both parties from liability or obligation when an extraordinary event or circumstance beyond the control of the parties prevents one or both parties fulfilling their obligation under contract
- Ability to declare FM dependent on:
  - Type of event
  - Wording of the clause
- Generally have a limited timeframe for the declaration
- Contract generally stipulates who decides whether it is an FM event

‘FORCE MAJEURE’ CONT…

- If declaration successful could avoid:
  - Obligation to buy in final product
  - Contractual costs for feedstock
  - May change revenue flows

- Whether the declaration of FM is accepted may take time to determine

- Insured may be reluctant to declare FM even if it mitigates the loss

PPA – FM EXAMPLE

- Gas fired power plant under a PPA
- Formula to calculate monthly revenue from available capacity is based on 6 month rolling average of availability
- Impact of shutdown continues beyond month of reinstatement
- Insured event resulted in shutdown of all units followed by staggered return to service
- Insured declared FM, which changed the formula to calculate revenue from available capacity so that there is no “tail” to the loss

PPA FM EXAMPLE

Month	% availability	Rolling average availability	Expected revenue from available capacity USD	Actual revenue from available capacity USD	Loss of revenue from available capacity USD
			No FM declaration		
Jan-18	100	105	1,050	1,050	0
Feb-18	0	78	1,050	783	267
Mar-18	50	70	1,050	700	350
Apr-18	100	70	1,050	700	350
May-18	100	70	1,050	700	350
Jun-18	100	70	1,050	700	350
Jul-18	100	70	1,050	700	350
Aug-18	100	87	1,050	867	183
Total – No FM declaration					**2,200**
			FM declared		
Feb-18	0	n/a	1,050	0	1,050
Mar-18	50	n/a	1,050	500	500
Total – FM declaration					**1,550**
Difference					**650**

- Need to consider on a case by case basis

SUMMARY

- Understanding contractual commitments for both feedstock and final product sales key to:
  - Understanding risk
  - Providing suitable cover
- Loss scenario - need to understand as soon as possible the impact of the contractual commitments to:
  - Understand the potential exposure
  - How / whether a loss can be mitigated
  - FM declaration?

Questions?