Neutral Citation Number: [2020] EWCA Civ 2349

Case No: A4/2019/2349

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE HIGH COURT OF JUSTICE
QUEEN'S BENCH DIVISION
COMMERCIAL COURT
Mr Lionel Persey QC (Sitting as a Deputy High Court Judge)
[2019] EWHC 1735 (Comm)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 04/12/2020

Before

LORD JUSTICE PETER JACKSON
LORD JUSTICE MALES
and
LADY JUSTICE ANDREWS

- -

Between:

BRITISH GAS TRADING LIMITED	**Appellant**
- and -	
(1) SHELL UK LIMITED	
(2) ESSO EXPLORATION & PRODUCTION UK LIMITED	**Respondents**

- -
- -

Michael Bools QC & Tom Pascoe (instructed by **Herbert Smith Freehills LLP**) for the **Appellant**
John McCaughran QC & Joyce Arnold (instructed by **Clifford Chance LLP**) for the **First Respondent**
David Wolfson QC & Douglas Paine (instructed by **Hogan Lovells International LLP**) for the **Second Respondent**

Hearing dates: 27th & 28th October 2020

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Approved Judgment

Covid-19 Protocol: This judgment was handed down remotely by circulation to the parties' representatives by email, release to BAILII and publication on the Courts and Tribunals Judiciary website. The date and time for hand-down is deemed to be on Friday 4th December 2020 at 10.30 a.m.

Lord Justice Males:

Introduction:

1. This appeal is concerned with two long term agreements ("the Principal Agreements") for the sale of gas from the Sole Pit Reservoirs in the North Sea. The agreements, on materially identical terms so far as this appeal is concerned, were between Shell and Esso respectively as the Sellers and British Gas as the Buyer. They require the Sellers to provide and maintain a capacity to deliver Natural Gas from the Reservoirs at a specified rate.

2. The first issue to be determined concerns the true construction of that obligation: for the purpose of deciding whether the Sellers have maintained the necessary capacity, is it permissible (as the Sellers contend) to take account of gas from other reservoirs which is owed to them by other gas producers in repayment of gas from the Sole Pit Reservoirs which the Sellers previously lent to those other companies to enable them to fulfil their delivery obligations to British Gas? The judge, Mr Lionel Persey QC, sitting as a Deputy High Court Judge, held that it is, and accordingly that the Sellers are not in breach of the capacity obligation. The second issue concerns the assessment of damages for breach of the capacity obligation, which the judge resolved (although strictly it did not arise in view of his conclusion of liability) in British Gas's favour.

3. British Gas now appeals against the judge's decision on the construction issue. The Sellers cross-appeal on the damages issue.

Overview

4. The Sole Pit field consists of two reservoirs, the Barque Reservoir and the Clipper Reservoir, defined in the Principal Agreements as "the Reservoirs", for which the Sellers are the holders of Production Licences. The Principal Agreements, concluded on 22nd December 1988 and due to run until at least 2025, are contracts for the supply of daily quantities of gas from the Reservoirs. There are contractual provisions which set the daily quantity which British Gas is entitled to nominate for delivery. If the Sellers fail to deliver the full amount properly nominated, then they will be in default and must bear the consequences (for which the agreements provide). The Principal Agreements are "take or pay" agreements, providing for a minimum amount of gas that British Gas must either take delivery of, or pay for, every year.

5. The quantity of gas which British Gas is required to take is dependent upon the "Total Reservoirs Daily Quantity" or "TRDQ". The TRDQ will change over the life of the contract, beginning with a "Run-In Period" which was followed by the "Build-Up Period" and then the "Minimum Plateau Period". Following the end of the Minimum Plateau Period, the Sellers had the right to serve Variation Notices which, unless successfully challenged by British Gas, would bring about a reduction (but never an increase) in the TRDQ.

6. In fact, however, the gas actually delivered to British Gas under the Principal Agreements does not consist of gas molecules exclusively produced from the Reservoirs. Instead gas produced from a number of different reservoirs (including the Reservoirs) is commingled and processed at the Shell Sub-Terminal at Bacton. Processed gas is then redelivered to the producers on a broadly *pro rata* basis for

delivery to British Gas. Provision for this is made in Article 5 of the Principal Agreements and in an agreement known as "STACA" ("the Shell Bacton Sub-Terminal Allocation Commingling and Attribution Agreement") dated 30th September 1997, to which Shell, Esso, British Gas and producers from other reservoirs are parties. Although STACA post-dates the Principal Agreements, those agreements had always expressly contemplated an allocation agreement, and STACA superseded a previous allocation agreement, known as "SPOTS" ("the SPOTS Allocation and Commingling Agreement") dated 9th June 1993.

7. STACA provides also for gas to be lent and borrowed between "User Groups" (the term used to refer to the producers from each of the various participating reservoirs or groups of reservoirs) in certain circumstances. Thus the Sellers, as the Sole Pit User Group, may be (and have been) required to lend gas produced from the Reservoirs (i.e. Sole Pit gas) to producers from other reservoirs, on terms that the gas so lent will be repaid as soon as reasonably practicable.

8. As a result of the substantial volume of Sole Pit gas which has been lent to other User Groups, there is currently a significant balance of gas which is repayable to the Sellers from other reservoirs. As at 28th May 2018, the amount of gas owing to them under STACA was 72,811 terajoules (TJ).

9. British Gas does not complain of any failure by the Sellers to deliver the amounts of gas properly nominated for delivery under the Principal Agreements. Rather its complaint, made because for some years the market price of gas has fallen below the price payable under the Principal Agreements, is that the Sellers are in breach of an obligation to provide and maintain a capacity to deliver Natural Gas from the Reservoirs at a specified rate. British Gas contends that, in order to comply with that obligation in circumstances where the production volumes of the Reservoirs were in decline, the Sellers ought to have taken steps to reduce the daily quantities of gas that British Gas was obliged to nominate for delivery under the Principal Agreements by serving Variation Notices to reduce the TRDQ. It says that, had such reductions occurred, it would instead have bought other gas in the market at a cheaper price.

10. British Gas's claim rests on three propositions, which were the subject of a trial of preliminary issues. In brief summary, these are:

    (1) First, that the Sellers' capacity obligation, contained in clause 6.4(1) of the Principal Agreements, required the Sellers to maintain the capacity to deliver the required contractual quantities from the Sole Pit Reservoirs themselves, taking no account of any gas which was owed to the Sellers in repayment of gas lent to other User Groups under STACA.

    (2) Second, that a term was to be implied into the Principal Agreements whereby the Sellers' right to serve (or not to serve) a Variation Notice to reduce the TRDQ had to be exercised honestly and in good faith, and not arbitrarily, capriciously or irrationally.

