LONG-TERM SUPPLY CONTRACTS – TIME FOR REVIEW

Louis Chiam* and Vishal Ahuja**

Long-term contracts for the sale and purchase of mineral commodities have been a feature of the Australian energy and resources industry for many years. While the use of long-term contracts appears to have increased in that time, a number of important legal underpinnings remain unresolved. In the complex (and lengthy) negotiation of long-term contracts it often seems that issues are resolved by reference to legal custom and practice rather than strict legal analysis. This paper outlines some of the main factors influencing the commercial use of long-term contracts and examines some of the more complex issues thrown up by long-term contracts.

> "The existence of an appropriately priced long-term sales contract yielding substantial revenues from a creditworthy customer commonly provides the lender with the security required to underpin the repayment of borrowed funds, and the assurance that the project that is intended to generate the required revenues will be viable for the term of the borrowings. The borrowing company is correspondingly assured that it will not thereby become financially over-extended. Confidential evidence as to a number of contracts for sale of gas and for pipeline haulage of gas over the last few years suggest that 15 years is not uncommon for a long term contract that underpins such financing".

Australian Competition Tribunal,
Re: AGL Cooper Basin Natural Gas Supply Arrangements
(1997) ATPR ¶41-593

INTRODUCTION

It is 20 years since AMPLA first turned its gaze on the use of long-term contracts in the Australian minerals market.[1] Since then, while much has changed, much remains the same. Despite some challenges, it appears today that the use of long-term contracts for the sale of mineral commodities remains a reality of increasing importance.

Long-term contracts have been the subject of a range of commentaries in that time, both from a practical and technical perspective. However, a number of recent developments make it timely to revisit this topic.

In recognition of the various articles which have addressed, both generally and specifically, the role and history of long-term contracts in Australia, this paper does not intend to cover old ground. That said, there is something to be said for 'revisiting' important material, and to that extent Part 1 of this paper draws on both previous commentary and our own views to provide an overview of the allocation of risk in long-term contracts.

---

* Partner, Mallesons Stephen Jaques

** Senior Associate, Mallesons Stephen Jaques.

The views and opinions expressed in this paper are the authors' and not necessarily those of Mallesons Stephen Jaques. This paper is a general overview and is not intended as legal advice.

[1] See, for example, L.W. Newman, 'Problems with Long Term Contracts: A Practical Viewpoint' (1986) *AMPLA Yearbook* 487; and I.J. Hardingham, 'Problems with Long Term Contracts: Change of Circumstances' (1986) *AMPLA Yearbook* 474.

The balance of the paper then examines a number of legal issues that, while common to many commercial contracts, are magnified in the context of long term contracts:

Part 2: fluctuations in market price;

Part 3: the calculation of damages for the buyer and seller following the termination of a long-term contract;

Part 4: changes in the underlying commercial circumstances;

Part 5: dealing with changes in the law; and

Part 6: the relationship between long-term contracts and the *Trade Practices Act* 1974 (Cth) ('TPA') and (5).

1. ALLOCATING RISK IN LONG-TERM CONTRACTS

1.1 Why use a long-term contract?

Long-term supply contracts require a buyer and a seller to commit themselves to a relationship for an extended period of time. At the risk of over-simplification, commercial parties enter into long-term contracts for two main reasons (both of which reflect a high-level concern with the allocation of risk).

First, from the seller's point of view, a long-term contract guarantees a market for a particular product for a designated period of time. This provides a reliable cash flow for the seller and is often used to justify or finance the significant infrastructure investment required to develop natural resources. As a result, long-term contracts have played a key role, particularly within Australia, in the energy and resources industry, giving investors (and their financiers) the confidence to invest large sums of money prior to full market development. These objectives are typically manifested within the contract in the 'Take or Pay' and variable pricing clauses.. These mechanisms are discussed in further detail below.

Second, from the buyer's point of view, a long-term contract guarantees the supply of the product for a designated period of time. This certainty is often necessary to justify investment in the buyer's production facility (for example, where the product will be used as feedstock or an energy source) or in down-stream distribution infrastructure. The seller's contractual supply commitment is often called the Annual Contract Quantity or ACQ.

Inevitably, the certainty provided by entering into a contractual relationship for an extended period of time results in a loss of flexibility, creating a tension between 'flexibility and accommodation to circumstances on the one hand and certainty and obtaining the benefit on the other'.[2]

Importantly, this loss of flexibility means that many risks common to any contract are magnified by the very nature of a long-term contract. This tension lies at the heart of most controversies surrounding long-term contracts. Whether it is an unforeseen change in circumstances or an assessment of damages following repudiation, commercial parties (and courts) often struggle to determine an appropriate resolution to the tension.

---

[2] LW Newman, 'Problems with Long Term Contracts: A Practical Viewpoint' (1986) *AMPLA Yearbook* 487, 487.

1.2 Australia's legal heritage – fitting a square peg into a round hole?

Before embarking on a detailed survey, it is worth observing that long-term contracts present a challenging task for practitioners and (when things go wrong) for judges alike. As will be seen from the balance of this paper, the challenge is not always fully answered. The reasons for this are complex and beyond the scope of this paper. However, a few features stand out.

- Long-term contracts tend to be large volume, high-value, bespoke contracts. This means there are fewer of them and the stakes in any litigation are very high. There is a very strong incentive to settle any dispute and, not surprisingly, they do not feature prominently in the law reports.
- The synthesis of contract law that emerged out of 19th Century English case law and, more latterly Australian case law, was based in an economy fundamentally different from today's. Importantly, these cases were principally concerned with single transactions (for example, the sale of goods) and, particularly in the Australian context, were dominated by contracts for the sale of land. In contrast, modern long-term contracts are often a complex series of transactions, stretching over many years.
- The explosion of statutory intervention in contracts has had a pronounced effect on long-term contracts which were, in many cases, agreed long before the statute was contemplated. The introduction of the TPA (discussed below) in the 1970's is perhaps the most significant of these changes.

1.3 Caveat emptor

Finally, it is important to preface this discussion by stressing that there is no single correct legal answer to any of the following risk allocations and that, as many commentators have pointed out,[3] no two long-term contracts are the same. Each is the result of extensive, and inevitably unique, negotiations which result in a contract specifically tailored to suit the interests of the parties concerned.

2. FLUCTUATIONS IN MARKET PRICE

As discussed above, a major attraction of a long-term contract is the ability of the seller to ensure price stability by means of a fixed pricing clause (with or without escalation provisions). This, combined with 'Take or Pay' provisions, seeks to ensure the seller a minimum fixed annual revenue. Where the contract is being used as a basis for investment by the seller, this clause is often of particular interest to investment committees and financiers concerned about downward movement in the market price. On the other hand from a buyer's perspective, a fixed price can render a contract uncompetitive if the wider market price falls.

---

[3] See Peter Bobeff, 'Long-Term Contracts for the Sale of Mineral Commodities' (1991) *AMPLA Yearbook* 335, 338 where he quotes Professor Daintith as concluding that 'there is certainly no such things as a standard contract in the iron ore industry, and it is doubtful whether it can be even said that there is a typical one.' See also John W McArdle, 'Long-Term Gas Contracts: Past, Present and Future' (1998) *AMPLA Yearbook* 165, 166.

In Australia, the recent contractual dispute between Powercor and Pacific Power highlights the risk of selling long in the context of volatile commodity markets.[4]Powercor was a retailer of electricity in Victoria and New South Wales. It purchased electricity from the relevant wholesale electricity pools at the half-hourly spot price but sold that electricity at fixed rates to its customers. To hedge its exposure to volatile spot prices, Powercor entered into a number of electricity derivative contracts with a New South Wales generator, Pacific Power.[5]

A dispute arose in respect of 11 of these contracts having terms of up to 10 years. Most of them involved simple swaps - if the spot price exceeded the agreed strike price, Pacific Power paid Powercor the difference multiplied by the notional volume of electricity. If the spot price was below the strike price, then Powercor paid the difference. Pacific Power was effectively selling electricity at a fixed price for up to 10 years while the half hourly spot price could fluctuate up to $5,000 per megawatthour.[6] In comparison, the spot price at the time the contracts were entered into was generally in the range of $10 - $20 per megawatthour.

Pacific Power refused to perform these contracts on the basis that there had not been a binding agreement concluded or such agreements had been entered into by employees who were not authorised to do so. However, Powercor was successful in obtaining an order for specific performance of the contracts. The value of these contracts to Powercor was estimated to be between $600 and $1,000 million as they apparently reflected the low spot prices of the time but such prices were expected to rise in the coming years.[7]

A number of the mechanisms used to ensure greater flexibility in the price are discussed below.

2.1 Long Term Market Price Indicators

A common mechanism adopted to ensure that the price reflects market conditions is to employ a long-term pricing indicator as published by an authoritative exchange or journal. However, such indicators, because of their retrospective nature, are often only published quarterly or at the end of each year. This can lead to practical difficulties as to what price is paid in the meantime and the need for payment adjustment mechanisms. The contract will also need to include a mechanism to determine a replacement indicator if the selected indicator is discontinued or the manner of its calculation materially changes.

