

Oil And Gas Termination Payments: Devil Is In The Details

Law360, New York (April 26, 2016, 11:28 AM ET) --

It has been almost two years since crude oil and natural gas prices began their long descent. Market prices of both commodities appear to be at or near bottom, with reports of credit downgrades, contract terminations and bankruptcies now in the news almost daily. Disputes over contract termination payments are sure to proliferate.

When confronted for the first time with the task of calculating the termination payment on a wholesale energy contract, an attorney with extensive experience in breach of contract and commercial damages matters could be forgiven for thinking that the answer is pretty much cut and dried. After all, energy contracts contain most of the information that factors into the solution to the valuation problem — contract prices, contract quantities, delivery dates, delivery location and so forth. Equally important, there are forward markets for many energy commodities — markets that reveal the market value of commitments for the delivery and receipt of specified energy commodities on specified future dates. Furthermore, most energy contracts are written under a standard form master agreement that sets out in considerable detail an agreed method for calculating the termination payment. It is not immediately evident that there's much room for dispute.

In fact, despite the relatively straightforward nature of the calculations, experience shows there is plenty of room left for disagreement.

Master Agreements for Purchase and Sale

The North American Energy Standards Board (NAESB) master agreement for the purchase and sale of natural gas specifies the termination payment calculation in Section 10.3.1:[1] It states that in an event of default the nondefaulting party calculates the value of remaining delivery commitments at market prices, subtracts the value of those commitments at contract prices, and then discounts the amounts back to the early termination date.

As of the early termination date, the nondefaulting party shall determine, in good faith and in a commercially reasonable manner ... the market value, as defined below, of each terminated transaction. The nondefaulting party shall (x) liquidate and accelerate each terminated transaction at its market value, so that each amount equal to the difference between such market value and the contract value, as defined below of such terminated transaction(s) shall



Richard Goldberg



James Read

be due to the buyer under the terminated transaction(s) if such market value exceeds the contract value and to the seller if the opposite is the case; and (y) where appropriate, discount each amount then due ... to present value in a commercially reasonable manner as of the early termination date

For purposes of this Section 10.3.1 'contract value' means the amount of gas remaining to be delivered or purchased under a transaction multiplied by the contract price, and 'market value' means the amount of gas remaining to be delivered or purchased under a transaction multiplied by the market price for a similar transaction at the delivery point determined by the nondefaulting party in a commercially reasonable manner[2] The rate of interest used in calculating net present value shall be determined by the nondefaulting party in a commercially reasonable manner.

This looks like a straightforward calculation, particularly when compared to the calculation of damages in, say, a market foreclosure case, where not only are relevant prices and quantities unobservable but the very structure of the problem is the subject of dispute.

Possible Points of Contention

In fact, calculating contract termination payments usually is straightforward — in principle. The difficulties arise in implementation. (The phrase “in a commercially reasonable manner” is one hint in the master agreement that there is room to disagree.) Here is a bulletin of some possible points of contention:

- Market prices of most energy commodities are volatile, which means they change rapidly. In fact, energy prices have the potential to change materially over the course of a single trading day. Master agreements usually call for price quotes to be obtained on the termination date, but that begs the question: When on the termination date? What if prices in the morning were very different from prices in the afternoon? What if price quotes are available only once a day and the prior day’s quote suggests that morning prices might have been very different from afternoon prices?
- Should the bid, ask, or mid-price be used as the basis for market value calculations? Does the answer to this question depend only on whether the nondefaulting party is the buyer or the seller?
- What if the contract delivery period extends beyond the time horizon of active trading for the relevant commodity? In these cases the expert needs to estimate the unobserved forward prices. Building the “back end” of the forward price curve requires judgment and perhaps some sophisticated statistical analysis and market price modeling. What is a commercially reasonable process for estimating long-dated forward prices?
- What discount rate is commercially reasonable? Should it be a standard reference interest rate like LIBOR or should it depend on the credit quality of one or both contract parties? If the discount rate depends on credit quality, when should that credit quality be assessed? How does collateral or a letter of credit affect the answer?