    (3) Third, that damages for breach of the capacity obligation in clause 6.4(1) should be assessed on the basis that, in order to perform it, the Sellers would have served Variation Notices that would have reduced the quantities which British Gas was required to take and pay for under the Principal Agreements.

11. The judge, agreeing with the Sellers, rejected the first two propositions. As a result, British Gas's claim was dismissed. British Gas sought permission to appeal in respect of both decisions, but received permission only on the first, i.e. the proper construction of clause 6.4(1). As to the third proposition, the judge did not accept the Sellers' argument that British Gas's damages case is bad in law. The Sellers cross-appeal this decision.

The Principal Agreements

12. The parties' agreements are detailed and complex. It is evident that they are the result of sophisticated and expert legal drafting.

13. Article 3 of each of the Principal Agreements provides as follows, words in bold being defined terms:

> "3.1 The Seller agrees to sell and deliver at the **Delivery Point** and BG agrees to accept and pay for Natural Gas produced from the **Seller's Interest** during the **Contract Period** in such quantities and at such times and in such manner as shall from time to time be established under this Agreement.
>
> 3.2 The Seller covenants with BG that throughout the Contract Period it will not (unless so permitted pursuant to Article 5 or clause 6.9(7)) produce from the **Reservoirs** all or any part of its entitlement to Natural Gas which arises by virtue of its **Seller's Interest** (nor permit Natural Gas to be produced) otherwise than for the purpose of deliveries to BG under this Agreement."

14. The "Seller's Interest" is defined as meaning "all that right title and interest in the production and ownership of Natural Gas from the **Reservoirs** to which the Seller is entitled by virtue of the **Production Licences** and the Seller's Agreements (being at the date hereof 50% of the total production and ownership of Natural Gas from the **Reservoirs**) …". The "Delivery Point" is the point at which gas is delivered to British Gas after processing at Bacton.

15. Pausing here, it can be seen that British Gas's obligation to accept and pay for gas is limited to gas produced from the "Seller's Interest", that is to say gas produced from the Sole Pit Reservoirs. However, the gas has to be delivered at the Delivery Point, by which time it would be commingled with gas from other reservoirs. This apparent contradiction is resolved by Article 5, which provides among other things that:

> "5.1 Without prejudice to the obligations of the Seller under this Agreement the Seller shall have the following rights …
>
> 5.3 Commingling
>
> The Seller shall have the right (but only upon and subject to the conditions hereinafter contained in this clause 5.3) to commingle Natural Gas produced from the **Reservoirs** with Natural Gas produced from any other accumulation or accumulations …"

16. The conditions which clause 5.3 went on to set out include that an "Allocation Agreement" has been entered into between the Seller, British Gas and all other producers of gas from the other reservoirs contributing to the commingled stream which would be delivered to British Gas at the Delivery Point after processing at Bacton. Thus what the Sellers are selling (and what British Gas has agreed to buy) is gas from the Reservoirs, but what is actually delivered to British Gas is a commingled stream of gas from all the reservoirs whose gas is processed at the Bacton facility.

17. Article 6 deals with the quantity which British Gas is required to take or pay for. The first step is to establish the "Total Reservoirs Daily Quantity" or "TRDQ" in force for the relevant Contract Year. Clause 6.1(1) provides:

> "6.1(1) In respect of each Day in each Contract Year during the **Contract Period** commencing with the **Build-Up Contract Year** there shall be established in the manner hereafter in this Article appearing a quantity (expressed in Terajoules per Day) by reference to which BG shall make its daily nominations for the delivery of Natural Gas from the **Reservoirs** under this Agreement and the Other Seller's Agreement (such daily rate being herein referred to as the '**Total Reservoirs Daily Quantity**' or '**TRDQ**')."

18. Article 6 envisages that the TRDQ will change over the life of the contract as the production profile of the Reservoirs changed, beginning with the Run-In Period, and increasing during the Build-Up Period and then the Plateau Period. The TRDQ established for the Plateau Period applies until the end of the Minimum Plateau Period at which point it remains constant until varied pursuant to a Variation Notice served by the Sellers.

19. Following the end of the Minimum Plateau Period, the Sellers has the right to serve Variation Notices pursuant to Clause 6.3(1):

> "6.3(1) … if in respect of any Contract commencing on or after six (6) o'clock am on 1st October 1997 (such Contract Year being herein referred to as the '**Specified Contract Year**') the Seller is of the opinion that it (together with the Other Seller) would be unable to maintain throughout the **Specified Contract Year** in accordance with the terms of this Agreement (and the Other Seller's Agreement) the **TRDQ** (together with the **Delivery Capacity** provided for herein and in the Other Seller's Agreement) applying for the Contract Year immediately preceding the **Specified Contract Year** (assuming the **Field Facilities** detailed below) the Seller (together with the Other Seller) may not later than 30 months nor earlier than 36 months prior to the start of the **Specified Contract Year** serve upon BG a notice in form and manner appearing in clause 6.3(2) (herein referred to as a '**Variation Notice**')."

20. Five points may be noticed. First, the Seller has a right, but not a duty, to serve a Variation Notice. Second, such a notice can only be served if the Seller forms the opinion that it will be unable to maintain the TRDQ throughout the Specified Contract

Year. Third, that opinion has to be formed assuming the existence of the specified "Field Facilities", a defined term which refers to the infrastructure "used in or provided in connection with the production processing and transportation of Natural Gas from the Reservoirs for delivery hereunder …". Fourth, any notice has to be served at latest 2 ½ years before the start of the Specified Contract Year to which it will relate. Fifth, a Variation Notice may be served whenever the Sellers form the necessary opinion concerning a future Contract Year. Thus there may be a series of Variation Notices after the end of the Minimum Plateau Period as the production capacity of the Reservoirs declines.

21. Pursuant to clause 6.3(2) a Variation Notice can only reduce and not increase the current TRDQ. The new TRDQ specified in such a notice has to be:

> "the maximum **TRDQ** which the Seller (and the Other Seller) are of the opinion they would be able to maintain (together with the **Delivery Capacity** provided for herein and in the Other Seller's Agreement) throughout the **Specified Contract Year** in accordance with the terms of this Agreement and the Other Seller's Agreement from the **Field Facilities** assumed in clause 6.3(1)."

22. When serving a Variation Notice, the Sellers are obliged to provide extensive technical data relating to the Reservoirs which is described in detail over several pages of the Agreement.

