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4 July 2023

CIF Weekly – issue 36

Rhine Shipping DMCC v Vitol S.A[1] – Internal offsetting of price risk exposure not equivalent to external hedging

The Commercial Court distinguished between the internal risk management processes of large oil traders that 'net off' the price risk exposure of different physical transactions and external hedging arrangements entered into with third parties. It held that the former are not to be brought into account when assessing the quantum of loss.

Facts

Vitol S.A. ("**Vitol**") had voyaged chartered the M/T Dilijah (the "**Vessel**") from Rhine Shipping DMCC ("**Rhine**"), in part, to carry a cargo of crude oil delivered at Djeno, Congo pursuant to a purchase contract. The price under the purchase contract was determined by the bill of lading date.

The Vessel's arrival to Djeno was delayed because it was detained at the previous loadport where its bunkers and stores were arrested due to dispute between third parties and the Vessel's bareboat charterer. As a result of that delay, there was a substantial increase in the price under the purchase contract. Vitol claimed that price difference (US$ 3,674,834.22).

Rhine argued that: (a) any loss suffered by Vitol had been reduced by its internal hedging arrangements (by US$ 2,871,971) and, to the extent reduced, was not recoverable; and (b) even if Vitol's loss had not been so reduced, the only recoverable loss was the loss suffered if those hedging arrangements had so reduced the lost.

Decision

The Court determined that Rhine was liable to for the increased price either as damages for breach of a warranty or under an indemnity in the charterparty. It went on to consider the following quantum questions:

1. *Whether Vitol's internal risk management processes reduced its loss?*

When a physical sale or purchase is made, this is entered into Vitol's trade capture system. That deal is matched with a corresponding physical deal(s). It is then possible for Vitol to analyse the overall price risk in the group of matched transactions, and its risk management procedure acts to lock in profits and reduce the impact of market movements. Under this procedure, it will first look to hedge the risk internally with a different group of matched transactions. This is more efficient and economical than going out to hedge this risk with an external counterparty. It also allows Vitol to understand the overall risk for a portfolio of transactions and, ultimately, across the whole of Vitol. If Vitol is long or short on a net basis on any particular position, it may then choose to hedge that position externally or run an unhedged position.

Here, Vitol put on a series of internal swaps to hedge against an increase in the price under the purchase contract. These swaps were recorded against the original pricing period but were then rolled to close at later dates once the Vessel was detained. This rolling of the swaps generated a gain within Vitol's trade capture system.

The Court held that the "*internal swaps are not legally recognised as binding contracts*"[2] because a

[1] [2023] EWHC 1265 (Comm) (26 May 2023)

[2] Paragraph 168.

legal person cannot contract with itself. They are internal arrangements and do not affect Vitol's profit or loss. The internal transfer of risk meant that the profit from the rolling of the swap shown for one portfolio was mirrored by a loss on the matched portfolio.

As such, the swaps are not equivalent to where external hedges have been entered into or closed out as result of a breach of contract.[3] Moreover, the other physical transactions entered into by Vitol (and that were offset against the swaps in Vitol's system) were not entered into for the purpose of hedging the risk on the Djeno cargo or mitigating the loss following Rhine's breach of the charterparty. They were entered into in the ordinary course of trading for unrelated commercial reasons.[4] Vitol was entitled to retain profits made on any such other physical transactions under the principle that the rights of a person who is not party to a contract cannot be adversely affected but it.

2. ***If the loss had not been so reduced by Vitol's internal risk management processes, was it too remote either because (a) it was outside the reasonable contemplation of the parties; or (b) Rhine had not assumed responsibility for it?***

Rhine contended that "*if Vitol's internal hedging arrangements did not operate to reduce its loss, then that amount of the loss suffered which would not have been suffered if the hedging arrangements had reduced the loss was too remote to be recoverable*".[5]

The Court disagreed on both formulations of Rhine's argument:

- Reasonable contemplation: Rhine said that Vitol exposed itself to the price loss by (a) entering into pricing contracts on different terms and (b) failing to hedge its risk in an effective way. Such practices were unusual and therefore not within the reasonable contemplation of the parties. However, the expert evidence was that (a) the pricing terms on the contracts for the sale and the purchase of the oil and (b) Vitol's internal risk management processes were both usual. The Court decided that a carrier in Rhine's position would have contemplated that Vitol may have internal risk management processes of this kind meaning the loss claimed was not too remote.
- Assumption of responsibility: Rhine's case was not that its exposure to the movement in the price of oil was outside the scope of its assumption of responsibility, but instead that Vitol's hedges were not executed externally. The Court held that it could conclude assumption of responsibility where "*a carrier of crude chooses to contract on terms which put some responsibility upon it in respect of delays but which do not seek to manage its exposure to loss based upon market movements in the price of crude*".[6]

Comment

This case provides a useful summary of the current status of the law on recoverability of hedging losses. In the oil markets, hedging is part and parcel of shipping and trading, making it easier for parties to prove foreseeability and/or assumption of responsibility.

Nevertheless, hedging tools can be complex meaning that the causal connection is likely to remain the challenge for claimants. In this case, the notional gain was easily calculated because it was already crystallised within Vitol's internal risk management system. Often hedging can be complex and require further modelling and analysis.

The distinction between internal risk management processes and external hedging arrangements with third parties is important for sophisticated traders. While here Vitol's notional profit did not have to be accounted for to reduce its recoverable loss, if the rolling of the swaps had led to a notional loss, then, following the logic of this decision, that loss would not have been accounted for to increase the recoverable loss.

Please click here for a copy of the full judgment.

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We hope that you find this update both useful and interesting. If you have any comments or would like to learn more about this topic, please get in touch with either your usual SH contact or any member of our commodities team by clicking here.

[3] cf. *Glencore Energy UK Ltd v Transworld Oil Ltd* [2010] EWHC 141 (Comm); *Choil Trading SA v Sahara Energy Resources Ltd* [2010] EWHC 374 (Comm).
[4] *Swynson Ltd v Lowick Rose LLP* [2018] AC 313.
[5] Paragraph 181.
[6] Paragraph 206.

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