2.2 Spot Market Prices

Having recourse to regular spot market prices is one way of circumventing the problem of applying a long-term price indicator retrospectively. Spot market prices are published by

---

4 *Powercor Australia Ltd v Pacific Power* [1999] VSC 110 (18 November 1999).

5 In the National Electricity Market, which includes Victoria and New South Wales, generators and retailers using the shared grid are generally required to buy from and sell into the wholesale pool rather than transact directly with each other through power purchase agreements. Accordingly, the derivatives discussed are financial instruments only, i.e. they do not involve the actual delivery of electricity. They are often called “contracts for differences”.

6 This represented the market cap, being the ascribed value of lost load. This was later increased to $10,000 per megawatthour.

7 New South Wales Legislative Hansard, “Pacific Power and Powercor Out-Of-Court Settlement”, 6 September 2000, Pages 8674 - 8685 (article 8).

exchanges in many jurisdictions for a variety of commodities. For example, in the energy sector, the National Electricity Market operator, NEMMCO, publishes half-hourly spot market price for electricity.[8] Pricing clauses with reference to spot market prices will inevitably result in substantial fluctuations in price over the term of the contract. Steps can, however, be taken to alleviate this. For example, it may be possible to include an averaging formula, which has regard to spot market prices over a particular period – whether one, three or six months – preceding the delivery month.

2.3 Price Review Clauses

Buyers and sellers seeking greater control over contract prices, and hesitant about 'succumbing' to externally set pricing indicators, may prefer to adopt price review mechanisms. Price review clauses, which dictate that the price is to be re-negotiated on a regular basis (for example, three or five years), have been commonplace.

The very real possibility of disagreement in price review negotiations is usually addressed by a contractual mechanisms for resolving deadlocks, whether by appointment of an arbitrator or expert, recourse to pricing indicators, or by some other means. However, these mechanisms can be extremely complicated and lengthy. In particular, the process of identifying and obtaining access to a sufficient number of similar contracts (to distil a "market price") can be time consuming and controversial.[9]

2.4 Risk sharing and protection mechanisms

Where the commodity is feedstock for a final product (for example, gas used to produce ammonia or electricity), then part of the price can be linked to the market price of the final product. This gives the seller a share in the buyer's margin of the final product but ensures that the buyer remains competitive because its main cost input will rise and fall with the market prices for the final product.

Any combination of price floors, caps and collars can be included to give the parties protection against massive upheavals in market prices. Sellers will often insist on a price floor to give project financiers satisfaction that there will always be sufficient cashflow to meet debt obligations. Buyers will often want caps to reflect fixed pricing agreed in downstream contracts. This can be addressed by use of rebates and credits which apply once the price returns above the floor or below

---

8 While the market is cleared on a half-hourly basis, the spot price is in fact calculated on the basis of dispatch offers processed on a five-minute basis.

9 For a recent example, see *Xstrata Queensland Ltd v Santos Ltd* [2005] QSC 323. In this case a 15 year contract between Xstrata and a consortium of producers from whom it acquired gas provided that after 10 years either of the parties could seek a price review. If a new price could not be agreed, then the matter would be referred to arbitration. A price review was sought by the producers. The parties did not reach agreement and the matter was referred to arbitration. On 9 September 2005 both Xstrata and the producers applied for leave to issue subpoenas for the production of documents to the arbitrators. The subpoenas were addressed to suppliers or industrial users of natural gas, with a view to obtaining information as to prices paid or proposed to be paid under contracts or arrangements to which they were parties. Most of the subpoenas were challenged, principally on the basis that information was said to be confidential, and its disclosure was perceived to be harmful even in the private context of an arbitration. Ultimately Xstrata was successful in obtaining 22 out of the 24 contracts that it sought to subpoena, although in some cases it was found that the subpoena should be varied so as not to required the production of certain classes of documents.

the cap. In some cases, this can effectively amount to a short term financing facility to tide a party over in times of depressed or high prices. However, all of these mechanisms raise two major issues – there will invariably be a cap on the credits or amounts by which one party gets ahead of the other and the question of how the final "true up" will occur at the end of the contract.

2.5 Current trends

Given the commercial sensitivity of pricing issues, it is difficult to collate a comprehensive survey of current trends in this area. However, in the authors' view, it is rare to find a long-term supply agreement tied solely to a downstream pricing indicator. More common is a fixed price linked to CPI, perhaps with part of the price floating in line with an indicator. No doubt a booming commodities market strengthens a seller's hand in these negotiations.

3. CALCULATION OF DAMAGES FOLLOWING THE TERMINATION OF A LONG-TERM CONTRACT

The potential pricing risks coupled with the large volumes involved naturally raise questions about appropriate remedies in the event of breach. This section explores some of the difficulties inherent in calculating damages for the buyer and seller following the termination of a long-term supply contract.

The discussion proceeds on the assumption that the relevant contract does not contain an enforceable liquidated damages clause to apply in the case of termination.[10] At common law damages are only available in the absence of a liquidated damages clause. Where a liquidated damages clause is deemed valid,[11] a claimant can only recover the sum stipulated under that clause, and cannot 'double dip' into the common law.

3.1 Calculation of damages for the seller

This situation arises where the buyer defaults, for example, by refusing to accept supply or by failing to pay. While the principles for the calculation of damages for the non acceptance of goods are prima facie set out under sales of goods legislation in each jurisdiction,[12] in practice long-term supply contracts generally exclude the operation of sales of goods legislation, and therefore common law principles apply. As the legislation is essentially a codification of common law

---

[10] As discussed below, there is a real question as to whether a liquidated damages clause in this context constitutes a penalty.

[11] A clause could be deemed invalid if, for example, it was found to be a penalty; that is, the quantified sum is not a genuine pre-estimate of the loss likely to be caused by a breach of the contract: *Dunlop Pneumatic Type Co Ltd v New Garage & Motor Co Ltd* (1915) AC 79.

[12] In Victoria, for example, section 56 of the *Goods Act 1958* (Vic) provides:

(1) Where the buyer wrongfully neglects or refuses to accept and pay for the goods the seller may maintain an action against him for damages for non-acceptance.

(2) The measure of damages is the estimated loss directly and naturally resulting in the ordinary course of events from the buyer's breach of contract.

(3) Where there is an available market for the goods in question the measure of damages is prima facie to be ascertained by the difference between the contract price and the market or current price at the time or times when the goods ought to have been accepted, or if no time was fixed for acceptance then at the time of the refusal to accept.

principles, this does not make a great deal of difference.[13] Where there has been a termination of a long-term supply contract by the seller, justified in law, the seller may claim damages for loss of the buyer's performance. These are generally referred to as 'loss of profit' or 'loss of bargain' damages. The principles that apply to the valuation of 'loss of bargain' damages depend on whether or not there is an available market for the goods. If there is an available market, the seller may recover the difference between the contract price and the objectively ascertained market price as at the time of the breach. Where there is not an available market, the seller may recover the actual net loss suffered (subject to principles of remoteness). These two alternatives are dealt with below.

3.1.1 Available market

If the buyer has defaulted and the seller can enter the market place to dispose of the goods, then the measure of loss is the difference between the contract price and the market price at the time of the breach. That is, the value of the lost performance lies in the advantage that particular long-term supply contract had over those available in the market. Market-based valuation of loss is an application of the principle that the innocent party is bound to take reasonable steps to mitigate the loss consequent on the breach.[14] The market price is to be ascertained objectively, contemplating a hypothetical sale by a hypothetical seller of the amount in question of the goods in question.[15] Where there are published or recorded market prices at the date of the buyer's breach, the actual price obtained by the seller upon reselling the goods at a later date is irrelevant. However, if there is no such information available, the court may accept other evidence (such as the price actually paid for the goods) in order to ascertain the market price.[16] Recourse to market price in assessment of damages is not peculiar to the United Kingdom or Australia. The United States position – both through case law[17] and the Uniform Commercial Code ("UCC") – reflects a similar approach.

Where the injured party has already resorted to the market, the onus is on the defaulting party to show that the transaction did not reflect the market value. That is, if the seller re-sells at a loss following repudiation of the sale by the buyer, it is up to the buyer to show that the price obtained was not the market price.[18]

Naturally, reference to an objectively ascertained market price is only justifiable where there is, in fact, an 'available market'. The definition of 'available market' rests on the availability of buyers and sellers, and their ready capacity to supply or to absorb the relevant goods.[19] While the majority of the case law dealing with the definition is from the United Kingdom,[20] there is useful Australian authority. In *Joseph v Harvest Grain,*[21] the New South Wales Supreme Court adopted the definition used by Sutton in *Sales and Consumer Law*:

---

13 As a corollary, while much of the case law is based on the sales of goods legislation, it is still instructive in examining common law issues.