23. British Gas is not obliged to accept the new TRDQ proposed by the Sellers. It is entitled to serve a notice of objection, in which case (if the parties cannot agree) the issue will be referred to an Expert pursuant to clause 6.3(6):

> "who shall determine the **TRDQ** for the **Specified Contract Year** being the maximum **TRDQ** which the Expert estimates the Seller (together with the Other Seller) acting as a **Reasonable and Prudent Operator** would be able to maintain throughout the **Specified Contract Year** in accordance with the terms of this Agreement and the Other Seller's agreement (due account being taken inter alia of the obligation to provide **Delivery Capacity** hereunder and under the Other Seller's Agreement and of the amount of Natural Gas which it is reasonably anticipated BG will require the Seller (together with the Other Seller) to deliver hereunder and under the Other Seller's Agreement)…"

24. Clause 6.3(7) prescribes a series of assumptions, all relating to the technical characteristics of the Reservoirs and the existing and likely future Field Facilities serving the Reservoirs. In the light of those assumptions, the Expert's task is to determine the maximum TRDQ which the Seller will be able to maintain. The clause contemplates, therefore, that British Gas's interest will be to have as high a TRDQ as is consistent with prudent operations. It protects British Gas in the event that it considers that the Sellers have reduced the TRDQ unnecessarily.

25. The Sellers have served several Variation Notices reducing the TRDQ between 2000 and 2009 as the production volumes of the Reservoirs declined. The most recent

Variation Notice was served on 1st October 2009, as a result of which the TRDQ was reduced to 83.41 TJ/Day. No further Variation Notices have been served.

26. In addition to determining the quantities of Natural Gas which British Gas is obliged to take or pay for, the TRDQ also determines the "Delivery Capacity" which the Sellers are obliged to maintain. That is dealt with by clause 6.4(1), which is the critical clause for the purpose of this appeal:

> "Subject to clause 6.8 with effect from the **Start Date** the Seller shall provide and maintain a capacity (herein referred to as the '**Delivery Capacity**') to deliver Natural Gas from the **Reservoirs** on each Day at a rate of not less than the **DCQ** applicable for such Day multiplied by one hundred and thirty (130) percent and BG shall have the right on any and every Day (subject as herein provided) to require delivery of Natural Gas at rates up to the appropriate **Delivery Capacity** determined hereunder notwithstanding that the aggregate of such daily requirements made in respect of any Contract Year exceed the **ACQ** …"

27. The "DCQ" is each "Seller's Proportion" of the TRDQ in force on any given day. Each Seller's Proportion is 50% and each Seller's DCQ is therefore 50% of the TRDQ. Collectively, therefore the Sellers are obliged under Clause 6.4(1) to maintain the capacity to deliver Natural Gas from the Reservoirs at the rate of 130% of the TRDQ.

28. This obligation is "subject to clause 6.8", which permits reduction of the TRDQ for the purpose of carrying out repairs and maintenance.

STACA

29. STACA is referred to in the Principal Agreements as the "Allocation Agreement", pursuant to an amendment to the Principal Agreements made on 30 September 1997. It has since been amended on a number of occasions. As well as being a supplier of gas, Shell is also the "Operator".

30. Under STACA, gas produced from a number of different reservoirs (including the Reservoirs), each reservoir or group of reservoirs being known as a "Source", is delivered into facilities for the transportation to, and processing of gas in, the Shell Sub-Terminal at Bacton. Gas from the various Sources is input into the facilities at measurement points known as Source Measurement Points. After processing it is then redelivered to the User Groups in a commingled stream. There are complex provisions for allocating an appropriate amount from this stream to each Source. Broadly, gas is allocated on a *pro rata* basis, based on the mass of the gas input into the system.

31. STACA also provides for the borrowing and lending of gas between User Groups in the event that any one such group is unable to supply the gas which that group's buyer has nominated for that day. Clause 4.1.1 provides:

> "Subject to Clause 4.2 in the event that on any Day any **User Group** is not able to meet its **Total Nomination** from its own **Source** each other **User Group** which is able to produce Natural Gas from its own

> **Source** in excess of its **Total Nomination** shall (taking account of the capabilities of its own then existing delivery and production facilities and of good oil and gas field practices) deliver Natural Gas from its own **Source** in excess of its **Total Nomination** to the extent necessary as determined by the **Operator** to enable the **User Group** which is not able to meet its **Total Nomination** to meet such **Total Nomination**. Provided always that a **User Group** shall not be required to deliver Natural Gas in excess of its **Total Nomination** if by so doing it would prejudice its obligations under a gas sales agreement."

32. A "Total Nomination" is the amount of gas that a User Group has nominated for redelivery to itself from the commingled stream on a given day in order to meet its delivery obligations to its buyer.

33. It is obvious, and is common ground, that gas which is borrowed by a User Group under this clause will count towards that User Group's delivery obligations so that British Gas is obliged to accept it, notwithstanding that the borrowed gas does not come from the User Group's own reservoirs. The whole purpose of this clause is to enable a User Group which would otherwise be unable to perform its delivery obligation to British Gas on any given day to do so.

34. Lending under this clause is not a matter of choice. Where the circumstances set out in clauses 4.1 apply, a User Group called upon to lend gas is obliged to do so if it is able to. This obligation, however, is subject to borrowing and lending limits which are set out in clause 4.2 and which apply on any day which is not a "Restricted Day". On a Restricted Day, which is a day on which capacity within any part of the Bacton facilities for transporting, processing and delivering gas is restricted for any reason, those limits do not apply.

35. Since at least 2008, the Sellers as the Sole Pit User Group have lent a substantial amount of gas to other User Groups. Because many of the days on which such lending occurred have been Restricted Days, such lending has to a large extent not been subject to the borrowing and lending limits in clause 4.2. As a result a substantial quantity of gas (referred to in STACA as the "Outstanding Amount") has built up which is owed to the Sellers by other User Groups in repayment of the gas thus lent. As at 28th May 2018 this Outstanding Amount was approximately 72,811 TJ, which is approximately 2.38 times the Annual Contract Quantity under the Principal Agreements.

36. Repayment of borrowed gas is dealt with in clause 4.3 of STACA which provides:

> "4.3.1 Each **User Group** shall ensure that whenever it has borrowed or lent Natural Gas the **Outstanding Amount** shall be brought to zero (0) as soon as reasonably practicable.
>
> 4.3.2 Each **User Group** shall further ensure that on at least one (1) of the last seven (7) Days of each Contract Year the **Outstanding Amount** shall be brought to or be at zero (0) provided that if such **User Group** is prevented from so doing for reasons beyond its reasonable control (acting and having acted as a **Reasonable and Prudent Operator**) such period shall be extended for so long as the **User Group** is so prevented. "

37. Thus the borrowing and lending provisions envisage that any lending will be temporary only, while acknowledging the possibility that this may not be possible for reasons beyond the reasonable control of the User Group concerned.

