TRANSACTIONAL
Project Development / Finance
Key Considerations in Energy Take-or-Pay Contracts
Daniel R. Rogers, Merrick White

Perhaps the most common type of off-take contract in a large scale energy project is the take-or-pay contract. A properly constructed take-or-pay contract provides the seller with an assured revenue stream that ensures an adequate return on the significant project capital investment and risks to which it is exposed. Additionally, it is a form of contract that is generally understood by lenders, and it is often the most important means for a seller to secure the substantial external debt financing on limited recourse terms that energy projects typically require. Typically, a seller is concerned with two fundamental risks: market demand risk and price risk. A take-or-pay contract places the risk of deteriorating market conditions on the buyer by requiring it to always be responsible for the payment for a minimum purchase commitment (sometimes referred to as volume risk shifting), leaving the seller with only the market price risks to manage, which in some cases may be hedged.

Given such vital importance, most readers would be surprised to see how often a so-called take-or-pay contract is not in fact written as such, with the commercial result being far less desirable than the seller and its lenders intended. This error is not confined to inexperienced negotiators and their counsel. In a recent infrastructure project involving a capital cost exceeding US$ 1 billion, the parties were surprised to discover fairly late in the development timeline that the so-called take-or-pay contract was not really so, despite its being described as such in the sponsors’ project information memorandum and having been signed off on by project lenders and a highly reputable project finance law firm. In another example a buyer under a long term gas sales agreement succeeded in having its “take or pay obligation” reduced by falling market demand, essentially making the contract a “requirements contract” (discussed in more detail below) in spite of the take-or-pay nomenclature. Just using the phrase “take or pay” in an agreement does not necessarily make it so.

Take-or-Pay Basics

A take-or-pay clause is essentially an agreement whereby the buyer agrees to either: (1) take, and pay the contract price for, a minimum contract quantity of commodity each year (the “TOP Quantity”); or (2) pay the applicable contract price for such TOP Quantity if it is not taken during the applicable year. As such, the buyer’s obligation is often being described as being “in the alternative” -- it can be satisfied in either of the two described ways. Most commonly, take-or-pay obligations are determined on an annual or contract year basis, and we shall assume an annual basis in this article, but the principles of take-or-pay can apply over different time periods, with quarterly and monthly take-or-pay obligations being seen. When expressed over shorter durations this type of take-or-pay clause is also commonly referred to as a “minimum take” or a “minimum bill” obligation.

Importantly, the take-or-pay buyer is not in breach or default of the contract if it fails to nominate or take delivery of the TOP Quantity in the applicable year. Often a buyer has the right to nominate zero deliveries in a year and this would not be a breach or default. Instead, the difference between the quantity actually taken by the buyer during that year and the corresponding TOP Quantity will form the basis of a deficiency quantity for which the buyer becomes obligated to make a take-or-pay payment to the seller at the end of that year.

Another key element of a take-or-pay clause is that the TOP Quantity is not fixed but is adjusted to reflect events that happen during the year. Typically the TOP Quantity is reduced by quantities that: (a) the seller
LNG and gas sales contracts provide the buyer with a right to take 5 It is also a valid choice not to take the TOP Quantity) is one of the key a careful quantity in later years Obligation as long as the buyer pays the Disputes

Many LNG and gas sales contracts provide the buyer with a right to receive a "make-up" quantity in later years (in some cases even during a brief period following expiration of the contract term) which corresponds to the quantity for which a take-or-pay payment was made. Typically, this make-up can be taken only after the buyer has first taken the TOP Quantity for that year, which preserves the seller’s assured annual revenue stream. Also, there are often restrictions over the period in which the buyer’s right to take make-up exists. Make-up is sometimes absent in other types of commodity take-or-pay contracts.

Take-or-Pay Disputes

Often if a take-or-pay payment is payable it will be substantial and the buyer will dispute it, usually by arguing that it is an unenforceable penalty or that its underlying cause was a force majeure event and therefore the TOP Quantity is reduced (or both). The fact that a take-or-pay payment is not due as a result of a contract breach or default (rather, it flows from the buyer’s valid choice not to take the TOP Quantity) is one of the key reasons why most English and U.S. courts have found take-or-pay clauses to be enforceable when a buyer challenges the clause as being an unenforceable penalty. Under these cases, the courts are usually quick to point out that where there is no breach there can be no penalty. Some courts view a take-or-pay clause as being similar to a capacity or reservation payment in which the payment is treated as being made in consideration for the seller’s obligation to stand ready to perform by making the agreed quantity of commodity available to the buyer, instead of being a payment for delivery of the actual goods. Other courts often characterize a take-or-pay payment as an advance payment for goods, especially if a make-up right is present, but we note that there typically is no transfer of title to the commodity until it is subsequently delivered.