14 *British Westinghouse Electric Co Ltd v Underground Electric Rys* [1912] AC 673.

15 The *Shearson Lehman* case, (No. 3) [1990] 3 All ER 723.

16 *Maclean v Dunn* (1928) All ER 947.

17 See, for example, Manchester Pipeline Corp. v Peoples Natural Gas Co., 862 F.2d 1439 (10th Cir. 1988).

18 *CFA Group v Mars Trading* [2001] NSWSC 112.

19 *Thompson Ltd v Robinson (Gunmakers) Ltd* [1955] Ch 177.

20 For commentary on the definition of 'available market' see J.P. Benjamin, *Benjamin's Sale of Goods* (5th edition, 2000) 871, K. Sutton, *Sales and Consumer Law* (4th edition, 1995)) 631, H.G Beale (General editor) *Chitty on Contracts* (29th edition, 2004)) vol 2, 1468.

21 (1996) 39 NSWLR 722.

> Available market would…seem to mean that buyers and sellers are procurable at once and within a reasonable distance of the aggrieved party in sufficient numbers to constitute the relationship of supply and demand and the consequent establishment of a price.[22]

The court also referred to the judgment of Upjohn J in *Thompson Ltd v Robinson (Gunmakers) Ltd:*

> [a]n available market merely means that the situation in the particular trade in the particular area was such that the particular goods could freely be sold, and that there was a demand sufficient to absorb readily all the goods that were thrust on it, so that if a purchaser defaulted the goods in question could readily be disposed of. [23]

Commentators suggest that whether there is an available market in any particular case seems to be treated as a question of fact, looking at both the nature of the subject-matter of the contract, and the circumstances of the innocent party.[24] The courts have not set formal limitations on the meaning of 'available market', because the concept provides only a prima facie measure of damages, which need not be applied wherever there is some justification for not doing so.[25] Recourse to the general principles of damages remain available to the innocent party (as discussed further below).

However, even a cursory examination reveals a number of important shortcomings in these principles. There is no Australian authority on what constitutes an 'available market' in the context of a long-term energy or resources supply agreement. It is therefore difficult to provide any authoritative opinion on the assessment a court would make. For the purposes of illustration, the following (albeit very rudimentary) hypothetical is used:

> *S (seller) and B (buyer) enter into a 20-year gas supply agreement. Five years into the contract B refuses to accept the gas, and S terminates the contract. S then brings an action against B for damages.*

The first question is whether there is an 'available market' in the context of a 20-year gas supply agreement. Several issues arise. For example, is the market one for the sale of all remaining gas (i.e. 15 years' supply) at once? For some of the larger gas contracts it is difficult to imagine any buyer seeking that much gas at once (let alone the physical impossibility of effecting such a supply). Or is the better course to look into the future and assess, on a year-by-year basis, what the market price would be for that year? While perhaps better reflecting commercial reality, this appears to run contrary to the prevailing case law.[26]

Alternatively, is there a market for the gas supply agreement itself (i.e. selling the contract rather than the gas)? It is difficult, to say the least, to contemplate the hypothetical sale of a 15-year gas supply agreement.

---

22 Sutton, op cit n 20, at 631.
23 [1955] Ch 177, at 187.
24 Benjamin, op cit n 20, at 875.
25 Ibid, at 874.
26 See, for example, *Francis v Lyon* (1907) 4 CLR 1023; *Dunkirk Colliery Co v Lever* (1878) 9 Ch. D. 20.

Similarly, how would a 'Take or Pay' clause affect this assessment? On one view, the 'Take or Pay' clause operates as a liquidated damages clause, and B should simply be required to 'cash out' its 'Take or Pay' obligation. However, what if (as is likely) the Take or Pay obligation is significantly greater than damages measured on an 'available market' test? This would increase the risk of the 'Take or Pay' clause being found invalid as a penalty.

Another complication arises from the fact that the relevant contract may form part of a much larger gas reserve, only a portion of which has been contracted. The reserve may be so large as to be, in effect, unlimited. If so, then S may argue that any on-market sale is an additional sale, as opposed to a substitute sale. S would argue that it would have made the second sale even if B had not defaulted. The test here is whether S had the ability and the opportunity to make the two separate profits. [27] If B is unable to show that S could not have earned the second profit but for its breach, then S would be entitled to the net profit of the contract between S and B.

Next, how would the claim by S stand in the context of the ubiquitous 'no liability for loss of profit' clauses, which seem to pepper so many commercial contracts today? The claim, based on the available market, is fundamentally one for loss of profits. However, how many sellers would regard such a clause as intended to prevent recovery of these types of damages?

Finally, and perhaps most importantly, how does all this sit with the commercial expectations of the parties? There is little doubt that sellers (and their financiers) expect that long-term contracts will deliver the expected revenue stream over time. Indeed, many sellers probably expect to be able to recover the full 'Take or Pay' commitment regardless of whether (to use the hypothetical) any gas is actually supplied. That said, a buyer in default could, with some justification, complain that such recovery constitutes double-dipping, as the seller, in effect, gets to sell the gas twice.

In the absence of clear Australian authority, some guidance on this issue can be provided by looking to North American jurisprudence and Australian case law on commercial leases.

In the United States, a number of cases have dealt with the application of the UCC to long term contracts with 'take or pay' provisions. In *Roye Realty & Developing Inc v Arkla Inc*[28] the buyer defaulted under a long term take-or-pay gas contract. The seller argued that it was entitled to recover the entire take-or-pay amount for the remainder of the contract term. The Oklahoma Supreme Court, referencing to Section 2-708(1) of the UCC,[29] held that, despite the take-or-pay clause, the measure of damages for non-acceptance or repudiation by the buyer is the difference between the market price at the time and place for tender, and the unpaid contract price (plus or minus incidental expenses and damages). While this decision disappointed the seller, the court also reached two important conclusions about assessing damages for the future (foregone) deliveries of gas that worked to the seller's advantage. First, the full amount of damages is calculated by reference to the prevailing market price at the time, ignoring any possible future market decline (or rise). Second, the seller's potential inability to tender gas over the entire term of the contract has no bearing on the assessment of damages.[30]

---

27 *Cameron v Campbell & Worthington Ltd* [1930] SASR 402.

28 863.P.2d 1150 (1993).

29 Which is couched in similar terms to section 56 of the *Goods Act* 1958 (Vic), supra.

30 In reaching its decision, the Supreme Court relied heavily on the earlier decision of *Manchester Pipeline, supra*.

While concerned with property rights, commercial leases have the twin advantages of being based nonetheless on general contract principles[31] and enjoying a rich history of Australia case law. These cases suggest two possible avenues.

First, the damages can be calculated by deducting the new rental from the lost rental (i.e. under the terminated lease) Griffith CJ, citing *Buchanan v Byrnes*,[32] stated that:

> In the ordinary case of a demise for a term of years with an express covenant to pay the rent, if the lessee unequivocally repudiates the lease and abandons the land, the lesser may at his option bring an immediate action for breach of covenant, in which he will be entitled to recover the full amount of the agreed rent for the whole term, less such sum as a jury may think he is likely to derive as profits from the use of land during the residue of the term.[33]

In the energy and resources context, this approach may be difficult to apply directly, mainly because commodities do not fall neatly into discrete parcels like commercial property. For example, it will be difficult to resell a like-for-like parcel of gas. That said, it would appear only a small extension to apply the leasing approach on a hypothetical basis (i.e. what price would the seller achieve for these volumes over these periods). After all, the usual contract law 'market test' can be applied on a hypothetical basis.

Second, the decision of Rowland J. In *Peet & Co Ltd V Rocc* suggests:

> …The true measure of damages is the difference between the value of the premises as a going concern with a tenant in possession pursuant to the contracted term and one without a tenant in possession at the relevant time at which such valuation is to be made being either the date of the breach or the date of acceptance of the lessor of that breach. In assessing the value of the premises without a tenant at the time, account must be taken of the commercial prospects of obtaining a tenant for the balance of the term then left, under the lease, and no doubt, the rent that could be commanded during that period.[34]

In our gas hypothetical, this could be extrapolated as an enquiry as to the value of particular gas reserves with a contract and the value without. This is arguably a simpler test, but suffers from the same disadvantage as the difference-in-rental test; that gas reserves and gas contracts do not come in neat parcels.

---

31 *Shevill v Builders' Licensing Board* (1982) 149 CLR 620.

32 (1905) 3 CLR 701.

33 *Lamson Store Service Co Ltd v Russell Wilkins & Sons Ltd* (1906) 4 CLR 672 at 684. Although *Lamson Stores* is principally concerned with whether a certain sum fixed in a contract should be treated as a penalty or liquidated damages.

34 *Peet & Co Ltd v Rocci* [1985] WAR 164 at 178. This case involved premises that could not be re-let and therefore could be construed narrowly. A tenant vacated his shop in breach of the relevant agreement. Damages for the landlord were calculated on the basis that the shop was incapable of being re-let because the shopping centre development in which the lease had been operating ultimately failed, and accordingly any subsequent lease was impossible.