38. Just as the gas which is borrowed in the first place can only be used to discharge the borrowing User Group's delivery obligations to its buyer, so too it is common ground that gas which is subsequently repaid to the Sellers will be delivered by the borrowing User Group into the Bacton processing facilities; it will then form part of the commingled stream delivered to British Gas and will count towards the Sellers' delivery obligations for the day in question. It is worth making clear that repaid gas is contemporaneously produced from the borrowing User Group's reservoir and can only be delivered into the Bacton facilities. There is no physical stock of borrowed gas and nowhere else for the gas to go once it is produced from the reservoir concerned.

Construction of the Capacity Obligation – the appeal

39. Having introduced the principally relevant provisions of these complex agreements, I turn to the first issue, which concerns the true construction of the Sellers' capacity obligation in clause 6.4(1) of the Principal Agreements.

40. British Gas's case is that this clause requires the Sellers to maintain the capacity physically to deliver 130% of the TRDQ from the Reservoirs. Because the TRDQ, since 1st October 2009, has been 83.41 TJ/day, this would mean that the Delivery Capacity which the Sellers have been obliged to maintain since that date has been 108.43 TJ/day (i.e. 83.41 TJ x 130%). British Gas's case is that the production capacity of the Reservoirs, which has necessarily been in decline since 1st October 2009, is less than this. The Sellers have not so far admitted this, but it seems likely to be true, that at some stage between 1st October 2009 and the present day, the production capacity of the Reservoirs has fallen below this level so that, if British Gas's construction is correct, the Sellers are in breach of the Agreements. If this were not the case, it would have been easy enough for the Sellers to say so.

41. The Sellers deny that clause 6.4(1) imposes an obligation on them to maintain the capacity to be able to deliver gas from the Reservoirs at the required rate. They say that in determining whether they have the capacity to deliver gas at the rate of 130% of the TRDQ it is legitimate to take account not only of gas produced from the Reservoirs but also of gas which is owed to them by producers from other fields in repayment of Sole Pit gas previously lent by them under STACA. British Gas accepts, as I understand it, that if the Sellers' construction is correct, the Sellers have so far complied with the capacity obligation in clause 6.4(1).

The judgment

42. The judge considered that clause 6.4(1) viewed in isolation was capable of being construed as contended by British Gas. He said that it was possible to construe the words "from the Reservoirs" as applying only to those molecules delivered from the Sole Pit reservoirs to the point at which the gas was commingled with gas from other reservoirs. He concluded, however, that when the British Gas construction was tested against the relevant provisions of the Principal Agreements and STACA, it began quickly to unravel. He made these points in particular:

(1) First, gas is not in fact delivered to British Gas "from the Reservoirs" but as a commingled stream of gas produced from all of the reservoirs operated by each of the User Groups in STACA.

(2) Second, because British Gas receives commingled gas in this way, there is no reason to distinguish between gas produced contemporaneously from the Sole Pit Reservoirs and repaid gas which is representative of (or equivalent to) historical production from the Reservoirs. In each case the gas in question represents (i.e. whether or not it is in fact) gas produced "from the Reservoirs".

(3) It is unnecessary for the Sellers to provide and maintain capacity to produce 130% of the TRDQ from the Reservoirs if they are able and entitled to meet their delivery obligations by drawing on the gas which is owed to them by other User Groups under STACA.

(4) The British Gas construction leads to absurd consequences, in particular to uncertainty as to the status of gas in what the judge called "the STACA substitution bank" (i.e. gas owed to the Sellers in repayment of gas previously lent).

(5) Accordingly gas owed to the Sellers by other User Groups "is gas that has been produced from the Reservoirs within the meaning of the agreements".

The parties' submissions in outline

43. Mr Michael Bools QC for British Gas submitted, in outline, as follows:

(1) First, the judge failed to take account of all of the relevant terms of the Principal Agreements. In particular, "Delivery Capacity" in clause 6.4(1) is a defined term used throughout the agreements in circumstances which make clear that it refers to the capacity physically to deliver gas from the Reservoirs; it must, therefore, have that meaning also in clause 6.4(1). That is apparent from the words "from the Reservoirs" in the clause, which would be superfluous if the Sellers can maintain the Delivery Capacity from another source. Further, the "Delivery Capacity" is directly linked to the TRDQ, which is expected to track the production profile of the Reservoirs over time, while the detailed provisions concerning the TRDQ and the service of Variation Notices are based entirely on the physical capacity of the Reservoirs.

(2) Second, the judge was wrong to place substantial reliance on the terms of STACA, which post-dated the Principal Agreements and therefore cannot affect the true construction of clause 6.4(1). Further, the judge was wrong to take account of the fact that, in the event, the Outstanding Amount under STACA has built up as much as it has; the parties would not have contemplated this as the lending of gas under STACA was intended to be subject to borrowing and lending limits and to be no more than a short-term expedient.

(3) Third, the judge wrongly construed the Principal Agreements as if they were life of field contracts, when they are in fact field specific depletion contracts. In particular, he was wrong to say at [41] that the Sellers were required to sell to British Gas a quantity of gas that equivalent to *all* of the gas produced from the Reservoirs.

(4) Fourth, the judge was wrong to say that there was no distinction between gas contemporaneously produced from the Reservoirs and gas which is representative of historic production from the Reservoirs. In particular, gas lent to other User Groups was produced in excess of British Gas's nominations and neither the Sellers nor British Gas had any control over when or even whether it would be repaid.

44. Mr John McCaughran QC for Shell and Mr David Wolfson QC for Esso supported the reasoning of the judge. Again in outline, their submissions were as follows:

(1) First, the words "physical" or "physically" do not appear in clause 6.4(1) and should not be read in.

(2) Second, clause 6.4(1) should be construed in light of the Sellers' covenant under clause 3.2, which prevents the Sellers from producing gas "otherwise than for the purpose of deliveries to [British Gas] under this Agreement". This restriction is subject to an exception to allow for gas to be lent under STACA, but such gas which is then repaid is still subject to the covenant in clause 3.2. Accordingly, repaid gas cannot be sold to anyone else and must be sold to British Gas, and should therefore be treated as "from the Reservoirs" for the purpose of determining Delivery Capacity under clause 6.4(1).

(3) Third, this conclusion is consistent with business common sense, because as long as the Sellers are able to meet British Gas's nominations with the correct quantity of gas, it does not make sense to conclude that they do not have the capacity to deliver such quantities of gas, particularly in light of the fact that they are not free to sell repaid gas to third parties.

(4) Fourth, even if the contractual provisions relied on by British Gas demonstrate a link between the TRDQ and the physical capacity of the Reservoirs, nowhere is it stated that such physical capacity is the *only* factor used to determine the TRDQ or that repaid gas under STACA may not be taken into account for this purpose.

(5) Fifth, British Gas's construction of clause 6.4(1) does not make commercial sense, because it accepts that the Sellers may treat repaid gas as gas "from the Reservoirs" for the purpose of fulfilling their delivery obligations, but not for their obligation to maintain the "Delivery Capacity".