Interestingly, neither English nor U.S. courts have taken the position that the presence of a make-up right is a requirement for an enforceable take-or-pay clause. In some U.S. cases, the courts held that where a right to make-up does exist but the buyer is unable to take such make-up quantities in the future the buyer is not excused from its obligation to fully perform the contract. That being said, most experienced energy lawyers and commentators agree that the existence of a reasonably crafted make-up right does make it much harder for a buyer to later assert a defense claiming the clause amounts to an unenforceable penalty. The inclusion of burdensome conditions or barriers to the buyer’s ability to receive make-up quantities, such as overly restrictive time periods or notice requirements, may of course cut against the use of make-up rights as a defense. Even if a take-or-pay clause can somehow be shown to amount to a penalty (which both English and U.S. courts still recognize may be possible in some settings), such a finding is not a defense to the buyer’s liability under the contract, but it instead affects the type and measure of damages that are available to the seller in the event of the buyer’s non-performance.

Because a take-or-pay buyer is at all times free to elect not to take the TOP Quantity in any year (in many contracts the buyer even has the right to schedule delivery and then refuse to accept delivery when tendered) without being in breach or default of any performance obligation – as long as the buyer pays the corresponding take-or-pay payment at year-end – a careful seller needs to understand that in a worst-case scenario a take-or-pay clause may cause it to go for up to a full year without making any deliveries to, or receiving any payments from, the buyer. As such, the seller should ensure that at a minimum it has sufficient payment security from the buyer to cover a full years’ take-or-pay liability. It is also important to be mindful that in take-or-pay contracts governed by U.S. law and to which Article 2 of the Uniform Commercial Code (“UCC”) applies, the seller may not be able in most cases to avail itself of any “adequate assurances” rights in order to require additional buyer security in a take-or-pay setting, since these UCC rights are predicated upon the seller’s “reasonable grounds for insecurity,” which typically occurs where there is an actual or imminent breach or default by the buyer.

Effects of Force Majeure on a Take-or-Pay Obligation

In any take-or-pay clause, careful structuring is needed in order to avoid the possibility that a buyer may be required to pay for a quantity of commodity that it failed to take due to a force majeure event that prevented performance by either the seller or the buyer. Since the buyer’s obligations under a take-or-pay clause are couched in the alternative, the occurrence of force majeure may excuse the buyer’s failure to take the TOP Quantity, but does it excuse the buyer from paying the seller for such quantity not taken? As long as payment can be made, the seller will argue that the buyer can fully perform its contract obligations by making payment of the applicable take-or-pay deficiency amount at year-end.
As discussed above, force majeure preventing the buyer from taking the commodity is one of the common deductions to the TOP Quantity, thus eliminating any take-or-pay obligation covering that particular quantity. While this is common in LNG and some gas sales contracts (which tend to have more fulsome and elaborate take-or-pay provisions), it is surprisingly absent in many take-or-pay contracts involving power, water, and other commodities. Absent specific treatment of how force majeure affects the buyer’s take-or-pay obligation, both sellers and buyers may find themselves testing the effectiveness of the contractual dispute resolution clause when a force majeure event occurs and the parties have different views as to whether payment remains due.

Seller’s Obligations Regarding Delivery in a Take-or-Pay Contract

Another area of extensive debate when negotiating a take-or-pay contract turns on whether the seller is obligated to actually deliver the commodity, or whether the seller is merely obligated to make such quantity available for delivery to the buyer at the agreed delivery point. As a purely legal matter, the completion of delivery essentially requires both the tender of delivery by the seller and the receipt and acceptance by the buyer. For example, a seller cannot deliver gas into a pipeline system if the buyer has not nominated such quantity for transportation with the pipeline operator, and the seller cannot deliver gas out of a pipeline system if immediately downstream of the delivery point the buyer closes a valve. Likewise a seller cannot deliver LNG or liquid fuel at the buyer’s receiving terminal if the buyer will not allow the ship to berth and connect to the unloading facilities. In all of the foregoing cases, the seller is able (and desires) to tender, or make available, the gas for delivery, but delivery has been prevented by an act or omission of the buyer.

As outlined above, a common deduction to the TOP Quantity is commodity that the seller was unable to deliver. When drafting a take-or-pay clause careful consideration must be taken to ensure that the buyer cannot prevent the delivery of the commodity and then claim that this should be a deduction to the TOP Quantity. To resolve this issue in a take-or-pay contract, the better legal and drafting practice for a seller is to provide that its obligation is satisfied when it tenders, or makes available, the agreed quantity of goods for delivery to the buyer, as opposed to stating that the seller must deliver the goods to the buyer. There is a line of English cases that appears to equate tender for delivery with actual delivery, but these cases did not arise in the unique take-or-pay contract situation in which the buyer’s obligations are in the alternative, and these cases are thus distinguishable on such grounds. Such cases also appear contrary to the arguably better-reasoned UCC practice which specifies that the seller’s obligation is fully performed when it tenders the specified quantity and quality of goods for delivery to the buyer at the agreed delivery point.

One significant risk area in take-or-pay contracts arises at the start of deliveries under the contract. If the buyer is delayed in commissioning the facilities it needs to receive and use the commodity, the seller will still expect the take-or-pay obligation to start on the contractual first delivery date: the deliveries may not start but the take-or-pay obligation will start to accrue. However, the seller must be able to demonstrate that, notwithstanding the buyer’s delay, the seller is available to make the commodity available for delivery. Otherwise, if the buyer can show that the seller cannot complete delivery, it may be able to argue that the TOP Quantity is reduced, thereby eliminating the take-or-pay accrual. When faced with this issue, the seller must still do all it can to demonstrate its capability to deliver the commodity. In practice, this has meant sellers completing wells and full manning production facilities, even though it was clear that their buyer would be several months or years late in commissioning the buyer’s facilities.