3.1.2 Actual net loss suffered

Where there is no available market, the general principles of damages apply. The fundamental principle is that 'the plaintiff is entitled to full compensation for the loss which he sustains in consequence of the defendant's [breach], subject to the rules as to remoteness of damage and to the plaintiff's duty to mitigate his loss'.[35] Applying the traditional test in *Hadley v Baxendale*[36] a seller is entitled to recover the actual net loss resulting from the breach, provided that that loss is not too remote. A court may look at any relevant evidence to calculate this value. In practice, this test is likely to be extremely difficult to apply. For example, in the hypothetical outlined above, other than for a number of specific items, how is actual net loss to be measured?

There may be operational expenses particular to the contract between s and b. For example, in order to provided shipped gas to b, s may have entered into a take or pay gas transport agreement with a third party. These costs are within the actual knowledge of the parties, and as such any expenditure or liability associated with the termination of the transport agreement is likely to be recoverable. The same would apply for any pre-operational expenses particular to the original contract that are no longer recoverable.[37]

Similarly, S is entitled to deal with the goods 'in any reasonable way'[38] to adapt them to suit another customer. Here this may mean altering the terms of the contract or incurring additional expenses. The calculation of S's losses will include the cost of the adaptation.[39]

Beyond these items, there is no natural measure other than payment in full for the remaining contract volume (i.e. 15 years' supply). However, it would be curious if this test produced a result so markedly different from the result under the 'available market' test.

3.2 Calculation of damages for the buyer

A similar analysis to that set out above applies, albeit reversed, to the calculation of damages for non-delivery of goods.[40] Set out below are key points of differentiation, and application of the principles to a (reversed) hypothetical scenario. A key consideration here is the recovery of losses in B's hands arising out of a consequential failure by B to deliver goods under a contract for resale to a third party. Once again, where there is an available market, the buyer may recover the difference between the contract price and the objectively ascertained market price as at the time of the breach. Where there is no available market, the buyer may recover the actual net loss suffered (subject, of course, to principles of remoteness). These two alternatives are dealt with individually below.

---

35 *Hungerfords v Walker* (1989) 171 CLR 125 at 143.

36 (1854) 9 Exch 341.

37 See *TC Industrial Plant Pty Ltd v Robert's Queensland Pty Ltd* (1963) 180 CLR 130. For a detailed discussion see also *Commonwealth of Australia v Amann Aviation Pty Ltd* (1991) 174 CLR 64.

38 *Re Vic Mill Ltd* [1913] 1 Chr. 465.

39 Ibid.

40 Once again, the principles are *prima facie* set out under sales of good legislation in each jurisdiction - see, for example section 57 of the *Goods Act 1958* (Vic).

3.2.1 Available market

The meaning of 'available market' is discussed above. In general, the same factors should be relevant in deciding whether there is such a market from the buyer's point of view as from the seller's. Here, however, the question is whether there are a sufficient number of sellers to readily meet all demands from prospective buyers. Therefore, if demand exceeds supply, there will not be an 'available market'.

3.2.2 General principles: actual net loss suffered

A simple hypothetical illustrates the general principles applicable to the calculation of damages for the buyer in this situation.

> *A (seller) and B (buyer) enter into a 20-year gas supply agreement. B intends to use the gas as fuel for a power station and has signed long term power sale agreements with a number of third parties under separate agreements. Five years into the contract A refuses to supply the goods, and B terminates the contract. B then brings an action against A for damages.*

Where there is no available market, the buyer is entitled to recover the actual net loss resulting from the breach, provided that that loss is not too remote (see above discussion on the test for remoteness). A court may look at any relevant evidence to calculate this value. For example, in the hypothetical set out immediately above, the calculation of damages will depend upon the actions that B takes after the repudiation of the gas supply agreement. The following points should be considered.

If, despite the absence of an 'available market', B has been able to find a substitute seller (c) for terms substantially similar to those in the original agreement, the actual repurchase cost may be used to calculate B's loss (if the terms of the repurchase are substantially similar to those in the original sale).[41] If the actual repurchase price was lower than the price of the original contract B will, prima facie, be entitled to nominal damages only. However, B may still be able to show a loss if there are expenditures or liabilities particular to the original agreement. For example, B may have entered into a take or pay gas transport agreement with a third party.

If B is unable to find a substitute product, it may recover as damages the reasonable cost of obtaining goods which are the nearest available equivalent in quality and price to the goods of the contractual description. This may involve, for example, procuring alternative fuel, such as diesel. Provided that B's mitigating action was reasonable, it may recover these additional costs.[42] However, if the substitute goods were later resold at an additional profit, the extra profit must be set off against the cost of buying the substitute goods. For example, in *Erie County Natural Gas And Fuel Co. Ltd V Carroll*[43] the defendants failed to supply gas under a gas supply agreement. This resulted in the plaintiff having to spend $58,297 in procuring gas from other sources and constructing works to bring the substitute gas to their plant. The plaintiff later sold these substitute sources and works for $75,000. The Privy Council held that the price obtained in the sale of the

---

[41] *Harlow and Jones Ltd v Panex (International Ltd), supra* 2 Lloyds Rep. 509*; Lazenby Garages Ltd v Wright* [1976] 1 WLR 459.

[42] *Hinde v Lidell* (1875) L.R 10 QB 265.

[43] [1911] AC 105

substitute sources and works should be deduced from the cost of procuring the substitute gas. Thus, only nominal damages were awarded.

A question then arises as to whether B can recover (i) the loss of profits on a resale which it was prevented from earning because of A's failure to deliver; and (ii) the loss which it incurred as a result of being made liable in damages to its customer for breach of the terms of the power sale. If the seller knew or ought to have known that the buyer bought the goods with a view to resale, then the buyer may be entitled to recover for both (i) and (ii).[44] This position was recently confirmed in *Joseph & Co Pty Ltd V Harvest Grain Co Pty Ltd.*[45] In this case the defendant failed to supply chick peas. It was held that there was no available market for chick peas, and the defendant was liable to the plaintiff for both loss of profit and resale damages.[46]

4: CHANGES OF CIRCUMSTANCE

This encompasses a broad spectrum of risk. The usual suspects include drying up of supply or finance, a natural disaster, market collapse, new competitors and new technology. Each of these may lead to the result that a party to the contract is no longer able to perform its contractual obligations in the manner originally intended; that is, performance may have become impossible or uncommercial. Traditionally, on a rigid interpretation of a long-term contract, the adversely affected party has one of three choices: 'soldiering on, paying damages or attempting to re-negotiate the terms of the contract'.[47] While there is increasing recognition, by both practitioners and the courts, of the need for greater flexibility in cases of changes of circumstance, this sits in a context where the courts remain of the view that a party is not entitled to relief simply because a long-term contract has become a 'bad bargain'.[48]

4.1 Express terms

As a result of perceived difficulties and ambiguities in the application of common law remedies (in particular, frustration, which is discussed below), the parties may themselves provide for the termination or adaptation of their long-term contract in the event that particular circumstances occur. The most common examples are force majeure clauses, which usually excuse performance should events which fall within the scope of the clause occur.

However, there are a number of issues which practitioners should consider when drafting a force majeure clause. The first is in relation to defining the scope of a force majeure clause (which is generally set by defining the force majeure events to which relief attaches). Force majeure clauses

---

44 *Patrick v Russo-British Grain Export Co. Ltd* [1927] 2 KB 535.

45 (1996) 39 NSWLR 722

46 It is important at this point to note the decision in *Re R. & H. Hall, Ltd. v W. H. Pim, Junr & Co Ltd* (1928)All ER 763. (cf *Williams Brothers v E. & T. Agius Ltd* [1914] AC 510). The House of Lords held that even where there is an available market, if a seller fails to deliver promised goods, and a resale has been contemplated by the parties to the original contract, damages may include the loss which the first buyer has incurred as a result of being made liable in damages to its customer for breach of the resale contract. This will obviously only be the case if a replacement product cannot be acquired with sufficient time to satisfactorily fulfil the sub-contract which the first buyer has created with a subsequent purchaser.

47 IJ Hardingham, 'Problems with Long Term Contracts: Change of Circumstances' (1986) *AMPLA Yearbook* 474.

48 Ibid.

are typically intended to deal with events or circumstances not within the reasonable control of a party. The definition can be left in general terms or (more commonly) defined by reference to a specific list of circumstances, whether on an exclusive or inclusive basis.[49] Regular candidates include 'acts of God', acts of governments or regulatory bodies (and a party's reasonable response to such acts) and adverse weather. The recent security climate has also caused acts of terrorism be added as a regular agenda item. Occasionally force majeure clauses cover a much wider range of circumstances which affect the 'commercial interests'[50] of the contracting parties. These often traverse 'hardship' issues, discussed below.

