Thomson Reuters™

Oil & gas: case law review, hedging losses

by Richard Southern KC and Richard Sarll, 7 King's Bench Walk

Status: **Dated 6 May 2025** | Jurisdiction: **England, Wales**

This document is published by Practical Law and can be found at: **uk.practicallaw.thomsonreuters.com/w-026-0904**
Request a free trial and demonstration at: **uk.practicallaw.thomsonreuters.com/about/freetrial**

This note reviews the case law on the recoverability of hedging losses under crude oil sale agreements.

Scope of this note

The index-based pricing mechanisms commonly used in crude oil sale agreements may expose the parties to risk as the market price for oil fluctuates. The parties often use derivative contracts to hedge (mitigate) against this risk. However, where performance under the sale agreement is delayed (for example, the seller fails to deliver the oil), this can lead to losses for the hedging party (hedging losses).

This note explains how hedging losses can arise and considers the recoverability of hedging losses in the law of damages.

For more information on oil sale agreements, see Practice note, Oil sale agreements: key issues for drafting, reviewing and negotiating.

How hedging losses can arise

The price under an oil sale agreement is often set at a premium to an index price reported by an agency such as Platts (rather than at a fixed price). The final price will usually be calculated by taking the average of these prices for a specified number of days around a fixed event (such as the issue of the bill of lading following completion of loading or, more rarely, the delivery date). This means the actual price can change radically between the time when the contract was agreed and the time when it came to be performed (the oil is loaded or delivered). If the market price drops, a buyer could find itself owning a volume of oil that it will be unable to sell for more than the price it paid. Any delay in performance increases this risk further.

Parties to oil sale agreements often use derivative contracts to mitigate such price fluctuations, whereby equal and opposite positions are taken in the futures or swaps markets so that any loss on the physical transaction is balanced by an equivalent gain on the paper transaction, thereby "locking in" the desired profit margin. To achieve this, it is necessary to align the physical and paper transactions as much as possible, including as regards their pricing periods. When there are delays in the performance of the physical contract, this can disturb the symmetry. Where a trader has sold goods and bought futures which will mature in the month of performance, the trader may need to "roll over" the hedge into the following month, or else there will be no hedge in place to protect against any further price fluctuations until performance.

The need to roll over the hedge can cause losses on the paper transactions, independent of any market loss associated with the falling price of the physical goods. The question is whether such hedging losses can be recovered at law.

The legal position

Market participants seem to accept that hedging outcomes are foreseeable. Hedging strategies are almost universally used and may even be predictable, whether or not they are precisely known in any given transaction. It is significant that, when the present version of the BP Oil International Limited General Terms & Conditions for Sales and Purchases of Crude Oil and Petroleum Products came out in 2015, it differed from the 2007 version by omitting "hedging or other derivative losses" from the list of "indirect or consequential losses" that were excluded (compare clause 33.1 of the 2007 version with clause 66.1 of the 2015 version).

Market participants have widely understood this change as showing an acceptance that hedging losses may be recovered. However, whether this is actually the case in law is much less clear. It may vary depending on the parties involved in the dispute. Although those involved in the oil trading market might treat hedging losses as not too remote to be recoverable, shipowners might not be expected to have the same background knowledge (see *Trafigura Beheer BV v Mediterranean Shipping Co SA [2007] EWCA Civ 794*).

One problem is that there are very few reported cases concerned with the recoverability of hedging losses, and those that exist often seem contradictory. Statements of the law can therefore only be tentative.

Unless the contract says otherwise, the starting point will always be the various measures for the recovery of damages prescribed by *Sale of Goods Act 1979* (SGA).

Hedging as part of original transaction

Whether hedging losses can be recovered may depend on whether the hedge was entered into as part of the original transaction or entered into following breach as a way of mitigating loss. This is because the SGA includes several rules for evaluating the measure of loss for common breaches of contract, such as the failure to take delivery of goods.