Legal principles

45. The court's approach to the construction of commercial contracts is now well known and, subject to one point, was not in dispute. The principles have been re-stated in *Arnold v Britton* [2015] UKSC 36, [2015] AC 1619 and *Wood v Capita Insurance Services Ltd* [2017] UKSC 24, [2017] AC 1173 and need not be repeated here. In short, the court's task is to ascertain the objective meaning of the contract, read as a whole in the light of the background knowledge reasonably available to the parties at the time when it was concluded.

46. The issue which arose concerns amendments. The critical clause, clause 6.4(1), formed part of the Principal Agreements from the outset and remained unchanged when they were subsequently amended, in particular at the time when STACA was concluded.

British Gas submitted that the meaning of the clause should therefore be determined by reference to the contractual provisions and background facts as they stood when the Principal Agreements were first agreed in December 1988 and that this meaning was unaffected by subsequent amendments. It relied on a dictum of Lord Hoffmann in *National Grid Co Plc v Mayes* [2001] UKHL 20, [2001] 1 WLR 864 at [67] and on the tentative view expressed, citing that dictum, in *Lewison, The Interpretation of Contracts*, (6th Ed, 2015) at page 88:

> "Contracts of long duration are often varied from time to time. It is undoubtedly the case that the variations must be read together with the original contract. It is not, however, clear whether in reading the original terms together with the variations the latter may be held to alter the meaning of an original unaltered clause. It seems unlikely that the parties would have wished to alter the meaning of a clause without actually altering its words, although an amendment may show what the parties thought their original contract meant. …"

47. The Sellers on the other hand submitted that when a contract is amended, its terms (including those which were not altered) must be construed in the light of the background circumstances existing at the time of the amendment, with the consequence that the meaning even of an unaltered clause may be changed by the amendment. They cited *Stena Line Ltd v Merchant Navy Ratings Pension Fund Trustees* [2011] EWCA Civ 543 at [32] to [34], together with the passage from *Lewison* immediately following that set out above:

> "… On the other hand, it may be forcefully argued that having taken the opportunity to review their contract, the parties must be taken to have entered into a new contract on the date of the (last) variation of it. If the latter view is correct, it may also alter the nature of the background that may be considered in construing the contract. Where a clause has itself been amended, the amended clause should be construed in the light of the background knowledge available to the parties at the date of the amendment. Thus where, for instance, a pension scheme is altered by the introduction of a new clause, that clause must be interpreted by reference to the circumstances prevailing at the date of its introduction. …"

48. It is unnecessary to determine this issue for the purpose of this appeal. The Principal Agreements as originally concluded contemplated that an "Allocation Agreement" would be entered into between the Sellers, British Gas and all other producers of gas from the reservoirs supplying gas to the Bacton processing terminal. In my judgment it makes little or no difference to the construction of clause 6.4(1) whether the meaning of that clause is determined as at the date of the original Principal Agreements in December 1988 or when those agreements were amended in the light of the conclusion of STACA in September 1997.

Discussion

49. I begin with the language of clause 6.4(1) of the Principal Agreements which, for ease of reference, I set out again:

> "Subject to clause 6.8 with effect from the **Start Date** the Seller shall provide and maintain a capacity (herein referred to as the '**Delivery Capacity**') to deliver Natural Gas from the **Reservoirs** on each Day at a rate of not less than the **DCQ** applicable for such Day multiplied by one hundred and thirty (130) percent and BG shall have the right on any and every Day (subject as herein provided) to require delivery of Natural Gas at rates up to the appropriate **Delivery Capacity** determined hereunder notwithstanding that the aggregate of such daily requirements made in respect of any Contract Year exceed the **ACQ** …"

50. Five points are important:

(1) First, this is an obligation to provide and maintain a certain capacity to deliver gas. It is, therefore, a capacity obligation and not a delivery obligation. It follows, in my judgment, that it is of only limited relevance to the construction of the clause to point out that what is actually delivered to British Gas is a commingled stream of gas produced from all of the reservoirs operated by each of the User Groups in STACA.

(2) Second, the capacity which the Seller is obliged to maintain is given a defined term, "Delivery Capacity". It will, therefore, be relevant to see how that defined term is used in other provisions of the agreement. It is to be expected that usage of such a defined term will be consistent throughout.

(3) Third, the rate at which the Seller must be able to deliver gas is the DCQ, which is half of the TRDQ in force on any given day. Thus there is a clear link between the Seller's capacity obligation and the TRDQ.

(4) Fourth, the obligation is expressly qualified by clause 6.8, which allows the Seller to reduce the TRDQ for the purpose of "installation maintenance repair modification or replacement" of delivery facilities in the event that such work will affect "its ability to supply Natural Gas under this Agreement". Although by no means conclusive, this is an indication that clause 6.4(1) is concerned with the physical capacity of the Reservoirs.

(5) Fifth, the obligation is to maintain a capacity to deliver gas "from the Reservoirs" at the specified rate. This is of particular importance, as all parties recognised. While the Sellers emphasised that the clause does not qualify "capacity" with the word "physical", the presence of the words "from the Reservoirs" means that it does not need to. The unavoidable fact is that gas which is repaid to the Sellers in repayment of Sole Pit gas previously lent by them is *not* gas "from the Reservoirs". The plain meaning of the clause, therefore, is that it is concerned only with the capacity to supply gas from the Sole Pit Reservoirs and not with gas from other sources. The Sellers recognised the force of this point, which they sought to meet by submitting that repaid gas had to be treated as if it were gas produced from the Reservoirs (or, as the judge

> put it, such gas represented gas produced from the Reservoirs). Thus it is the Sellers, rather than British Gas, who are seeking to read words into the clause. But there is in my judgment no sound basis for doing so. Clause 6.4(1) contains no such deeming provision while clause 5.3, which deals with commingling, draws a distinction between gas "produced from the Reservoirs" and gas "produced from any other accumulation or accumulations", without suggesting that the latter should be treated as the former, either for the purpose of the capacity obligation in clause 6.4(1) or at all.

51. Taking these points together, I would go further than the judge who thought that clause 6.4(1), considered in isolation, was capable of being construed in the way for which British Gas contends. In my judgment the words of the clause provide strong support for this construction.

52. I consider next the other relevant provisions of the Principal Agreements, in order to see to what extent they either confirm or undermine this provisional conclusion.