A second issue, relating to the effect of a force majeure event and common to energy and resources supply agreements, is whether the parties intended delivery to be from a particular source, or whether the agreement is simply to deliver a particular (generic) product.

Consider for example a gas supply agreement where the seller owns only one source of gas, and that source is damaged by a force majeure event. If the contract stipulated this to be the exclusive source of supply for the seller, then the force majeure event would relieve the seller. However, if the contract stipulated alternative sources of supply, then the force majeure event would not. If it is unclear, and the source of supply is not set out under any express term in the contract, the seller can find itself unable to rely on the force majeure clause.

In general, if the contract is one for the sale of an unascertainable good by description (such as gas) the seller cannot rely on a force majeure clause merely because an event prevents it from acquiring the goods from its intended source, but leaves it open to it acquiring goods of the contract description (albeit at a higher price) from other sources.[51] The intention of the parties in this respect should be considered and documented during the negotiation of the contract.

4.2 Implied terms

It might be suggested that where there are no express terms dealing with a change in circumstance, a term should be implied to give business efficacy to the contract. This argument is inherently problematic. Case law clearly highlights that courts are slow (or at least say they are slow) to imply terms into a contract.[52] The requirements to imply a term are well defined, following the High Court formulation adopted in *BP Refinery (Westernport) Pty Ltd v Hastings Shire Council*:[53]

(1) it must be reasonable and equitable;
(2) it must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it;
(3) it must be so obvious that 'it goes without saying'';
(4) it must be capable of clear expression;
(5) it must not contradict any express terms of the contract.[54]

---

49 That is, the list either limits the extent of force majeure events ('A force majeure event means one of the following: …') or seeks to clarify or even extend the list ('A force majeure event includes the following:…').

50 For further discussion, see Bobeff, op cit n3, at 347.

51 *Exportelisa SA v Guiseppe Figli Soc. Coll.* [1978] 1 Lloyd's Rep. 433.

52 See, for example *Codelfa Construction Pty Ltd v State Rail Authority of NSW* (1982) 149 CLR 337.

53 (1997) 180 CLR 266.

54 These were cited with approval in *Codelfa*, op cit n 52.

There is clear authority that where an express contract is detailed and comprehensive (as is generally the case in long-term contracts), it is difficult to imply an additional term. This point was stressed by Mason J in *Codelfa Construction Pty Ltd v State Rail Authority of NSW*:[55]

> In many cases, what the parties have actually agreed upon represents the totality of their willingness to agree; each may be prepared to take his chance in relation to an eventuality for which no provision is made. The more detailed and comprehensive the contract the less ground there is for supposing that the parties have failed to address their minds to the question at issue…Accordingly, the courts have been at pains to emphasise that it is not enough that it is reasonable to imply a term: it must be necessary to do so to give business efficacy to the contract.[56]

In practice, the requirement of business efficacy usually proves to be a major stumbling block, as it is often possible to salvage some commercial operation to a contract without implying a force majeure clause.

4.3 Doctrine of frustration

A detailed discussion of the law of frustration, which has been the subject of extensive academic commentary[57], is beyond the scope of this paper. Essentially the doctrine of frustration arises in one of two situations: (1) where a change in circumstance renders the performance of the contract impossible; and (2) where a change in circumstance renders the 'commonly perceived purpose of the contract' impossible.[58] In relation to the first, commercial hardship or inconvenience will not fall within the scope of the doctrine. Therefore a rise or fall in market price, an increase in expenses, labour shortages or currency depreciations would not fall within the scope of frustration.[59] However, delay caused by strike or a natural disaster could bring about frustration. A failure of source of supply could also bring about frustration (subject to the discussion above in relation to the express terms of the contract in relation to the alternative sources of supply).[60]

The second situation is not restricted to literal impossibility, also applying to 'cases where the event which renders the contract incapable of performance is the cessation or non existence of an express condition or state of things, going to the root of the contract, and essential to its performance'.[61] However, such circumstances, in the case of long-term contracts, are difficult to

---

55 (1982) 149 CLR 337.

56 Ibid, at 346.

57 See generally N. Seddon, *Cheshire & Fifoot's Law of Contract* (first published in Australia 1966, 8th Australian edition, 2002) 1.107-1.111; J.W. Carter, *Carter on Contract* (2002) vol 2, Chapter 39.

58 Hardingham, op cit n1, at 477. *Codelfa*, op cit n 52.

59 Ibid, at 478.

60 Long term gas contracts usually include a specific reserves shortfall clause which excuses the Seller from its supply obligations when there are insufficient gas reserves to supply all customers. Supplies are usually allocated pro rata according to annual contract quantities entitlements unless foundation customers have been given priority.

61 *Krell v Henry* [1903] 2 KB 740. In this case, Mr Henry hired a flat from Mr Krell in Pall Mall for June 26 and 27, on which days it had been announced that the coronation processions for Edward VII would take place and pass along Pall Mall. Unfortunately for Mr Henry (and His Majesty) the King succumbed to appendicitis and had to undergo an emergency appendectomy. The coronation process was cancelled (it in fact took place on 9 August 1902). Mr Henry argued that the taking place of the processions on the days originally fixed along the proclaimed route was the foundation of the contract and accordingly

envisage. Moreover, the doctrine of frustration is generally severely limited, if not expressly excluded, by express terms of the contract (most notably, by a force majeure clause).

Put simply, it is a brave party that chooses to avoid a tense up-front discussion on particular circumstances, in the hope that, once the contract is signed, the doctrine of frustration will come to its aid.

4.4 Economic hardship clauses

It is not unusual to see clauses requiring the parties to negotiate changes to the contract to alleviate economic hardship suffered by a particular party. Economic hardship can be broadly defined or made objectively determinable (for example, a party has suffered negative cashflow for a particular period). In some cases these clauses will provide specific rights such as changes to the contract quantities or even termination. However, such clauses are usually 'agreements to agree' - they may specify a procedure but do not guarantee a result. Rarely will parties provide for binding dispute resolution in respect of these clauses as this could involve a third party fundamentally changing the contract.

Where changes in circumstances occur, the contract will often require the parties to negotiate changes in good faith. Even if it is not an express requirement of the contract, it may well be that Australian Courts will imply an obligation to perform a commercial contract in good faith where it is not inconsistent with the express terms of the contract.[62] While negotiation in good faith involves an obligation to act reasonably and honestly and not arbitrarily or capriciously, it does not require a party to act contrary to its own legitimate interests.[63]

Accordingly, a party having the benefit of an economic hardship clause should therefore seek to spell out the nature of the changes to be made. Conversely, if a party wants to 'quarantine' aspects of the contract from a good faith negotiation, then it should do so expressly by giving itself 'absolute discretion' as to whether such changes should be made.[64]

---

refused to pay the balance of the monies owed. The court held that despite a lack of fault in the contract or apartment itself, the non-occurrence of the coronation procession was sufficient to frustrate the contract. Mr Krell was thus unable to recover the balance of rent fixed by the contract.

62 The Federal Court has endorsed an implied obligation of good faith in *Pacific Brands Sport & Leisure Pty Ltd v Underworks Pty Ltd* [2005] Aust Contracts R 90-213 and in *Luce Optical v Budget Specs (Franchising) Pty Ltd* [2005] FCA 1486 (20 October 2005). Similarly, the New South Wales Court of Appeal in both *Burger King v Hungry Jacks* [2001] NSWCA 187 (21 June 2001) and *Vodafone Pacific v Mobile Innovations* [2004] NSWCA 15 (20 February 2004) endorsed an implied obligation of good faith. In Victoria, there have been a number of cases implying an obligation of good faith but the Court of Appeal has recently taken a more cautious approach: *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228. The High Court had an opportunity to consider the role of good faith recently in *Royal Botanic Gardens and Domain Trust v South Sydney City Council* [2002] 186 ALR 289 at 301 but the Court declined to comment on the doctrine.

63 E Peden, "When Common Law Trumps Equity: the Rise of Good Faith and Reasonableness and the Demise of Unconscionability" 21 (2005) Journal of Contract Law 226; *Gary Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR 41-703, at 43-014.

64 In *Vodafone Pacific v Mobile Innovations* [2004] NSWCA 15 at 195, 198 and 206-209, Giles JA held that a clause allowing a party to exercise its absolute discretion in performance of a contractual obligation sufficed to exclude an implication of good faith in the contract.

4.5 Mistake

Although not sitting comfortably with Australian jurisprudence, an interesting counter-point is provided by a strand of American case law which suggests that the principles of mistake and rectification can be extended to amend pricing mechanisms that operated poorly. For example, in *Aluminum Company of American v Essex Group, Inc.* the court considered a 21 year aluminium supply contract (worth hundreds of millions of dollars). It contained a complex index-linked pricing regime which the court described as prepared "with more than customary sophistication and care". Despite this, the pricing regime failed to contemplate a rapid rise in the seller's costs that resulted in the seller incurring significant losses in order to meet the supply obligations.

