Commercial & Legal Issues under Long Term Contracts Conference

The History & Destiny of Long Term Contracts

by

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Introduction

This paper is to be delivered at the end of the day during which detailed papers have been delivered on various legal issues which commonly arise before and after long term contracts are entered into. The organisers have wisely chosen rather broader issues as the subject of the paper to be delivered at the end of a long and demanding day. In this paper my objective is to attempt to rise above the detailed legal issues which have been the focus of attention earlier in the day, and to address broader characteristics commonly found in long term contracts. That endeavour will be assisted by a brief consideration of the history, and the destiny of long term contracts.

Personal experience

I should first disclose that, like many members of the legal profession, I have spent large amounts of time, and derived fees which correspond with that time, dealing with issues that arise under long term contracts. This is hardly surprising, given that long term contracts are commonly a feature of significant resource development projects, and of course the economy of Western Australia has been focused upon the development and exploitation of natural resources for many decades now. In that economic context I spent almost two years of my life engaged virtually full time in a dispute arising from a royalty provision in a contract which enabled a major mining company to develop an iron ore mine, and which applied for the life of the mine. Another two years of my life was largely devoted to a dispute between a coal mining company and an electricity provider which was the purchaser of coal under a take or pay contract of 25 years duration. Another year of my life was spent preparing for and appearing in an arbitration which was to fix the price of gas to be supplied to an electricity provider under a long term contract. Almost another year was spent preparing for and litigating a dispute arising under a long term contract for the management and operation of a casino.

There seems to be little doubt that long term contracts supply good grist to the legal mill. It is useful to reflect on why this is so.

Allocation of risk

I do not purport to have any expertise in economics, having given only fleeting attention to the subject during the course of my studies. However, from my naïve and unsophisticated viewpoint, it seems that a major difference between a short term contract and a long term contract is the degree of risk borne by the parties under the latter species.

Let me try and illustrate my point by taking, as an example of a short term contract, a contract for the instantaneous exchange of goods for money - say, the purchase of a cup of coffee. The price is identified, the goods produced and delivered, payment made and the goods consumed within 20 minutes or so. Neither party bears any significant risk. However, if the time period of the contract is delayed, risk to the parties, and the potential for dispute increases.

Let us take, as an example of a longer term contact, a contract in which the price is agreed but settlement of the transaction delayed - for example, the purchase of a unit in a property development yet to be constructed. The price and terms are settled by the parties in the context of market conditions existing at the time of their negotiation and entry into the contract. However, the contract falls to be substantially performed in different market conditions - namely, those which prevail perhaps two or three years later after the development has been completed. Experience tells us that in a market of rising property prices, it is not uncommon for sellers to endeavour to avoid performance of their contracts, thereby reaping the extra profits available if the units are sold into a buoyant market at the time of their completion. Conversely, if the property market is falling, experience tells us that purchasers will be looking for ways to avoid the obligation to perform, as performance will require them to pay more for the unit than it is worth at the time of settlement.

I hope these homely examples illustrate my point, which is that the longer the term of the contract, the greater the risk to the parties because of the unpredictability of changing circumstances over the period of the contract.

This point can also be illustrated by the personal experiences to which I have referred. The case involving the iron ore royalty arose because, during the life of the contract, techniques of beneficiation of ore were developed which enabled ore which was not considered saleable at the time the contract was entered into to be improved in quality and sold so as to produce revenue. The dispute between the parties arose from their differing view as to the impact under the contract of this event, which was not foreseen at the time the contract was entered into. Similarly, the long term take or pay coal contact to which I referred was negotiated at a time shortly after a major 'oil shock' in the late 1970s, and at a time when it was generally expected that there would be significant energy shortages, and significantly rising demand for energy. Neither of those things occurred as expected, with the consequence that the obligation to pay for a large amount of coal which was surplus to the requirements of the purchaser became particularly onerous. In the case of the gas supply contract to which I referred, the pricing formula which applied in the first period of the contract had utilised indices which included an index based on the price of oil which had varied in a way, and to an extent not foreseen by the parties at the time they entered into their contract. They were initially unable to agree as to the formula that should be used to replace the pricing formula which had applied for the first period of the contract, although ultimately they were able to settle their differences (but only after three months of hearing). In the case involving the casino, the profitability of operations was significantly affected by a dramatic increase in competitive casino operations in the region, giving rise to many disputes between the owner (who was losing money) and the operator.

