

Client Alert

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Hurricane Harvey – The Impact of Force Majeure on the Oil and Gas Supply Chain

As shut down notices continue to roll in, it appears that the level of damage wrought by Hurricane Harvey to oil and gas infrastructure along the Gulf Coast may vary significantly by asset class in the final analysis. Although a number of pipelines and upstream producers have curtailed operations due to the storm, the heaviest impact so far has been to oil refineries along the Gulf Coast. This is not a total surprise – Houston and Corpus Christi, two of the cities most affected by the storm, are both major refining centers, but nonetheless the total volume of refining capacity subject to curtailment has been a bit startling. Some of the largest plants in the United States have completely shut down operations, including the ExxonMobil Baytown refinery, Shell's Deer Park plant and Valero's Corpus Christi plant; further affecting the supply chain, both the Port of Houston and the Port of Corpus Christi were totally shut down and remained closed at the time of this writing. Perhaps most significantly for the broader industry, this loss of downstream refining capacity could cause a domino effect that rolls up the oil and gas supply chain, as oil continues to be produced upstream without any downstream outlet. Early indications are that this process has already started, with certain transporters with primary delivery points into affected refineries now being forced to curtail upstream receipts points as their systems back up, affecting buyers and sellers up and down the pipeline.

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Force majeure analysis after hurricanes

People living along the Gulf Coast have various rituals they perform whenever a hurricane comes ashore. Personal rituals vary from family to family, but one commercial ritual occurs at all companies up and down the oil and gas supply chain, including producers, shippers, processors, refiners, traders and lenders (and now add LNG liquefaction facilities, private equity investors and mineral interest investors), when commercial managers and their lawyers gather in half-empty offices and pull out their hydrocarbon contracts to determine what impact an announced or anticipated shut-down or curtailment will have on their business, including how to respond to a counterparty declaring force majeure, and whether, and how and in what form, to make their own declaration. If they have available hydrocarbons/capacity at a delivery point subject to curtailment, they may

strategize a way to take advantage of price spikes caused by a localized scarcity or glut. But more typically their overriding concern is defensive – how to escape a situation where a counterparty’s failure to perform makes their own performance impossible (or grossly sub-economic) under their other obligations up or down the supply chain.

Allowable scope of force majeure

As noted above, the portion of the oil and gas supply chain most affected by Harvey in terms of direct outages has been refineries along the Gulf Coast – i.e., the force majeure “epicenter” is at the refineries. With nowhere to deliver, pipelines leading to refineries are starting to back up; causing shippers, including buyers, sellers and upstream producers, to automatically lose capacity on the line. As the supply chain freezes up, force majeure declarations will also start to roll in the same direction, as each party in the chain tries to avoid being the one left holding the bag – in the present case, this probably means that a party would be forced to sell excess hydrocarbons into a locally-depressed market. This type of force majeure ripple effect is not uncommon in the oil and gas industry, especially during a major event like a hurricane, but it is interesting to note that most jurisprudence on this subject involves analysis of a ripple effects moving in the opposite direction – i.e., curtailment of upstream supply rolling downstream; case law is overweight in this regard mainly due to an influx of cases after Hurricanes Katrina and Rita, which impacted offshore production and transport more than Harvey.

The issue that tends to arise most frequently when a force majeure event hits and ripples along the oil and gas value chain (whatever direction it moves) is whether “force majeure” under the relevant contract is intended to include events affecting parts of the supply chain that are upstream or downstream of the actual delivery point relevant to the contract. In many cases, a party is permitted to declare force majeure when its performance is affected by a force majeure condition that occurs elsewhere on the supply chain – e.g., in relation to the contract delivery point, an event curtailing an upstream source of supply, upstream or downstream transportation capacity, or downstream usage (refining) or a downstream market; but this is not always the case. In many instances this type of “force majeure chain” is broken intentionally by the agreement of the parties, typically in conjunction with a firm commitment (e.g., when a shipper agrees to support the capital build-out of a system or facility, regardless of its ability to ship during certain conditions) or under commodity trading agreements, where the parties agree to assume the obligation to cover at the applicable delivery point; however in certain cases the break occurs due to oversight or an ambiguity under the contract.

The available case law analyzing this issue, which it should be noted is relatively scarce, typically focuses on whether the parties clearly agreed that the upstream or downstream infrastructure subject to the applicable force majeure-type event (i.e., the affected source of supply, transportation capacity, usage or market), and the availability thereof, would be incorporated as a component of the performance obligation of the relevant party, or whether the parties instead agreed to tender performance at the relevant delivery point notwithstanding the availability (or shut-down or curtailment) of such upstream or downstream infrastructure. Any actual language in the contract pertaining to this issue is usually determinative, with language expressly qualifying or disqualifying specific categories of upstream and downstream infrastructure/ circumstances as force majeure being the most persuasive. Courts in the relevant jurisdictions have not yet fully resolved the appropriate outcome when a contract is completely silent on the incorporation of upstream or downstream infrastructure/circumstances as part of the applicable party’s performance obligation. In the majority of cases where a contract is silent as to this issue, courts have leaned towards excluding failure of the secondary factor as an allowable force majeure event, unless the failure somehow also causes curtailment of performance at the relevant delivery point; however, courts have given some leeway in cases where the availability of the relevant upstream or downstream factor is obvious or well known to the parties, either due to past dealings or to the physical reality of the markets at and around the delivery point, and the economic result of forcing a party to perform (cover) at the delivery point would be unreasonable under the circumstances.