Although these facts bear more than a passing resemblance to a "bad bargain", the court was willing to look closely at the commercial negotiations leading up to the contract. While stressing that a party's erroneous prediction as to future events is not a "mistake" so as to attract a remedy, the court found that in this case the pricing regime did constitute a mutual mistake. Both parties knew that the seller sought a formula which would cover its out of pocket costs and a set profit and each (wrongly) assumed the pricing regime was adequate to fulfil this purpose.

5: CHANGES IN LAW

5.1 Sources of changes in law

Changes in law, while strictly a subset of changes in circumstance generally, have a number of important characteristics that warrant separate examination, principally relating to the nature of the changes and the way they affect long-term contracts.

As with other changes in circumstance, the risk of changes in the law is magnified significantly for a long-term contract. Changes in the law can occur many years after a contract is signed and may significantly alter the 'bargain' originally intended by the parties when entering into the contract, to the potential detriment of either the buyer or the seller. A brief survey of legislative and judicial shifts over the last 20 years illustrates some of the changes that commercial parties (and their lawyers) would have struggled to anticipate in 1986.

On the legislative front, the diverse spectrum of change has included the introduction of Part IIIA of the TPA (facilitating compulsory third party access to services from 'essential infrastructure' such as railways, ports and pipelines), the goods and services tax (GST) introduced by the Commonwealth Government in 2000 (which is discussed in more detail below) and the Mandatory Renewable Energy Target scheme imposed under the *Renewable Energy (Electricity) Act* 2000 (creating a new form of property, the renewable energy certificate, enjoyed by certain renewable generators, together with a new tax imposed on electricity retailers).

Judge-made law has evolved significantly in that time as well. Contract drafters in 1986 were safe in the knowledge that, at the height of the Mason High Court, further rapid change in High Court decisions was assured. Having already laid down new law on frustration in *Codelfa*[65] in 1982 and revolutionised the scope of unconscionability in *Amadio's Case*[66] in 1983, the Court went on to

---

65 *Codelfa*, op cit n 52.

66 *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.

hand down a series of landmark decisions in contract law. 1988 alone saw the seminal *Waltons Stores v Maher*[67] (significantly expanding the reach of estoppel into the sphere of commercial contracting) and *Trident General Insurance v McNiece*[68] (recognising important exceptions to the doctrine of privity). In more recent times, the Gleeson Court has left its own mark on contract law, with decisions such as *Astley v Austrust*[69] (and the flurry of legislative responses[70]) significantly altering the landscape for commercial contracts.

5.2 Impact on long-term contracts

As these examples illustrate, it is virtually inevitable that the legal environment prevailing at the time any long-term contract is entered into will be overtaken by major changes in law. In addition to the usual issues associated with the risk of changes in circumstance, changes in law present two particular complications.

The first is an example of sovereign risk. Long-term contracts are often connected, directly or indirectly, with Government itself. For example, many large resources projects are underpinned by a State Agreement (or a development agreement) between the developer and the State in which the resource deposit is located[71]. As a result the State will be a party to relevant long-term contracts (or important underlying contracts). This raises the prospect that, through the different arms of Government, the State has different (and potentially conflicting) roles. In particular the executive arm that enters into relevant contracts as sponsor contrasts with the role of the legislative arm in, for example, regulating the minerals industry. Not surprisingly, constitutional niceties about separation of powers rarely provide adequate comfort for commercial parties and their financiers.[72]

Second, recognising that statutory change can have an adverse impact on existing commercial arrangements, most major legislative amendments include some form of transitional provisions. These are often designed to preserve the validity or operation of particular pre-existing conduct or arrangements that would otherwise be proscribed under the new legislation. However, these transitional provisions typically have a 'sunset date', beyond which the relief will not apply. Also, they tend to be narrowly drafted, leading to extremely technical and complex analyses (and uncertainty) about whether particular conduct or arrangements are protected. The impact of a change in the law on long-term contracts is illustrated by the Australian Government's introduction of GST.

5.3 Case study – GST

While it is now a well-established feature of commercial life in Australia, most Australian readers will be all too familiar with the complexities arising from the introduction of GST on 1 July 2000.

---

[67] (1988) 164 CLR 387.
[68] (1988) 165 CLR 107.
[69] (1999) 197 CLR 1.
[70] See for example, *Wrongs Act 1958* (Vic) Part V.
[71] Some of the better known examples include the *Iron Ore (Mt Newman) Agreement Act 1974* (WA), which facilitated the development of BHP Billiton's Mt Newman Iron Ore Mine and the *North West Gas Development (Woodside) Agreement Act 1979* (WA), which facilitated the establishment of the North West Shelf oil and gas fields.
[72] For a further discussion of sovereign risk see generally P. Turner, 'Sovereign Risk' (1993) *AMPLA Yearbook* 135; A.J. Ray, 'Sovereign Risk: Commentary' (1993) *AMPLA Yearbook* 167; D. Gately, 'Sovereign Risk: Commentary' (1993) *AMPLA Yearbook* 173.

However, for those whose recollections are dimming or who had the good fortune to be otherwise engaged in 2000, a brief recapping is worthwhile.[73]

On 2 December 1998 the Commonwealth Government introduced into Parliament its much anticipated suite of bills to impose and administer the GST (collectively, the 'GST Bill'). After a somewhat complicated path through the Senate, the GST Bill (by now significantly amended) received Royal Assent on 8 July 1999 and took effect on 1 July 2000. The objective of the GST Bill was to impose a 10% value-added tax on most supplies of goods and services. In order to ensure the tax only applied to 10% of the final 'consumer' sale (that is, that the tax did not have a compounding effect on consecutive on-supplies in the production chain preceding the ultimate supply) the GST Bill adopted a two-limb structure of tax and credit.

First, the tax was imposed on suppliers of goods and services (and not the recipient) at a rate of 1/11th of the consideration for the supply. The intention was that the supplier would gross-up its 'real' price by 10% and thereby recover an amount equal to the GST from its customer. The second limb was that if the customer was simply an intermediate participant in the production chain (i.e. it on-supplied the goods or services to another person rather than being an end customer), then the intermediate customer was entitled to claim a rebate from the Government (the input tax credit) equal the amount of GST that the first supplier had added to its invoice. By this somewhat convoluted means, GST was effectively only paid by end consumers (who were not entitled to an input tax credit).

The structure, which was imposed on all supplies of goods or services regardless of when the relevant contract was signed, worked well provided the supplier was able to increase its prices (typically by 10%) to pass through the GST. Naturally, this presented a problem for parties to long-term contracts entered into before the GST regime where the pricing structures were locked in.

Recognising this difficulty, the GST Bill included transitional provisions for supplies made under contracts entered into before 8 July 1999 (the date of Royal Assent). The effect was to treat these supplies as 'GST-free' until the earlier of a 'review opportunity' or 1 July 2005 (i.e. five years after the regime commenced).

The concept of 'review opportunity', while straightforward enough in concept, proved enormously complicated to apply in particular situations. Many of these related to circumstances where long-term contracts such as leases purported to provide for price reviews, but in fact provided suppliers (in this case landlords) with limited ability to increase rents to pass through GST.[74]

Meanwhile, the sunset date loomed increasingly large for parties to long-term contracts that did not enjoy a 'review opportunity'. While it may have been hoped that most long-term contracts would have expired or been renegotiated over five years, many continued unaltered. Left as is, the regime would have imposed GST on these suppliers from 1 July 2005 in circumstances where the suppliers would have had no ability to pass it through to their customers.

---

[73] This is a simplified summary for illustration purposes only. It ignores a number of important aspects of the GST regime, for example, recipients who are not entitled to a full input credit.

[74] For a detailed discussion, see. T. Cantwell, 'Government Treats Long-Term Contracts to GST' *Australian Property Journal* 38 (No 1, February 2003) 68.

This was obviously an untenable situation and in early 2005, the Commonwealth introduced new laws[75] to address the so-called long-term non-reviewable contracts. The effect was to reverse the usual GST obligation for these contracts. Under the new laws, parties were encouraged to renegotiate their contracts to deal with GST. In the event agreement could not be reached, the supplier could elect to shift the GST obligation so that the recipient became liable to pay GST (i.e. instead of the supplier). In those circumstances, the recipient would still be entitled to an input tax credit in the usual way. As a result, neither supplier nor seller are (in a net sense) out of pocket, but long-term non-reviewable contracts are now an exception to the standard GST regime.

The GST case study teaches us a few important lessons about changes in law. The first is that it is very difficult to predict the future. It is difficult to imagine any commercial party accurately anticipating the scope and nature of the GST, even as late as 1998.

Second, and perhaps more importantly, for those who did anticipate the GST (conceptually at least) the worst situation to have been in was to have deployed a half-right pass-through clause. If the clause did not adequately anticipate the mechanics of the GST, then it could have left the supplier with an incomplete remedy. However, the clause may have still qualified as a 'review opportunity' so as to take the contract outside the transitional relief.