The advantages of long term contracts

If, as I am suggesting, one of the dominant characteristics of a long term contract is the exposure of the parties to that contract to the adverse consequences of events which cannot be foreseen or predicted during the term of the contract, why then do parties enter into them? Assuming that the parties to these contracts are rational, they must perceive the contracts to have advantages which outweigh the risks to which I have referred.

Referring again to the long term contracts that are common in the resource sector, and with which I have had personal experience, the commercial advantages of those contracts are fairly obvious. From the perspective of the project developer, a long term contract provides a guaranteed stream of revenue which makes the project bankable. For those not experienced with the vernacular which prevails in this area. by the term 'bankable' I mean to refer to financial feasibility which makes the project attractive to prospective lenders or investors.

The advantages for the purchaser are equally obvious. Certainty of supply, and some degree of certainty with respect to price enables commodity purchasers to plan and develop their businesses around those parameters.

However, long term contracts for the supply of natural resources and commodities will very often exist against a context in which there is a spot market for the supply of that resource or commodity. The price of the commodity on the spot market will often be much more volatile than the price applicable under a long term contract. Accordingly, at some points in time the long term contract may appear disadvantageous to the supplier, and at other points in time disadvantageous to the purchaser. There may be points in time at which the gap between the price payable under the long term contract, and the price payable on the spot market is so great as to outweigh the advantages of certainty and predictability to which I have referred. That is the environment in which one or both of the parties may send for their lawyers.

The risk of the price payable under the long term contract getting out of step with current market conditions is often addressed by provisions which enable the price to be adjusted during the course of the contract. One such mechanism could involve the adoption of the spot price, or use of an index derived from spot prices, where there is a well developed spot market for the commodity. The more those price adjustment mechanisms are responsive to current market conditions, the less the risk that one or other party will be disadvantaged by entry into the long term contract. Conversely however, the more responsive the price adjustment mechanisms are to current market conditions, the less will be the advantages of predictability and certainty, which are very often the advantages which the parties sought to achieve through their long term contract in the first place.

I will return a little later to consider price adjustment mechanisms in long term contracts in the context of my assessment of the future of those contracts. But before attempting to estimate the future, it is usually desirable to review the past.

The history of long term contracts

My many references to long term contracts in the context of the development of major projects on a scale commensurate with an industrialised economy is capable of creating the impression that the history of long term contracts is linked with and related to the history of industrial development. However, that impression would be false.

Perhaps the most obvious form of long term contract which has a very long history entirely unrelated to industrial development, is long term contracts for the lease of land. Students of legal history would be well aware that long term leasehold was a dominant form of land tenure in the United Kingdom and many other parts of Europe. It is a form of tenure which was even used by the British to gain possession of colonies, such as Hong Kong. Long term leases have all the characteristics of the need to address risk allocation, and market fluctuation in the terms of the contract. In that context, contractual mechanisms for the review and revision of rent payable under long term leases have been a feature of the law of contract for centuries. Those provisions have given rise to large bodies of precedent, derived from the many cases involving disputes between landlord and tenant with respect to the operation of rent review provisions. It is beyond the scope of this short paper to endeavour to address the legal principles which have emerged in that body of jurisprudence, and which are in any event well covered in many of the standard texts.

Holding parties to their bargain

I have already referred to the tension between the achievement of the advantages of certainty and predictability which motivate parties to enter into long term contracts, and the desirability of avoiding the contract becoming unduly onerous to one or other party as a result of unforeseen circumstances or changes in market conditions which had not been predicted. Because of that tension, there will almost always be a limit to which any contractual provisions can insulate a party to a long term contract from the adverse consequences of changing conditions. It is therefore likely that, despite the best efforts of parties and their lawyers, when negotiating and concluding their bargain, circumstances will develop in such a way that, after a period, one or other party wishes to avoid the burden of their agreement. What then are the mechanisms available to the other party to hold the defaulting party to their bargain?

