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PRATT'S

ENERGY LAW

REPORT



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Dealing with Damages in Infrastructure Contracts

*By Seth Belzley**

Oil and gas and energy infrastructure continues to see massive investments in the United States as markets continue to evolve in reaction to changes in supply and demand for energy brought on by technological and regulatory developments. Oftentimes, developers of energy infrastructure, whether a refinery or a solar farm, face little risk that the market for the production from these assets will disappear. Indeed, in many cases, the regulatory framework provides a market of last resort for certain types of energy infrastructure. In other cases, infrastructure is developed to serve very specific markets in which there will be little, if any, demand for the infrastructure if the expected customer defaults. When a customer does default, the infrastructure owner faces unique challenges associated with calculating and collecting damages. This article explores this issue in more detail by providing a brief overview of applicable law and suggesting approaches for addressing it in the commercial agreements that often support the investment of significant funds into energy infrastructure.

The markets in the United States for oil and gas have seen dramatic changes in the past 10 years. These changes have been driven primarily by the incredible increase in the production of oil and gas from fields around the country, but also by regulatory changes domestically and abroad, most notably the U.S. lifting the ban on crude oil exports, approvals of LNG export facilities in the U.S., and Mexico opening up its oil and gas markets to international companies. Changes to the supply of and demand for oil and gas create new market opportunities for participants who have the capability of moving oil and gas from areas of oversupply into areas that are undersupplied. But taking advantage of these opportunities requires logistics assets that can process and transport oil and gas efficiently enough to preserve the arbitrage opportunities created by the market changes. A study published by the American Petroleum Institute (“API”) during the height of the oil boom in the U.S. estimated that

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investment in U.S. midstream and downstream petroleum infrastructure would need to be between \$60 billion and \$80 billion per year to keep pace with changing markets.¹ While slumping oil prices over the last two years has undoubtedly tempered the ability of investors to earn acceptable returns while pursuing development of the needed infrastructure, the point remains—massive infrastructure investments are necessary for companies to take advantage of new market opportunities.

All infrastructure projects present a variety of risks to the developers throughout the lifecycle of the project—from permitting and regulatory issues to construction delays—and it is the primary responsibility of the business people and lawyers leading the development to effectively manage these risks while developing the project quickly enough for the developer and its customers to take advantage of market opportunities. This article focuses on one risk presented in projects—customer defaults.

For some infrastructure projects, the risk presented by potential customer defaults is not great. For example, the developer of a solar farm that constitutes a “Qualifying Facility” (“QF”) under the Public Utility Regulatory Policies Act (“PURPA”) can usually rest assured that there will be a backstop purchaser at wholesale rates of the electricity the farm generates.² But in other cases where the markets that justify certain infrastructure are less robust, a customer default can destroy the economics of an infrastructure project. For example, if a developer builds an oil pipeline to transport oil produced from certain wells, the developer is at great risk if its sole customer, the owner of those particular wells, defaults because the wells never produce. In cases involving these kinds of infrastructure projects, which this article will call “unique energy infrastructure” or a “unique energy asset,” the ability of the infrastructure developer to mitigate its damages is extremely limited—customers will not line up to use an oil pipeline to nowhere. So how can the developer of unique energy infrastructure, recognizing this risk on the front end, adequately protect itself in the commercial contracts relating to this kind of asset?

¹ See American Petroleum Institute, *Oil & Natural Gas Transportation & Storage Infrastructure: Status, Trends, & Economic Benefits* (2013).

² Although a hallmark of PURPA since 1978 has been that electric utilities have a mandatory obligation to purchase power from a QF at avoided cost rates, the Energy Policy Act of 2005 authorized the Federal Energy Regulatory Commission (“FERC”) to suspend the mandatory purchase obligation if it finds that a specific QF has access to competitive wholesale markets. FERC has issued such orders in certain markets for QF projects such as solar PV facilities over 20 megawatts (“MW”) of capacity. Therefore, projects with a defaulting offtaker customer under 20 MW can rely on the mandatory purchase obligation to provide them with wholesale power rates but projects above that threshold have to rely on competitive wholesale markets.

WHY IS THE STANDARD APPROACH TO DAMAGES INADEQUATE?

At the outset, the standard approach to damages may be adequate as a matter of law, but that may not be good enough in practice. The standard approach to awarding default damages to a non-breaching party seeks to put the non-breaching party in the position it would have been in if the breaching party had not breached. In the case of a default by a customer of a unique energy asset, that means the developer should get paid what the customer promised to pay. Sounds good, right? But there are catches. First, the non-breaching party must prove its damages. In a well-drafted take-or-pay contract, this should be easy. But in cases in which revenue depends on events that will occur in the future, such as the volume of oil expected to be transported through a pipeline, proving damages can be very difficult.