Perhaps ironically, a supplier whose long-term non-reviewable contract was completely silent on GST stood a better chance of a satisfactory outcome via the transitional provisions and the subsequent 'reversing' legislation in 2005.

6: RELATIONSHIP WITH LONG-TERM CONTRACTS AND THE TRADE PRACTICES ACT

6.1 The Trade Practices Act: Why is it relevant?

The main provisions relating to long-term contracts are set out in Part IV of the *Trade Practices Act* 1974 (Cth) ("TPA"), which is concerned with activities that may restrict dealings or affect competition.[76]

By their very nature long-term supply contracts result in significant volumes of a commodity being tied up for an extended period of time without third party access. Although the duration of a long-term contract is generally not, of itself, anti-competitive, particular provisions that may be included in a long term contract to facilitate the bargain may be anti-competitive, requiring authorisation from the Australian Competition and Consumer Commission ('ACCC').[77] The long term nature of the contract can exacerbate the anti-competitive effect of provisions such as Take or Pay provisions, rights to sell or buy additional quantities to the exclusion of other sellers or buyers and 'most favoured nations' clauses.

---

75 The suitably evocative *Tax Laws Amendment (Long-Term Non-Reviewable Contracts) Act 2005* (Cth) which took effect on 22 February 2005.

76 For an overview on the purpose and scope of this Part, see the oft-cited judgment of Deane J in *Refrigerated Express Lines (Australasia) Pty Ltd v Australian Meat and Livestock Corporation* (1980) 44 FLR 455.

77 Authorisation confers immunity from certain provisions of the TPA on the parties in relation to the authorised conduct for the period of the authorisation.

of particular relevance are sections 45(2) and 47.[78] Section 45(2) proscribes the making of, or giving effect to, contractual provisions which have the purpose, effect or likely effect of substantially lessening competition. Section 47 also prohibits various kinds of exclusive dealing which has the purpose, effect or likely effect of, substantially lessening competition.

The issues are best demonstrated by case studies. We have chosen the *AGL Cooper Basin* case[79] and the New Zealand *Kapuni* case,[80] which highlights a number of key practical implications for parties to a long-term supply contract. However, before considering the case studies, it is important to understand how the relevant TPA provisions apply to the proposed conduct in making and giving effect to the contract and the impact this will have on the parties' assessment of the competition risk. A note of warning before we begin – the relevant TPA provisions are complex, so the comments in this section are necessarily high level and does not purport to cover all of the issues involved.

6.2 The initial assessment

The relevant TPA clauses require an assessment of the impact of potentially anti-competitive conduct on competition in the market. This is a particularly complex area beyond the scope of this article but, in essence, it involves a 'future with and without' test, i.e. what will be the effect on competition in the market if the proposed conduct occurs compared to a future where it does not. It is not a 'before and after' test, i.e. comparing the current state of competition with the state of competition if the conduct occurs.[81] The difficulty with long term contracts is that their length can make the 'crystal ball gazing' quite hazardous. The parties cannot ignore the longer term impact, even if it is speculative to some degree. Accordingly, the parties can face a difficult upfront assessment when making the contract as to whether they should be seeking authorisation of potentially anti-competitive elements.[82]

Another complicating factor is that the assessment cannot be quarantined to individual long term contracts. Both sections 45 and 47 allow provisions over a number of contracts to be aggregated to determine whether there is any combined anti-competitive effect.[83] Therefore, it might be necessary to consider each party's portfolio of similar contracts. The question then becomes at what point the conduct comprised by the aggregate impact of the contractual provisions has an anti-competitive effect and whether conduct can be differentiated so as to avoid aggregation.

The competition test in sections 45(2) and 47 does not involve questions of public benefit. In contrast, most long term contracts that have been considered by the Tribunal or the Courts have been in the context of authorisation which requires that the public benefits outweigh the detriments

---

78 We are not considering the so called "per se" breaches of section 45 (exclusionary provisions) and 47 (third line forcing) which are automatically breaches of the TPA irrespective of their impact on competition or specific provisions relating to joint ventures.

79 *Re AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593.

80 *Shell (Petroleum Mining) Company Ltd & Todd Petroleum Mining Co Ltd v Kapuni Gas Contracts Limited & Natural Gas Corporation of New Zealand Ltd* (1997) 7 TCLR 463.

81 *Stirling Harbour Services Pty Limited v Bunbury Port Authority* (2000) ATPR ¶41-783 at 41-267.

82 For a proposed six step approach to assessing the anti-competitive impact of a long term contract at its inception, see A.I. Tonking, "Long-term contracts: When are they Anti-competitive?" (1998) 6 CCLJ 13 at 27.

83 See section 45(4) and 47(10)(b) of the TPA.

arising from the lessening of competition.[84] It is important not to confuse this 'public benefits' test with the competition test as many of the justifications for long term contracts are often more relevant to the public benefits test. They are separate tests which should be applied sequentially – is there a substantial lessening of competition? If so, then are there sufficient public benefits to justify an authorisation?

6.3 The TPA's continuing application

It would also be wrong to assume that it is a one-off assessment. Sections 45(2) and 47 have a continuing operation throughout the life of the contract. Thus, a provision which did not substantially lessen competition when the contract was made may have that effect at some later time. With long term contracts, there is obviously a greater chance of this occurring due to changes in law, industry structure or the market:

> …the provisions of a contract which were not initially avoided by the Act can become void either by reason of the coming into operation of new or altered provisions of the Act or by reason of an alteration in circumstances without any change in the relevant provisions of the contract: for example, a contract which came within the protection of s45 of the Act could lose that protection by reason of one party to the contract increasing its share of the market.[85]

The following case studies provide a useful comparison as they both involve long term gas contracts. The *AGL Cooper Basin* case deals with an authorisation application (i.e. a public benefits test) while the *Kapuni* case deals with an assessment of whether a contract has or was likely to substantially lessen competition (i.e. the competition test). In both cases, the contracts had been on foot for some time.

6.4 Case study: AGL Cooper Basin Natural Gas Supply Arrangements

The case concerned a 30 year contract (entered into in 1971) between natural gas producers operating in the Cooper Basin (in South Australia) and AGL to supply gas to AGL in New South Wales ('Letter of Agreement'). The Letter of Agreement contained a number provisions which had the potential to be viewed as anti-competitive:

(a) Right of First Refusal (Clause 12), which granted a first right of refusal to the producers for any gas supply to AGL above the volumes contemplated in the contract (provided that the producers' prices and terms were no less favourable);

(b) Take or Pay (Clause 18), which required AGL to purchase 80% of specified annual volumes (the ACQs) from the producers for the term of the contract;

(c) Exclusive Dealing (Clause 20), under which AGL agreed not to take gas from any other source, except to the extent that requirements exceeded the ACQ; and

(d) the contract term of 30 years.

---

[84] For example, *A C Hatrick Chemicals Pty Limited* (1978) 18 ALR 129; *Application by Broken Hill under s 101A for Review of Notice by the Commission re Purchasing Agreement with Koppers Ltd* [1981] ATPR 40-203; *Re Australian Gas Light Company* [1986] ATPR 50-114; *AGL Cooper Basin* case, op cit, n56. Each of these cases are analysed by Tonking, op cit, n78.

[85] *Trade Practices Commission v Milreis Pty Ltd and others* (1997) 14 ALR 29 FLR 144 at 168.

Each of (a) to (d) is relevant in the context of the discussion in Part I of this paper. However, each is also potentially anti-competitive.

As was common at the time, the South Australian Government passed legislation exempting the Letter of Agreement from the operation of Part IV of the Trade Practices Act. Even though the Letter of Agreement was exempt, authorisation from the ACCC was sought and granted in 1986, as the exemption did not extend outside of South Australia. On 27 March 1996 the ACCC revoked the authorisation, and granted a more limited substitute authorisation. The rationale for the revocation was that there had been material changes in circumstances since 1986, including amendments to the Letter of Agreement, the ability of producers from the Gippsland Basin to compete in the market for gas supply to NSW and the emergence of additional sources of metered gas to domestic and industrial consumers in NSW. The producers applied to the Tribunal to review the revocation decision.

Despite finding that there had been a change in circumstances since 1986, the Tribunal overturned the decision of the ACCC, concluding that on balance, the benefits of the Letter of Agreement still outweighed the public detriment even though those benefits may have decreased in light of social and economic changes. The Tribunal restored the 1986 authorisation. In doing so, it made a number of important observations on the anti-competitive elements of the Letter of Agreement.

With respect to the right of first refusal established by clause 12 (see (a) above) the Tribunal held the provision could be adjudged ‘highly anti-competitive’.[86] This was centred on the fact that it compelled AGL to disclose to the producers the details of any offer from alternative suppliers. This was heightened by evidence which suggested that AGL would be increasingly required to seek alternative suppliers.[87] As a result, although up until now the clause was little more than a ‘dead letter’, the Tribunal held that the clause now had the potential to inhibit competition between alternative suppliers of AGL.