- Prices for OTC contracts are quoted for standard contract quantities. Should these prices be adjusted if the terminated contract specifies a “large” or “small” contract quantity relative to the standard contract size?
- What if the contract specifies delivery to a point that is far from a market hub? Energy prices — especially prices of natural gas — can vary by substantial amounts over relatively short distances, depending on the availability of transportation and storage capacity. What is a commercially reasonable process for estimating prices at delivery points where there are no market price quotes or the market is very illiquid?
- What if the terminated contract is an option? “Plain vanilla” options are traded on many commodities but these markets are for fewer delivery points and generally for shorter time horizons than the corresponding forward markets. Because option values depend on price volatility, option valuation without directly observed market prices may require the application of complex models of market price uncertainty.
- Disputes sometimes involve the termination of a nonstandard contract. For example, the contract may give the buyer rights to increase or decrease delivery quantities. In cases like these with nonstandard “embedded options,” specialized valuation models may be needed to calculate contract values.

Disagreements about implementation can result in large differences in monetary claims. Of course, the higher the stakes, the greater the chances the disagreements will wind up the subject of a contentious legal proceeding. In many cases thoughtful, careful application of economic principles can narrow the range of opinion and lead to better outcomes for well-prepared contract parties. In our experience, the ability to bring knowledge of energy trading and marketing together with expertise in derivatives, statistics, corporate finance and the economics of energy and commodity markets have been critical to achieving favorable results.

Lessons for Today

All of this is particularly germane today: The collapse of natural gas, petroleum and other energy prices is now well into its second year and the prospects for a quick turnaround look pretty dim. In the meantime, the hedge positions that many players put on prior to the collapse are rolling off, so that unhedged cash flows are all that’s left to cover outstanding debt obligations. A February 2016 “distressed company watch list” contained over a dozen oil and gas companies whose prior year U.S. Securities and Exchange Commission filings expressed doubts about their ability to continue as a going concern.[3] Over 30 oil and gas exploration and production companies have declared bankruptcy since mid-2014 and there are predictions for several dozen more.[4]

Indeed the current state of the North American oil and gas industry is reminiscent of the electricity and natural gas markets following the California energy crisis of 2000 to 2001. Power and gas prices across North America fell to levels that led in 2002 to 2004 to credit downgrades of all of the major energy marketing and trading companies, including Aquila, Duke Energy Trading and Marketing, Dynegy, El Paso, and Williams, and of course to the demise of Enron. Many independent power producers, such as Calpine and NRG, wound up in bankruptcy. We know from experience that disputes about contract termination payments arose in a number of these episodes, and the contracts at issue included standard forward agreements as well as more complex structures, such as spark spread options.

The lessons for contract counterparties are clear: Be sure to obtain price quotes or other valid market price data as close as possible to the termination date and time. The longer the delay between termination and pricing, the greater the potential for disputes over market value. Obtaining multiple price quotes and/or prices from several relevant markets also narrows the scope for dispute. And be sure to think about and understand the attributes of the contract that are germane to the determination of what constitutes a “similar transaction”.

The lessons for attorneys anticipating contract terminations or responding to demands for termination payments in oil and gas bankruptcies and restructurings are also clear. Be aware of the potential points of contention. Be prepared to negotiate and, if necessary, to litigate these points by undertaking analysis of alternatives in advance. And remember that master agreements generally favor the nondefaulting party, which is responsible for calculating termination payments in a “commercially reasonable” manner.

—By Richard E. Goldberg and James A. Read, The Brattle Group

Richard Goldberg is a principal with The Brattle Group in San Francisco. He specializes in complex litigation and management consulting matters in which careful analysis and modeling of economic, business, or financial data is critical. James Read is a principal with The Brattle Group in Cambridge, Massachusetts. His consulting practice is focused on the energy industry, especially electric power and natural gas.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] NAESB Master Agreement dated Sept. 5, 2006.

[2] Section 10.3.1 also identifies possible sources for market prices: “To ascertain the market value, the nondefaulting party may consider, among other valuations, any or all of the settlement prices of NYMEX Gas futures contracts, quotations from leading dealers in energy swap contracts or physical gas trading markets, similar sales or purchases and any other bona fide third-party offers ...”

[3] See <http://www.themiddlemarket.com/news/distressed-company-watch-list-mens-wearhouse-and-warren-energy-259817-1.html>

[4] See “The crude downturn for exploration and production companies, one situation, diverse responses,” Deloitte Center for Energy Solutions, and “A third of listed E&Ps worldwide at risk for bankruptcy, Deloitte says,” SNL, Feb. 19, 2016.

All Content © 2003-2016, Portfolio Media, Inc.