In that situation, *section 50(3)* of the SGA provides that "[w]here 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 and the market or current price at the time or times when the goods ought to have been accepted". While this is described as only a prima facie rule, the presumption in applying the "market measure" has been applied rigorously, with the result that the innocent party's actual contractual arrangements are usually ignored, even if this produces the result that it is in fact undercompensated or overcompensated. See, for instance, *Slater v Hoyle and Smith [1920] 2 KB 11,* in which the buyers were able to deliver inferior goods under their sub-contract without suffering loss, yet were still awarded damages according to the market measure. As Scrutton LJ said, "The rules of English law do not always give an exact indemnity, and in this case I think they do not".

The market measure is reflected in two reported cases concerned with hedging transactions entered into at the time of the original transaction.

Where there is an available market

The first case is *Addax v Arcadia Petroleum Ltd [2000] 1 Lloyd's Rep 493.* There, Addax was selling crude oil on a free on board (FOB) basis to Arcadia. Arcadia was due to lift the oil by ship-to-ship transfer. It was a condition of the contract that delivery aboard Arcadia's vessel would take place on 22 or 23 May. The price payable by Arcadia was based on the Platts quotation for five days after the bill of lading was issued. In breach of contract, loading did not take place in the required period and the bill of lading was not issued until 31 May. The difference between the market value of the goods when they should have been delivered and when they were actually delivered was $1 million.

Addax was purchasing from head sellers on terms that were not back-to-back as regards the pricing period, so it hedged its exposure against price fluctuations in the period between the time when the head contract was to price, and the time when the sub-contract was to price. (It had agreed a deferred pricing period for the head contract, since it speculated that the market price would fall.) Its actual loss from the late delivery under these transactions was $800,000. When issuing proceedings, it claimed this sum (not $1 million).

For its part, Arcadia argued that Addax would have suffered no loss at all if only it had agreed head contracts and sub-contracts which were back-to-back as regards the pricing periods, and had not taken out any hedge. The judge rejected that argument. He observed that "[t]his was a commercial contract to be looked at on its own". If only Addax had claimed $1 million (rather than the lesser sum of $800,000) the judge would have been prepared to award that sum in line with the market measure. It was only if he was wrong about that, and it was instead relevant to take the actual contractual arrangements into account, that the judge went on to observe that the hedging transactions would still need to be considered, on the basis that they were "part and parcel" of the deal. But that remark was obiter. The decision demonstrates the traditional primacy of the market measure where there is an available market. In such instances, it suggests that hedging losses and gains should simply be ignored.

For more information on the meaning of FOB, see Practice note, The Incoterms® Rules: overview of key terms: FOB.

Where there is no available market

Where there is no available market, the assessment of damages is based on the party's actual losses. In this situation, there is greater scope for taking hedging transactions into consideration.

This was the case in *Glencore Energy UK Ltd v Transworld Oil Ltd [2010] EWHC 141 (Comm).* In that case, Glencore was buying crude oil from Transworld and selling to BP. The ordinary market measure did not apply, as there was no available market.

The head and sub sales had different pricing periods. Glencore therefore hedged its market exposure by selling Brent futures. There was a problem with delivery, and the cargo was not delivered in March as planned, but the contract was not terminated. Glencore rolled over its hedges accordingly. However, in May Transworld made clear it would not perform the contract. So, Glencore closed out its hedges and terminated the contract, realising a loss of $8.6 million (a figure which comprised $8 million on the hedges, and $600,000 by way of loss of profit based on the difference between the head and sub-contract).

However, Glencore did not claim that sum. Instead it claimed the higher sum of $11 million, being the difference between the contract price and the price that the oil would have commanded if it had been delivered in June when the contract was finally terminated.

The judge did not award the $11 million claimed. Instead he awarded $8.6 million. He accepted that, in closing out its hedges, Glencore had established its loss, commenting:

> ”I agree with Transworld that the position as regards the hedges is not *res inter alios acta*, nor is it equivalent to insurance. Hedging is on the evidence an integral part of the business by which Glencore entered into the contract for the purchase of oil, and since the losing out on an early termination established a lower loss than would otherwise have been incurred, that has to be taken into account when determining the loss.” (*Blair J, at paragraph 78.*)

The decision is a surprising one and may be thought incorrect, for it prefers as the measure of damages a loss based on hedging rather than the loss which arose out of the physical contract that was broken.