53. First, as already noted, clause 6.4(1) uses the defined term "Delivery Capacity". That clause is also used elsewhere in the Agreement. I shall return to the use of the term in clause 6.3 which is concerned with the service of Variation Notices to reduce the TRDQ. Elsewhere, in clause 7.2 it is used in the context of the number of wells and platforms which the Sellers are required to provide in order to maintain throughout the Minimum Plateau Period the Plateau TRDQ "together with the associated **Delivery Capacity** provided for in this Agreement …". In clauses 20.1 and 20.2 the context is the existence of "Special Reservoir Conditions" (which is defined to mean "conditions prevailing within the **Reservoirs**") as a result of which the Sellers are unable to maintain "the ability to deliver Natural Gas from the **Reservoirs** at the **Plateau TRDQ** (together with the associated **Delivery Capacity** provided for herein …)". These provisions are all concerned with the Sellers' ability physically to produce gas from the Reservoirs. They suggest that this is also the meaning of the term "Delivery Capacity" in clause 6.4(1).

54. Second, the link between the Sellers' capacity obligation and the TRDQ is significant. As I have explained, the TRDQ changes over the life of the contract, with three distinct periods (the Run-In Period, the Build-Up Period and the Plateau Period), and with an option for the Sellers to serve Variation Notices to reduce the TRDQ after the end of the Minimum Plateau Period. These periods broadly track the expected physical production profile of the Reservoirs. It follows that the TRDQ, and thus the Delivery Capacity, was expected to be based upon the physical production capacity of the Reservoirs.

55. Third, the Sellers' right to serve a Variation Notice under clause 6.3 arises when they form the opinion that they will be unable to maintain the TRDQ "together with the **Delivery Capacity** provided for herein …)" assuming the availability of specified "Field Facilities". The Variation Notice which is then served must specify the maximum TRDQ and Delivery Capacity which the Sellers are of the opinion they will be able to maintain assuming those facilities. The notice must include technical data relating to the physical capability of the Reservoirs, including such matters as suction pressures, various reservoir simulation models and aggregate reservoir deliverability curves, as well as details of any new facilities which the Sellers are planning to install. These detailed provisions are exclusively concerned with the ability of the Sellers to

produce gas from the Reservoirs. Conspicuously they say nothing about the possible availability to the Sellers of gas from other reservoirs which, if taken into account, would or might enable the Sellers to maintain the TRDQ and its associated Delivery Capacity. That is a strong indication, in my judgment, that such gas is not intended to be taken into account for this purpose and that what matters is the ability of the Sellers physically to produce gas from the Reservoirs.

56. That view is confirmed when the further provisions of clause 6.3, dealing with the situation in which British Gas disputes the new TRDQ proposed by the Sellers, are considered. Those provisions involve the appointment of an Expert to determine the new TRDQ. The Expert is required to make a series of assumptions, all of which relate to the physical capacity of the Reservoirs, but again nothing is said about the possible availability of gas from other sources.

57. Reading the Principal Agreements as a whole therefore supports the British Gas construction of clause 6.4(1). Far from causing it to unravel, as the judge suggested, the provisions to which I have referred (with which the judge did not deal in his judgment) confirm the provisional view which I have formed based on the language of clause 6.4(1) itself.

58. I consider next the impact of STACA, accepting the Sellers' submission that the Principal Agreements and STACA must be read together. That is apparent from Articles 3 and 5 of the Principal Agreements, which make the Sellers' obligation not to produce gas from the Reservoirs otherwise than for delivery to British Gas under the agreements subject to Article 5, which among other things provides for commingling in accordance with STACA. It is STACA which provides for the borrowing and lending of gas between User Groups in the event that any one such group is unable to supply the gas which British Gas has nominated for that day.

59. However, clause 4.3 of STACA clearly contemplates that such borrowing and lending provisions will be temporary only. Thus a User Group which has borrowed or lent gas must ensure that this is repaid "as soon as reasonably practicable" and must further ensure that "on at least one (1) of the last seven (7) Days of each Contract Year the **Outstanding Amount** shall be brought to or be at zero".

60. These provisions are entirely inconsistent, to my mind, with the future repayment of such lent gas being taken into account by the Sellers when serving a Variation Notice. Such a notice must be served at the latest 2 ½ years before the Contract Year to which it relates. But if in the meanwhile any Outstanding Amount has been brought to zero as clause 4.3 contemplates, the Sellers will have no way of knowing whether in 2 ½ years' time they will be net lenders or, if so, in what amount. It is true that clause 4.3 acknowledges that reducing the Outstanding Amount to zero in the short-term, or even at the end of each Contract Year, may not be possible. The obligation is to do so "as soon as reasonably practicable" and is subject to a User Group being prevented from doing so "for reasons beyond its reasonable control". Nevertheless, while allowing that reducing the Outstanding Amount to zero may not be possible, the clause contemplates that in general it will be.

61. I see nothing in STACA, therefore, to call into question British Gas's construction of clause 6.4(1) of the Principal Agreements.

62. Finally, the Sellers invoke commercial common sense, submitting that it makes no sense to ignore gas which is available to them, particularly in circumstances where such gas can only be used for the purpose of delivery to British Gas under the Agreements. I would doubt whether commercial common sense has much of a role to play in the construction of detailed and expertly drafted contracts such as those in issue here. But in any event, I see nothing surprising, let alone nonsensical, about the British Gas construction. The purpose of clause 6.4(1) is to ensure security of supply of gas from the Reservoirs. There is no reason why, when dealing with capacity as distinct from delivery, the possible availability of gas from other sources should be taken into account. The availability of such gas is inherently uncertain. It depends on the ability of the borrowing User Group to repay such gas as and when needed by the Sellers. The fact that, in the event, this seems not to have been a problem cannot affect the construction of the contract.

63. For all these reasons I would hold that for the purpose of deciding whether the Sellers have maintained the necessary Delivery Capacity in accordance with clause 6.4(1), it is not permissible to take account of gas from other reservoirs which is owed to the Sellers by other gas producers in repayment of gas from the Sole Pit Reservoirs which the Sellers previously lent to those other producers. I would therefore allow the appeal.

Assessment of damages – the cross-appeal

64. It is therefore necessary to consider the cross-appeal, for which purpose it must be assumed (and in any event seems likely to be true) that the Sellers have been in breach of the capacity obligation in clause 6.4(1) from some date between 1st October 2009 and the present day. That is because it must be assumed that a time came when the Sellers were unable to maintain a Delivery Capacity of 108.43 TJ/day (i.e. 130% of the TRDQ) of gas from the Reservoirs, even though they have been able (with some limited exceptions) to meet British Gas's delivery nominations. They have been able to do so, no doubt, in part because of the availability of gas which is owed to them by other User Groups and in part because British Gas has been nominating the minimum amounts which it is obliged to take and pay for in view of the availability of cheaper gas elsewhere on the market.