The Tribunal was less critical of clauses 18 and 20 (collectively the ‘Take or Pay’ clauses - see (b) and (c) above) due to their interdependence with the entire contract. This is to be contrasted to the right of first refusal which the Tribunal observed was independent of the other clauses, and generated no benefit. These observations correlate to the discussion in Part I of this paper; that ‘Take or Pay’ clause are - and particularly so at the time the Letter of Agreement was entered into - a conventional method of allocating risk in a long-term contract. That said, the Tribunal noted that in the more sophisticated economic environment of 1996, such allocation of risk could be made via mechanisms which were less anti-competitive (for example, a two-part tariff).

In relation to the length of the contract, the Tribunal noted that ‘a lengthy contract term did not necessarily represent a detriment, but rather may contribute to the achievement of a benefit’.[88] The Tribunal recognised the importance of long term contracts to underwrite major new developments. It also indicated that the length of the term is more likely to be justifiable where it reflects the period over which the borrowings are to be amortized and secure cash flows are required.[89]

---

86 *Re AGL Cooper Basin*, op cit n78, at 44,219 and 44,221.
87 Ibid, at 44,218-44,219.
88 Ibid, at 44,221.
89 Ibid, at 44,219 and 44,220-44,221.

At the time of the decision, the Letter of Agreement was substantially completed. The ACCC argued that the benefits of the agreement were 'sunk". The Tribunal was bound to assess the likely future, while the agreement merely sustained investments of the past. The producers argued that there is a continuation of the benefits over the life of the contract and a need for certainty of contracts. The Tribunal acknowledged the importance of preserving contracts and the impact of its decision on future investment. It rejected the ACCC's view that, on a future with and without analysis, completed contractual commitments are 'sunk' and can be disregarded.[90]

Accordingly, although the Tribunal found that detriment did arise by way of the clauses identified under (a), (b) and (c), it concluded that this was outweighed by the continuing substantial benefit derived from the Letter of Agreement when considered as a whole:

> …in some instances these provisions were so essential in their effect to the original conclusion and implementation of the Letter of Agreement, as to be intrinsic also to the achievement of the benefit that arises from its existence and implementation. This consideration warns against assessment of particular clauses in isolation from each other. It is important that benefit or detriment is determined by considering the Letter of Agreement as a whole. It is the sum of its parts, some of which in their effect are anti-competitive, but others have positive benefit.[91]

6.5 Case study: *Shell (Petroleum Mining) Co Ltd v Kapuni Gas Contracts Ltd*

This case had two parts. The first part related to the interpretation of a long term gas contract signed in 1967 under which the sellers sold natural gas from the Kapuni field to the buyer. The Kapuni field was the first major field discovered in New Zealand. The contract was used to underwrite the development of the field and both parties made significant investments in facilities and pipelines. The field was initially thought to have proven reserves of approximately 263PJ. For the first 25 years, the total contract quantities amounted to about 264PJ of which some 96% was subject to take or pay obligations. The dispute arose over rights to the substantial reserves (some 400PJ) left at the end of the 25 years. The sellers essentially argued the contract ended after 25 years. However, the buyer was successful before the New Zealand High Court in arguing that the field was dedicated to it and it was thus entitled to the remainder of the gas. This effectively extended the contract for at least another 15 years.

This finding required a resolution of the second part of the action. The buyer was the assignee of the contract rights from Natural Gas Corporation of NZ ('NGC"). NGC remained liable to the sellers under the contract and also operated the buyer's business. NGC had significant interests in the New Zealand gas industry. The sellers argued that this dominant position together with the buyer's continued entitlement to the Kapuni gas contravened section 27 of the New Zealand *Commerce Act* 1986. Section 27 is equivalent to section 45(2) of the TPA; that is giving effect to the Kapuni contract was engaging in conduct which was likely to have the effect of substantially lessening competition in certain gas markets. On this basis, the sellers sought to cancel the contract altogether.

---

[90] Ibid, at 44-216.

[91] Ibid, at 44, 220.

In applying the competition test, the Court said it could have regard to any efficiencies which were pro-competitive even though it did not involve a public benefits assessment under an authorisation. There were exploration and efficiency arguments in favour of the contract and the Tribunal agreed that exploration would slow if long-term contracts could be broken once the capital cost of the project had been recovered. However, the pro-competitive impacts did not outweigh the foreclosure of competition which arises from the NGC's unconstrained market power. The Court found the contract breached section 27 and was unenforceable:

> …we are left with an exclusive dealing contract which has run for 29 years, which could easily last for another 20 and which ties up the whole of the only significant onshore gas field in New Zealand in the hands of the dominant wholesaler.[92]

Although not required, the Court made some comments on authorisation which it would expect to be for a period long enough to allow the recovery of the capital investment, a return on that investment and to maintain an acceptable level of exploration. It could have been persuaded to authorise the contract for a period of 25 or even 30 years from its inception.

In order to create a more competitive environment, the Court ordered that the output of the Kapuni field was to be divided equally between the parties which effectively gave the sellers rights to half of the gas without having to compensate the buyer.

6.6 Practical Implications

The discussion raises a number of practical implications for parties to long term contracts.

(a) Parties will have to turn their mind to the possible application of the TPA to long term contracts, particularly where they contain provisions which, by their nature, are potentially anti-competitive. The parties will need to consider the impacts over the term of the agreement and any other similar contracts in their portfolio. Generally, most long term contracts are unlikely to substantially lessen competition but care is needed when a party is in a dominant position in relevant markets, where the contracted commodity is scarce or the quantities involved are very large.

(b) Where there is likely to be a substantial lessening of competition but there are offsetting public benefits, then authorisation may be appropriate. However, it would be preferable for the parties to renegotiate the contract to ameliorate the anti-competitive benefits rather than seek authorisation. The process of obtaining an authorisation can be time consuming and expensive. Further, it will generally be only for a fixed period – there is a risk that the authorisation will not be for the full term of the contract and may be reviewable at the very time that it is envisaged changes to the market may occur. For example, in the ACCC's recent draft determination for the PNG gas project, the ACCC proposed that the authorisation would expire after 16 years, not the 30 years requested by the applicants which represented the life of the project.[93] The 16 years represented the period which the ACCC believed project financiers required to fund the project.

---

92 *Kapuni* case, op cit n79, at 531.

93 ACCC, 'Draft Determination: Application by certain companies ExxonMobil Group, Oil Search Group, the Mineral Resources Development Company Limited Group, and the Merlin Petroleum Company for authorisation in respect of the PNG Gas Project', 11 January 2006.

(c) The observations made in *AGL Cooper Basin* and *Kapuni* in relation to the length of the contract – namely a recognition that a lengthy period is necessary to ensure that related projects get off the ground, thus inducing public benefit – were particularly notable. When an authorisation is sought, the term of the contract will be more easily justified if it reflects the period required to sustain the investment and amortize debt. A long initial term combined with "evergreen" provisions are at greater risk of not meeting the public benefits test.

(d) The competition risk is a continuing one through the life of the contract. A contract which did not breach the TPA at its inception may subsequently do so due to external changes or contract variations. Even having an authorisation may not be a complete protection as authorisations can be revoked for a material change in circumstances. *AGL Cooper Basin* gives some comfort that changes to the contract which do not affect the substantive conduct which was authorised will not constitute a material change in circumstances.

(e) At least in the authorisation context, when assessing the contract during its term, contractual commitments which are "sunk" cannot be disregarded.

(f) As *Kapuni* shows, the implications for a long term contract breaching the TPA can be very significant. It is not a risk that can be ignored in the drafting stage.

7. CONCLUSION

Long term contracts have a rich history in Australia's energy and resources sector. In many cases, significant Australian developments and infrastructure are a legacy of such contracts. There are suggestions that in Europe and North America there is a trend away from long term contracts,[94] perhaps reflecting a buoyant commodities market. However, this trend is not as strong in geographically remote Australia.

Despite the maturing of energy and resources markets, it is likely that long-term contracts will continue to be a feature of the Australian legal landscape in the future.

However, as our survey has illustrated, a number of important aspects of long-term contracts are without a comprehensive foundation in case law. Not surprisingly, custom and practice (both legal and commercial) has filled the void and long-term contracts have become a paradise for "lawyers' law".

With the increasing prevalence of long-term contracts, many of the topics we have explored will, no doubt, be the subject of judicial consideration in the years to come. The challenge for the courts will be to give effect to the commercial intention of long-term contracts in an environment of relatively modest (and in some cases, non-existent) precedent. As will have been seen from our analysis, we believe the current legal framework is sufficiently adaptable to meet this challenge.

---

[94] O Arowolo, 'Abolition of Long-Term Contracts: The Implications and Options for Bankability in Energy Project Financing' (2006) 24(1) *Journal of Energy & Natural Resources Law* 16.