Even assuming the developer can prove lost revenues, there's another problem with the standard approach, from the developer's perspective at least—the developer is required to mitigate its damages. For the developer of a unique energy asset with very few potential alternative customers, mitigation can be very difficult, if it is even possible. But a developer can expect its defaulting customer to have a different perspective on this and to counter that the developer could have mitigated damages, but failed to do so, and that the customer cannot be held responsible for those unmitigated damages. So this mitigation requirement presents a risk to the developer of a unique energy asset that a defaulting customer will vigorously challenge its liability for damages and that this challenge will, at best, cost the developer a lot of lawyer and expert fees to overcome or, at worst, lead a court to agree with the customer's arguments that the developer cannot collect its full measure of damages.

So while in theory the standard approach to damages makes sense, in practice it can put considerable risk on the developer of energy assets that are highly tailored to a certain customer or market. This is true even for simple projects, and even more true for projects that are complex or involve opaque markets. Addressing this issue requires the lawyers and business people to negotiate carefully drafted damages provisions into the commercial agreements related to the project that will guide the parties—and, if necessary, the court—to the right measure of damages in the event of a default by the customer.

DRAFTING THE DAMAGES PROVISIONS

As described above, the default law related to damages presents serious risks to the developer of energy assets that are usable only by certain customers or only when certain markets exist. To avoid these risks, the lawyers drafting the relevant commercial contracts should squarely and clearly address damages issues. And there is a range of options available for lawyers to do so. At the very

least, the documents should provide precatory language or acknowledgements of the parties relating to damages issues so that anyone later interpreting the contract has the benefit of the context in which the parties negotiated the contract when attempting to discern the intent of the parties. The developer may also wish to provide provisions that allow the parties to calculate damages following a breach. These damages could be liquidated damages, which can be reduced into a single sum that is determinable at the time of breach, or simply stipulated damages, where the parties agree upon the method for calculating damages that become payable over a period of time following the breach. Finally, to bootstrap the damages claims of the developer, the contract should include waivers and covenants that prevent the customer from making claims in litigation relating to failure to mitigate or the unreasonableness and unenforceability of liquidated damages provisions.

Provide Context

The golden rule of contract interpretation is that the interpreter should attempt to give effect to the intent of the parties to the contract. But anyone who has negotiated a complex contract understands that the intent of the parties is very context specific. And when context changes, it can be difficult to remember all of the details of the parties' prior understanding, which can make it difficult for a contract interpreter to determine what the intent of the parties was at the time. It is also true that in subsequent litigation or arbitration, the reviewing court or panel may disregard testimony on intent of the parties where such intent is not clear within the contract. In such situations, the interpreter may be more likely to impute trade usage, course of dealing between the parties or course of performance unless the contract establishes clear guidance on the intent of the parties when it comes to damages. So to help the interpreter of the agreement, a well-written contract relating to a unique energy asset should provide more detail than might be customary regarding the context in which the agreement was negotiated. If the asset being built for the customer is highly specialized or customized and incorporates features that other customers might not pay for, *state that*—it can give context as to why the rate being paid by the customer exceeds what otherwise might be considered a market-based rate. If the asset is part of a larger system to which access is limited, which can often be the case in energy assets, then *make sure the interpreter knows* that the universe of customers who might be able to access the asset is limited and therefore mitigation will be more difficult for the asset owner. If the asset is being built specifically for a customer, the parties should *recognize and acknowledge in writing* that the developer is relying upon the commitments that the customer is making to justify the construction of the asset. Even though statements of fact and context can seem out of place in an agreement that

otherwise speaks for itself, such context can be extremely valuable in the event of a dispute over damages. It is also important that if the contract represents a departure from industry standard forms of agreements or typical understandings in the industry, the contract clearly indicate an intent of the parties to depart from such industry standards. Conversely, incorporating industry standards by reference into a contract can have the effect of incorporating accepted allocations of legal risk into the damages allocations in contracts.

Prescribe Damages

To a large extent, parties are permitted to determine the remedies that will be available in the event of a breach to ensure enforcement,³ although courts do not allow damages to be punitive against one of the parties. But the parties to a contract are typically in the best position to anticipate the damages that a breach will cause one of the parties and to negotiate up front provisions for calculating those damages. And as long as the parties draft formulas that are enforceable, setting out the measure of damages in the contract avoids any arguments regarding the non-breaching party's duty to mitigate as well as the possibility that a court might fail to award damages as a result of uncertainty.

Damages provisions will, however, be subject to judicial review, and courts will refuse to enforce damages provisions under certain circumstances. Liquidated damages “refers to an acceptable measure of damages that parties stipulate in advance will be assessed in the event of a contract breach.”⁴ Liquidation of damages is awarded where a party can show that at the time the contract was formed (1) it was difficult to measure the actual damages in the event of breach and (2) the damages provided are reasonable.⁵ Courts take one of two approaches when determining whether a liquidated damages clause is reasonable: single-look and second-look. The single-look approach is the traditional method which provides that the reasonableness of liquidated damages is judged as of the time the contract was made, not at the time of the breach.⁶ “As long as the liquidated sum was a reasonable prediction of the potential damages—as judged at the time the contract was made—courts following this approach will

³ Corbin on Contracts § 55.1.