One important, outstanding question is whether the judge’s remarks (which if correct point in favour of the recovery of hedging losses) can be transposed into the situation where there is an available market, despite the approach taken in *Addax.*

Hedging losses incurred due to steps taken in mitigation of loss

Different considerations may apply where the losses in question result from hedging transactions entered into only after the breach has occurred, rather than at the time of the original transaction. There is one decision which concerns such a situation: *Choil Trading SA v Sahara Energy Resources Ltd [2010] EWHC 374 (Comm).*

In this case, Choil was buying naphtha from Sahara and intending to on-sell to Petrogal. A quality defect was discovered but Choil could not itself reject the goods, since it had purchased them on an “as is” basis. However, it lost its buyer (Petrogal) who could and did reject the goods. The effect of being left with goods on its hands was to expose Choil to loss if the market price dropped. It therefore began hedging to protect itself from price fluctuation. Eventually, Choil agreed a substitute on-sale contract with another party, Blue Ocean.

In the meantime, the market price had risen. This allowed Choil to sell at a higher price to Blue Ocean than it had agreed with Petrogal, even with the quality defect. Choil nevertheless suffered countervailing losses on its hedges. Sahara therefore argued that Choil had suffered no loss, since the price of the physical goods had actually risen.

The judge rejected that argument, holding that the hedging loss needed to be taken into account. He observed, “The damages in issue constitute the difference between the sound arrived and damaged values of the goods together with the reasonable cost of mitigation”. He continued:

> ”In the trade in which both parties operated, hedging was an everyday occurrence. Anyone in Choil’s position would have been expected to hedge ... It did not require any special knowledge to realise that hedging was what Choil was likely to do. It was regarded as a normal and necessary part of the trade.” (*At paragraph 164.*)

The judge awarded the difference between the price paid by Blue Ocean for the physical goods (a positive figure) and the hedging position (a negative figure).

This decision might therefore suggest a greater opportunity to recover hedging losses if they have occurred when mitigating loss. However, the decision deserves caution. Here too, there were aspects of the market measure rule in play: Choil could not immediately sell the goods to another purchaser, so had to take out a hedge. If, however, there had been an available market for goods at the time when the defect was discoverable, the market measure rule would ordinarily treat the innocent party as having promptly entered the market and sold the goods (thereby assessing the loss accordingly) irrespective of what mitigating steps it actually undertook.

Finally, if hedging losses incurred when mitigating loss can be taken into account, one would expect the same to be true of hedging gains, which would have the effect of reducing the amount of the recoverable loss. This is indeed the case, as the next section shows.

Portfolio hedging

End users, traders of oil and others typically hedge only the net exposure of their portfolio. This involves matching broadly equal and opposite exposures within their business and only making external hedging contracts for the resulting net exposure over a prescribed limit. This process saves the costs of hedging each transaction individually, although in a large organisation identifying and monitoring the overall net exposure can be complex. *Rhine Shipping DMCC v Vitol SA [2023] EWHC 1265 (Comm)* was such a case.

In *Rhine v Vittol*, the vessel was ordered to load first in Ghana and then at Djeno in Congo. However, while in Ghanaian waters the vessel was arrested by third parties, which caused it to be delayed. The delay in loading of the vessel at Djeno caused Vitol to have to pay an increased price for the cargo loaded there. Vitol claimed the increased cost of the Djeno cargo as damages for breach of charter. The shipowner argued that Vitol's hedging arrangements should be taken into account in assessing Vitol's recoverable loss.

The judge first considered external hedging, concluding (at [155]):

> "Where a party has entered into a hedging transaction with a third party [an "external" hedge] and has done so in consequence of the breach in order to mitigate its loss ... profits made on such a hedge are to be brought into account in reduction of the loss. A benefit received as a result of such a hedge would not be one that arose independently of the circumstances giving rise to the loss."

That was an orthodox example of how, in principle, gains made by hedging undertaken by way of mitigation of a breach of contract are to be brought into account when assessing the measure of damages. This conclusion was not challenged on appeal and was accepted by the Court of Appeal as being correct (*Rhine Shipping DMCC v Vitol SA [2024] EWCA Civ 580)*).