The first and most obvious mechanism is the remedy of specific performance. However, it is well established that the remedy of specific performance will not be granted in a circumstance in which enforcement of the remedy would require continual curial supervision of the contract. The prospect of such curial supervision is inherently likely in the case of long term contracts. It follows that specific performance is likely to be remedy of limited utility in this area.

The limited utility of specific performance is however amply augmented by the availability of damages assessed on the basis of the innocent party's expectation that the other party would perform their side of the bargain. The conventional measure of damages for breach of contract is the sum required to put the innocent party in the position in which they would have been had the defaulting party performed their side of the bargain. If that measure of damage is correctly and accurately applied, it follows that a party in default is unable to gain a financial advantage by failing to perform. However, the difficulty of accurately assessing damages for failure to perform a long term contract should not be underestimated. Those difficulties arise from the aspects to which I have already referred - namely, the difficulty of predicting the future in a world of fluctuating market conditions.

The future of long term contracts

Given the venerated history of long term contracts, and their current significance in a resourced-based economy like that of Western Australia, there is no reason to suppose that such contracts will be any less significant in the future. The tensions to which I have referred, between certainty and predictability on the one hand, and disadvantage arising from unforeseen circumstances or unpredictable market conditions on the other, will continue to provide an incentive for devising contractual mechanisms for striking an appropriate balance between these competing objectives.

If I had to try and predict the mechanisms for the revision of price and other significant terms that are likely to find favour in long term contracts entered into over the next few years, I would nominate expert determination and arbitration.

Expert determination

There is of course nothing novel about a contractual provision which empowers an expert to make a determination that adjusts to the rights and obligations of the parties under a contract. An obvious example is the rent review clause which provides that the rent is to be assessed by a valuer to be appointed by the parties. The process is not adversarial, and does not require significant inputs from the parties other than in relation to the appointment and remuneration of the expert. The legal principles to which I have referred in the most general terms already, significantly constrain the grounds upon which a court will set aside a determination made by an independent expert pursuant to the provisions of a long term contract. This has advantages and disadvantages in terms of predictability and certainty. On the one hand, certainty is enhanced because the determination is binding and only vulnerable to attack on very limited grounds. On the other hand, predictability is diminished because the expert might make a determination which is idiosyncratic and extreme and which cannot be set aside by the parties.

Arbitration

Arbitration has some of the characteristics of expert determination, in the sense that the principles which constrain judicial interference with an arbitral award are well established. However, unlike the process of expert determination, the process of arbitration gives the parties the opportunity to make a significant contribution to the process, by adducing evidence and presenting argument to the arbitral body. The provision of that opportunity carries with it the burden of time and cost. However, in some cases the parties will consider the effort and expense associated with the conduct of an arbitration to be justified by reduction in the risk of an award or determination which is 'out of left field'.

One distinct advantage of the arbitral process is that it is more likely to provide an opportunity for the parties to themselves assess the strengths and weaknesses of their respective positions and, through that means, arrive at a negotiated solution of their dispute. This is perhaps best illustrated by the fact only one of the four major cases to which I referred, and to which I collectively allocated about half a decade of my life, went to an adjudicated outcome. Three were resolved by agreement between the parties. The case which went all the way had features which strongly suggested that the parties were motivated by idiosyncratic objectives rather than commercial pragmatism. It seems to me that this experience reflects the unwillingness of parties to long term contracts to take a risk that an adjudicated determination will produce an outcome which is outside their acceptable range, and their preference to endeavour to negotiate an outcome which is within the acceptable range of each of them, although well short of the optimal outcome which each party had hoped to achieve.

This brings me to my final point. It seems to me that the challenge which long term contracts present to the legal profession and to the commercial community, is to arrive at mechanisms for the resolution of disagreements with respect to those contracts which do not involve the large amounts of delay and expense which have characterised the resolution of disputes in relation to these contracts in the past. New forms of dispute resolution which emphasis collaboration and consensus, and minimise adversarial processes, are likely to gain favour with clients who are weary of the expense, risks, and delays associated with adversarial processes. It is very likely that Seminars like the one which has been conducted today will better equip the legal profession to address this important challenge.