⁴ Thomas Whelan, *Enforcement of Commercial Leases*, 3 *Tex. Wesleyan L. Rev.* 283, 295 (1997).

⁵ James P. George, *Rent Concessions and Illegal Contract Penalties in Texas*, 48 *S. Tex. L. Rev.* 645, 650 (2007).

⁶ Trey Qualls, *Take a Second-Look at Liquidated Damages in Texas*, 67 *Baylor L. Rev.* 666, 670 (2015).

generally enforce the liquidated damages provision.”⁷ With the single-look approach, actual damages are irrelevant. The single-look approach gives weight to what the parties actually agreed to at the time the contract was created without inserting the court’s opinion as to the parties’ intent. In contrast, the second-look approach determines reasonableness by comparing the stipulated sum in the contract not only to the amount of damages that could reasonably be anticipated at the time the contract was entered into, but also to the amount of actual damages caused by the breach. The second-look approach prevents a large windfall in the event that actual damages are less than the stipulated amount; however, it “interferes with the parties’ freedom of contract and undermines the certainty they have in their bargains, thus defeating the purpose of stipulating damages in the first place.”⁸

Many contracts related to energy assets chose Texas law to govern the agreement, so it is important to note the approach that Texas courts take to this issue. Texas courts have oscillated between the single-look and second-look approaches, but most recently have landed on the second-look approach in *FPL Energy LLC v. TXU*.⁹ Thus, even if a liquidated damages provision is used, if actual damages are significantly less at the time of breach, the liquidated damages provision will be disregarded in Texas. In essence, the second-look approach favors a policy of fairness above enforcing the parties’ intent as reflected in the contract, which means a court will do what it thinks is fair no matter how well the contract anticipated and addressed damages issues.

Nevertheless, in order to give a liquidated damages provision the best chance of being enforced by a court, particularly a court that uses the single-look approach, a drafter should keep the following tips in mind:

- Provide acknowledgements from both parties that the actual damages are difficult to calculate, that the damages formula set out in the contract is a reasonable approximation of the actual damages that are expected to be incurred, and that the parties intend for the contract to be enforced as written. This, again, is precatory, contextual language, but it is also estoppel and reliance language.
- Label the provisions and define terms using the term “liquidated damages” and avoid using the word “penalty” (such as “default penalty”). Courts will refuse to enforce liquidated damages that penalize the defaulting party (which is a shorthand way of saying that they will only enforce damages clauses that are reasonable), so calling

⁷ *Id.* at 670.

⁸ *Id.* at 674.

⁹ 426 S.W.3d 59 (Tex. 2014).

them a “penalty” does not help with enforceability.

- Go to great lengths to accurately calculate damages. The more specific the calculation is, the more likely it is to be a reasonable approximation of damages and the more likely a court is to enforce the provision (both because it appears to be reasonable and because it appears that the parties more specifically considered the appropriate measure of damages). To accurately calculate the estimated damages, take into consideration whether the measure of damages should change over time, as well as what components should go into the measure and how those can be most accurately determined.

There are a few publicly available agreements that serve as models for illustrating these recommendations.¹⁰

Include Waivers and Covenants

Even with a well-drafted agreement, disputes may arise and the parties to a contract may find themselves in litigation or arbitration. In such a case, the customer will likely argue, among other things, that the damages provision is unenforceable and that the developer failed to properly mitigate its damages. To counteract these arguments and increase the likelihood that the liquidated damages provision will be enforced, a contract should include a waiver by the defaulting party of the right to claim that the damages provision is unreasonable and unenforceable and a covenant that the defaulting party will not make those arguments in a dispute. But even with these waivers, a court may decide that the damages provision is unenforceable. In that situation, the parties will be left to fight over the appropriate measure of damages and whether the non-defaulting party appropriately mitigated damages. For these reasons, although its enforceability is also open to question in certain jurisdictions including Texas,¹¹ in cases where mitigation of damages is very difficult, a contract should eliminate the obligation for the non-defaulting party to mitigate its damages and include a waiver by the defaulting party of the right to claim that the non-defaulting party failed to mitigate damages.

CONCLUSION

All projects present risk and not all of these risks can be fully eliminated. But

¹⁰ See, for example, the Amended and Restated Products Offtake Agreement between Paulsboro Refining Company LLC, Morgan Stanley Capital Group Inc., and PBF Holding Company LLC, dated August 30th, 2012 PBF Energy Inc.’s Amendment No. 3 to Registration Statement on Form S-1 (Registration No. 333-177933).

¹¹ See, for example, Tex. Prop. Code § 91.006, which declares the contractual elimination of the duty to mitigate to be against public policy and therefore void.

with a good understanding of the related law and reasonable foresight into the issues that will arise in a dispute, lawyers can and must help their clients reduce the risks associated with customer defaults under the agreements that justify the energy projects and help those clients adapt to and take advantage of new market opportunities.