In fact, the hedging in question in *Rhine v Vitol* was internal, whereby Vitol internally and automatically allocated exposures to matching opposite exposures. As the judge put it (at [139]):

> "The purpose of this exercise [the internal hedging process] was, ultimately, for Vitol to identify its net total pricing risk exposure across its entire book of physical trades, in order to decide what, if anything, to do about it. Principally, in respect of any net risk, whether to hedge externally that net position or to run (having understood the nature and extent of the risk) an unhedged position."

It appears that Vitol decided to do nothing about its net exposure (or at least, did nothing about it). The exposure in question was treated as sufficiently set off within Vitol's overall book of business (see [143]).

The judge went on to analyse the relevant case law and concluded that internal hedging should not be brought into account because such internal accounting matters were not transactions capable of reducing the loss suffered. As he put it (at [168]):

> "The internal swaps are not legally recognised as binding contracts. They were internal arrangements within Vitol, and they do not affect Vitol's profit or loss."

That conclusion is surely correct. Internal hedging is a convenient phrase but a misleading one. Internal risk management procedures, whereby equal and opposite exposures are internally matched and set off against each other, are not hedging in any commercial sense.

On appeal the shipowners sought to put their case differently. They argued that, as a result of the delay to the loading of the cargo, Vitol's overall net exposure was impacted by the value of the delayed cargo. External hedges that would otherwise have been made were no longer required and were not made; those hedges would have been loss-making (because during the period of the delay the value of the physical cargo rose) so that hedging loss was avoided, and should be brought into account when assessing the measure of damages.

The appeal failed because the shipowners did not have the findings of fact at first instance to support such a case. But Popplewell LJ went on (at [56]- [59]) to refer to *Swynson Ltd v Lowick Rose LLP [2017] UKSC 32 [2018] AC 313* and *Globalia Business Travel SAU v Fulton Shipping Inc (The New Flamenco) [2017] UKSC 43 [2017] 1 WLR 2581*, and to express the opinion, obiter, that the collateral benefit principles would place formidable difficulties in the way of the shipowners' new argument succeeding, even if the avoided loss were made out on the facts. Those reservations are understandable on the uncertain facts of that case. But it is suggested that in an appropriate case the proposed argument would be sound in principle.

There is no principled difference between hedging profits that were made and hedging losses that were avoided, in each case as a result of the delay. Both should be brought into account, in accordance with the overriding compensatory principle. It is necessary to look at the innocent party's overall financial position to properly compare the position it was in as a result of the breach with the position it would have been in if the breach had not occurred. Its hedging activities and outcomes are part of that overall financial position.

While an avoided portfolio hedging loss may not be a step taken in direct mitigation of a breach, it is an avoided loss and it does arise because of the delay. The question then is whether it is a collateral benefit. That depends on the facts of the case. If the facts show that because of the breach and ensuing delay the innocent party's external hedging position was deliberately different from what it would have been if the breach had not occurred, then the avoided loss surely must be brought into account.

Summary of key points

Whether and, if so, how and to what extent, hedging and its financial effects are properly brought into account in assessing the measure of damages depends on the particular facts of the case. The usual principles of causation, mitigation and remoteness apply to those facts. Hedging is not, and should not be, subject to special rules or principles.

The measure of damages is to be assessed in accordance with the compensatory principle as it applies to the assessment of damages for breach of contract, namely putting the innocent party in the position it would have been in if the contract had been performed in accordance with its terms. That measure necessarily requires consideration of the counterfactual position. The counterfactual position depends on the facts of the case. That measure also requires consideration of the actual position and the extent to which loss caused by the breach has, in fact, been avoided or reduced by measures taken in response to the breach, including hedging gains or losses.

In all cases, it is necessary to prove the causation of a hedging gain or loss, and that the gain or loss is not a collateral benefit. Ordinarily, the party saying that hedging should be taken into account will need to demonstrate that the hedging gain or loss was due to the breach complained of. This may be factually challenging where hedges are not linked to individual trades, but instead where only the net exposure on a portfolio of business is hedged, as in *Rhine v Vitol*. But, it is submitted that avoided hedging losses, as well as accrued hedging profits, can in an appropriate case be brought into account in assessing the measure of damages.