65. The question arises, therefore, how damages for breach of the capacity obligation should be assessed.

66. British Gas's case is that, in order to avoid being in breach of the capacity obligation, the Sellers would have served one or more Variation Notices reducing the TRDQ, which would have had the effect of reducing the quantities which British Gas was required to take and pay for under the Principal Agreements. It claims damages (which it says amount to over £61 million up to the end of the 2017/18 Contract Year) consisting of the difference between the price of gas which it could have purchased on the market and the price which it actually paid to the Sellers for gas which it would not have been required to take if the TRDQ had been reduced in this way. It recognises, however, that the question whether the Sellers would have served any and if so what Variation Notices is a question of fact and says that this is not capable of being resolved by way of preliminary issue.

67. The Sellers on the other hand say that the TRDQ was at all material times 83.41 TJ/day, so that their obligation was to maintain a Delivery Capacity of 108.43 TJ/day, being

130% of the TRDQ. If they had done so, gas would have been supplied to British Gas in the same quantities as were in fact supplied and British Gas would have paid the same amount as it did in fact. It has therefore suffered no loss as a result of any breach.

The judgment

68. The judge preferred British Gas's submissions on this issue. He cited the decision of this court in *Durham Tees Valley Airport Ltd v Bmibaby Ltd* [2010] EWCA Civ 485, [2011] 1 All ER (Comm) 731, a case in which the defendant airline had contracted to base and fly two aircraft from the claimant's airport over a 10 year period but had subsequently repudiated that contract. The defendant argued that the damages for repudiation should be nominal because the contract did not specify the number of flights required or passenger numbers to be carried and that, in the absence of any minimum requirement, the claimant had suffered no loss. That argument was rejected. The Court of Appeal held that when assessing damages, the court had to make an estimate of how the contract would have been performed if it had continued.

69. Patten LJ said:

> "79. … The court, in my view, has to conduct a factual inquiry as to how the contract would have been performed had it not been repudiated. Its performance is the only counter-factual assumption in the exercise. On the basis of that premise, the court has to look at the relevant economic and other surrounding circumstances to decide on the level of performance which the defendant would have adopted. The judge conducting the assessment must assume that the defendant would not have acted outside the terms of the contract and would have performed it in his own interests having regard to the relevant factors prevailing at the time. But the court is not required to make assumptions that the defaulting party would have acted uncommercially merely in order to spite the claimant. To that extent, the parties are to be assumed to have acted in good faith although with their own commercial interests very much in mind."

70. Toulson LJ agreed and identified a number of possible permutations:

> "96. The cardinal principle of any assessment of damages for breach of contract is that the innocent party (the claimant) is entitled to be put in the same position as he would have been in if the defendant had not broken the contract. This requires a careful analysis of the contract. Subsidiary general rules have been developed for measuring damages in different types of case, although there may be a need for caution to see that they are not applied mechanistically in particular situations where to do so would defeat the cardinal principle. As the case law shows, there is a wide range of possible permutations which may affect the right way to assess damages. They include the following, although not every case falls neatly into one of them:
>
> 1. The contract requires the defendant to do X or Y.

> 2. The contract requires the defendant, if he has not done X, to do Y.
>
> 3. The contract requires D to do X and the claimant has a reasonable expectation that he will do Y.
>
> 4. The contract requires the defendant to do X and allows him a discretion how he performs the obligation."

71. The judge considered that the present case, like the *Durham Tees Valley Airport* case, was within Toulson LJ's category 4 and that if, contrary to his views on the first two preliminary issues, the Sellers were indeed under an obligation to track the decline of the Reservoirs by the service of Variation Notices, the case was one in which they had a discretion as to how they would perform. It was therefore necessary, as a matter of fact, to investigate this issue.

The submissions on appeal

72. On appeal the parties essentially reiterated the positions which they had adopted before the judge.

73. The Sellers submitted that the judge was wrong to regard this as a category 4 case. There was a single obligation to maintain a Delivery Capacity of 108.43 TJ/day. That remained the position unless and until the Sellers served a notice to vary the TRDQ, which they had no obligation to do. In any event, unlike the *Durham Tees Valley Airport* case, this is not a claim for damages for repudiation, but a claim for damages for past breaches while the contract remained in being.

74. British Gas submitted that the question how the Sellers would in fact have performed their obligation to maintain a Delivery Capacity of 130% of the TRDQ is a question of fact which can only be determined at trial, British Gas's case being that even if Sellers were under no obligation to serve Variation Notices, they would in fact have done so in order to comply with that obligation.

Discussion

75. There is no dispute that the relevant principle for the assessment of damages is the principle stated by Parke B in *Robinson v Harman* (1848) 1 Ex Rep 850 and reiterated many times since in cases at the highest level:

> "The rule of the common law is, where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in a situation, with respect to damages, as if the contract had been performed."

76. It is unnecessary to rehearse here the many cases in which this principle has been applied. I summarised some of the recent House of Lords and Supreme Court cases in *Classic Maritime Inc v Limbungan Makmur Sdn Bhd* [2019] EWCA Civ 1102, [2019] Bus LR 2854 at [66] to [89].

77. Damages must therefore be assessed on the basis that the party in breach had performed its obligation. That is not, or at least is not necessarily, the same as saying that damages

should be assessed as if the party in breach had taken steps to avoid being in breach of contract in the first place.

78. As Toulson LJ emphasised in *Durham Tees Valley Airport*, it is therefore of critical importance to construe the contract in order to identify the obligation of which the defendant is in breach. In the present case the obligation in clause 6.4(1) was to maintain a Delivery Capacity of 130% of the TRDQ in circumstances where it was known that the TRDQ would change over the period of the Agreements and, in particular, that the Sellers had a right in some circumstances (but never a duty) to serve a Variation Notice to reduce the TRDQ after the expiry of the Minimum Plateau Period. On any given day it is a straightforward matter to ascertain what capacity the Sellers are obliged to maintain. All that is necessary is to ask what is the current TRDQ and to multiply that by 130%. To construe the contract in this way promotes certainty and clarity. In contrast, to construe the contract as requiring the Sellers to predict the maximum capacity they will be able to maintain in 2 ½ to 3 years' time, and to serve Variation Notices to adjust the TRDQ accordingly, is far from straightforward, as well as having the effect of converting a right into a duty.

79. In those circumstances the Sellers' obligation, in my judgment, was to maintain a Delivery Capacity of 130% of whatever the TRDQ was from time to time. They were under no obligation to serve a Variation Notice with a view to reducing the TRDQ in the event that they foresaw a future inability to comply with that obligation. Damages cannot be assessed as if they were under an obligation to serve such a notice: to do so would be contrary to the terms of the parties' contract. Nor can damages be assessed on the basis that the Sellers would in fact have served a Variation Notice when in fact they did not.