Contrasted With “Take-and-Pay” Contracts

In contrast to take-or-pay, a take-and-pay contract obligates the buyer to both take and pay the contract price for a minimum quantity of commodity each year. This type of contract is often generally described as a “firm off-take” contract. If the buyer fails to take the minimum contract quantity in any period, it will be in breach or default of the contract each time such failure occurs, and it will become liable to the seller for damages upon the occurrence of each such breach or default. The buyer does not have the right to decline to take the agreed quantity and then make a year-end take-or-pay payment, and likewise the buyer does not become entitled to receive make-up at a later date for any quantity that it has not taken.

The damages available to the seller when the buyer fails to take delivery of the commodity may be in the nature of unspecified general damages, or they may consist of stipulated liquidated damages, but in most cases they will not be the full contract price for the untaken quantity. In recovering any general damages the seller is often required to take steps to mitigate its losses, which can require a seller to resell the commodity not taken by the buyer and to credit the resale proceeds against the seller’s damage claim. In a take-or-pay contract, the seller is under no such mitigation or resale obligation, and if it does manage to resell the quantity not taken by the buyer
the seller is entitled to retain the full sales proceeds of the sale and it is not obligated to account to the buyer for such proceeds.

The key distinguishing feature in a take-and-pay contract is that each failure by the buyer to take the minimum contract quantity is a separate breach of contract for which the seller must bring a corresponding damages claim, and if the buyer actively resists the seller’s claim it may be a long period of time before the seller is able to recover its damages. Unless the contract contains a liquidated damages provision covering this type of breach, in seeking recovery for such breach the seller will be required, among other things, to show proof of its actual loss as well as evidence of its efforts to mitigate such loss. All of this will typically require considerable time to pursue.

This means that, in spite of a clear and enforceable contractual remedy, the take-and-pay seller may find that it still has no reliable stream of cash flows from the buyer, and its ability to meet ongoing operating costs and pay debt service will depend on its ability to quickly and successfully resell the quantities not taken by the buyer. If the contract also includes a typical exclusionary clause in which a party may not recover damages for lost profits or lost business opportunities, the seller also may find itself without an effective remedy for the buyer’s breach. Fortunately, in take-and-pay contracts governed by U.S. law and to which Article 2 of the Uniform Commercial Code (UCC) applies, the seller may also be able to avail itself of its adequate assurances rights upon a breach or default by the buyer. In such event, the seller may be entitled to suspend further performance of the contract until it has obtained appropriate assurances from the buyer.

**Contrasted With “Requirements” Contracts**

In contrast to take-or-pay, a “requirements” contract does not have a minimum contract quantity. Instead, a requirements contract obligates the buyer to take all of its demand for a commodity from the seller. In effect, the seller takes the market risk of the buyer, though typically for a higher commodity price to reflect the increased risk. While, from a buyer’s perspective, this type of contract would be very favourable in an uncertain market (no over-commitment to purchase commodity that is not required), this type of contract is relatively uncommon in large scale infrastructure projects since without the assured revenue stream from a TOP Quantity it is difficult for the seller to raise external debt financing.

Precisely defining what is the demand of the buyer (e.g., what facilities? what area? what time period? maximum demand levels?) can be somewhat complex in a requirements contract setting. In addition, if the buyer breaches its obligation to only take its commodity requirements from the seller, then the seller’s loss is the profit it would have earned from the buyer on the commodity that it would otherwise have sold (reduced by any commodity resale proceeds received by the seller from any mitigation sale), and as such the damages available to the seller, and the seller’s obligation to mitigate its loss, are similar to those that apply for a breach of a “take-and-pay” obligation.

**Conclusion**

While take-or-pay is not the only way to manage delivery obligations in long-term commodity sales agreements, it remains the most common form. Yet despite being common in practice, the take-or-pay clause is still often poorly drafted. Parties entering into take-or-pay contracts involving energy commodities should be aware of the essential features and limitations of the basic take-or-pay obligation, as well as being careful to navigate the important differences between a take-or-pay obligation and a take-and-pay obligation or a requirements obligation.

While a properly crafted take-or-pay clause can provide significant comfort to sellers and lenders that there will be adequate revenue flows over the life of the contract period, care must also be taken to understand the potential “lumpiness” of such payments in a worst-case scenario, as well as the implications of the buyer’s flexibility rights on the seller’s payment security needs. Finally, sellers and buyers will also need to pay close attention to the handling of force majeure in a take-or-pay setting, as well as giving consideration to the seller’s exact obligations in respect of its fundamental contract performance obligation. As we have seen all too often recently, in some settings these issues have been missed or simply glossed over in the rush to conclude a deal, and the consequences of some of these errors in a long-term contract setting may be felt for many years to come.
The content of this publication and any attachments are not intended to be and should not be relied upon as legal advice.