Allocation of capacity during curtailment

Another issue that can arise when a force majeure event impacts the oil and gas supply chain occurs when the applicable event causes only a partial curtailment, but not a complete shut-down, of a party's ability to perform at a particular delivery point. To the extent the issue is not addressed in the relevant agreement between the parties, the allocation of available performance/capacity by the curtailed party between similarly situated customers can become contentious. Sometimes under these circumstances, whether due to the ambiguity of its obligations under relevant contracts, the confidential nature of its trades as between unrelated counterparties, or just as the knee-jerk reaction by traders during a storm, a curtailed party may elect to maximize the revenue that it obtains on its remaining capacity, either by allocating performance overweight towards existing contracts with better pricing, or by allocating zero to existing contracts in order to take full advantage of spiking spot prices. Courts have tended to look unfavorably on non-pro rata allocation among existing customers in this case, to the extent made for reasons other than operational concerns.

Delivering and responding to notices of force majeure

It is important to proceed carefully and thoughtfully when issuing your own declaration of force majeure. Consider whether the declaration will be likely to cause disproportionate losses to your counterparty, where the counterparty does not have the option to issue a corresponding declaration of force majeure up or down the supply chain, as applicable, and will be forced to cover its performance to other parties at a loss, or to otherwise bear penalties, fixed costs, etc. If so, you may want to proceed with extra caution, as disputes are more likely to result, and consider whether there are any available transactions to offer as alternative performance.

A force majeure declaration should be made in a timely manner and in accordance with contractual requirements, including any relevant notice requirements, but should where possible avoid: (i) extraneous detail, including names and actions of particular individuals, (ii) unnecessary speculation as to causes or as to the motivation of other parties, and (iii) potentially incorrect information, including aggressive estimates on recovery times, etc. If it is necessary to describe the force majeure event, make sure to include a description of the actual cause affecting performance at the delivery point, in addition to any other relevant circumstances – for instance, if delivery into a downstream transporter is impossible because the pipeline is full, and the pipeline is full because Hurricane Harvey shut down a downstream refinery, make sure to note at least the direct cause of force majeure (no capacity at the receipt point of downstream transporter), and consider also noting the root cause (Hurricane Harvey) to the extent it is helpful in the context of the explanation – it probably will be, as a hurricane equates to a root-level force majeure event in most people's heads.

Curative work

Sometimes the facts and circumstances do not necessarily align in your favor when the music stops, like it just did, and you need to work with the contracts that you have on the table. If this happens do not despair, and remember that an integral part of any force majeure event is working to clean up a messy situation. In any event, it may not be too late to implement remedial measures to help your case (if it comes to that). Some options include: (i) clarifying/confirming treatment of force majeure under ongoing or completed transactions with a willing counterparty, before a claim/demand posture accrues between you and them, (ii) offering alternative performance that will put the counterparty in a similar economic position, and/or (iii) reviewing and preserving records relating to upstream and downstream counterparty performance (or curtailment thereof) that caused your own force majeure event, in the event it becomes necessary to seek contribution at a later date.

Additional information on this topic is available

This notice to clients is a shortened version of a longer article on the effect of force majeure on the oil and gas supply chain that will be published in the upcoming King & Spalding Energy Newsletter, which will include, among other things, a more detailed citation of authorities. If you would like to receive the longer article in advance of publication and/or directly by email, please contact the author at peterhays@kslaw.com.

A personal word on the devastation and the recovery

King & Spalding's energy practice is global, but we have our largest single energy presence in Houston, Texas, with over 80 lawyers and 150 total staff. Most of our Houston lawyers have core practices in the oil and gas industry, representing clients based in and around the city and along the Gulf Coast. We live here, and in the surrounding neighborhoods and towns; and with our families, alongside our clients and colleagues, we have experienced and borne witness to the storm, and the rains and high water. We note with anguish that the impact of its harshness was not uniform, and that some households suffered desolation while others were spared.

We offer our deepest sympathies to those most affected, and will do our part to ensure a swift and complete recovery to those most in need. Last, we recognize with much trepidation that although the water in Houston has started to recede, flooding along river basins is continuing, and in some cases worsening, and that our neighbors in Louisiana, many of who came to our aid so recently are now in the path of the rains. Our thoughts are with them.

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