80. Accordingly the relevant counterfactual for the purpose of assessing damages is that the Sellers would have maintained a Delivery Capacity of 108.43 TJ/day. This is in accordance with the fundamental principle that damages must be assessed on the basis that the party in breach had performed its obligation. On this basis, British Gas has suffered no loss. In contrast, British Gas seeks to assess damages on a different (and in my judgment wrong) principle, namely that the party in breach would have taken steps to avoid being in breach of contract in the first place.

81. In my view this is not a category 4 case as described by Toulson LJ in *Durham Tees Valley Airport*. Rather, it is a single obligation case in which the defendants' obligation is simply to do X – that is to say, to maintain a Delivery Capacity of 130% of whatever the TRDQ is from time to time, that figure being established in accordance with the agreed contractual machinery in Article 6 of the Principal Agreements.

82. For these reasons I would allow the cross-appeal.

Disposal

83. For my part, therefore, I would allow both the appeal and the cross-appeal. That would mean that the ultimate result is essentially the same. British Gas will be entitled at most to nominal damages, but otherwise its claim for damages must fail.

Lady Justice Andrews:

84. I have had the advantage of reading in draft the judgment of Males L.J., and there is nothing that I can usefully add to his masterly analysis of the contractual provisions that in my judgment leads to the inexorable conclusion that Clause 6.4(1) should be construed as relating to the Sellers' physical capacity to produce gas from the Reservoirs. Accordingly, when considering whether that contractual obligation has been performed, it is impermissible to take into consideration the Sellers' ability to use repaid gas from other User Groups to perform their obligations to deliver the requisite contractual quantities to British Gas. I therefore agree with Males LJ, for the reasons he has given, that the appeal must be allowed.

85. I have found the cross-appeal far less straightforward, because of the malleable nature of the contractual obligation of which, for these purposes, we must assume the Sellers were in breach. In my judgment it does not easily fit within any of the categories adumbrated by Toulson LJ in the *Durham Valley Tees Airport* case. The obligation here was an obligation to maintain a *capacity to deliver* from the Reservoirs 130% of the TRDQ; but the Sellers were able to change the TRDQ and thereby change what they needed to do in order to perform that obligation. In a sense, therefore, they did have a choice as to how they performed the contract.

86. I can understand why the judge thought this was a category 4 case, because the obligation to deliver 130% of the TRDQ could be fulfilled by exercising the contractual discretion to change the TRDQ. However, I agree with Males LJ that once the TRDQ was set (if necessary, by expert determination) the Sellers had no choice about how to perform their obligation under Clause 6.4(1). They had to be in a position to produce and deliver 130% *of that quantity* from their own resources, unless and until they elected to reduce the TRDQ by service of a Variation Notice. The obligation that was breached was an obligation to maintain the capacity to deliver 130% of the TRDQ that currently dictated how much gas British Gas was obliged to take up and pay for, and not 130% of some lower TRDQ that might be declared in substitution for that figure in future.

87. That interpretation is consistent with the commercial purpose of the obligation under Clause 6.4(1), namely, to secure continuity of supply of the minimum amount of gas that British Gas was contractually obliged to take up and pay for at any given time. The obligation to maintain capacity arose independently of the delivery obligations and irrespective of the fact that it was possible to meet the delivery obligations by delivering repaid gas (or, indeed, borrowed gas) under the STACA arrangements.

88. What makes this contract so unusual is that the party which is under the obligation to maintain the production capacity is also able to decide what the parameters of that obligation should be at any given time. Despite this, on reflection I have reached the conclusion that the potential for unilateral variation of the term which has been breached is an irrelevant distraction, because it makes no difference to the assessment of loss flowing from a continuing breach of a term which has <u>not</u> been varied.

89. It would not be open to a party who has breached a contractual obligation over a period of, say, one year to contend that, had it appreciated that it was in breach of contract, after two months it would have exercised a contractual option which enabled it to perform the contract in another way, which would have put an end to the breach, and therefore the injured party is only entitled to recover two months of its losses. It is not possible to re-write history in that way for the purposes of assessing damages for a

breach that has already occurred. The converse must also be true. The injured party can only claim such recoverable loss, if any, as flowed from the proven breach. Since the option to change what had to be done in order to fulfil the contractual obligation was never exercised, the approach to the assessment of damages is no different from the approach that would be taken if the option did not exist.

90. I accept, of course, that the purpose of the provisions entitling the Sellers to unilaterally vary the contract was to address the scenario in which they no longer had the capacity to deliver 130% of the existing TRDQ – the scenario that we must assume for these purposes has arisen here – and to relieve them from the consequences by bringing about a situation in which they were no longer in breach. If they so elected, the obligation under Clause 6.4(1) would remain an obligation to maintain a capacity to deliver from the Reservoirs 130% of the TRDQ, but the obligation would be performed by maintaining a lower production capacity because the Sellers had adjusted the TRDQ downwards. Thus the ability to serve a Variation Notice provided the Sellers with a contractual safeguard against the consequences of a breach of Clause 6.4(1). If they exercised the option after the capacity had fallen below the contractual requirements, they would cease to be in breach of contract as soon as the election took effect, and damages for the breach would be measured over that period.

91. No doubt the parties expected that is what would happen once the Sellers became aware that their production capacity had diminished. However, the very fact that the Sellers had an option, rather than an obligation, to vary necessarily envisages that there might be circumstances in which they would be unconcerned about the consequences of being in breach of Clause 6.4(1), and would decide that they did not need to reduce the TRDQ. From a commercial perspective, the question whether they would wish to avail themselves of that safeguard would be likely to depend on their exposure to damages for the breach.

92. In a case where the User Groups would be unable to repay sufficient of the borrowed gas, or lend the Sellers sufficient gas under the STACA to make up any prospective shortfall in delivery of the amounts nominated by reference to the Delivery Capacity based on the current TRDQ, the commercial imperative to serve a Variation Notice might be overwhelming. However, in the present case, the Sellers had no problem in delivering against the TRDQ which they had set. The concern which Clause 6.4(1) was designed to safeguard against was not an issue in practical terms, because the Sellers did maintain continuity of supply.

93. This case concerns the quantification of losses arising from a breach which, on the facts, was never brought to an end by service of a Variation Notice. Absent such an election, the damages to be quantified would be the loss, if any, suffered in consequence of the Sellers' failure to maintain the (unmodified) capacity to deliver 130% of the TRDQ as at the date of the breach, measured over the whole of the period while that breach continued. That is the loss with which we are concerned. The key question is therefore whether we can conclude, without the need for evidence, that it inevitably follows from the fact that the Sellers could (and in the event did) perform their *delivery* obligations by using repaid gas from other User Groups to make up the shortfall in the quantities that they were unable to produce from the Reservoirs, that British Gas has suffered no loss in consequence of their breach of Clause 6.4(1).

94. If the answer to that question is yes, then the protection afforded to the Sellers by the power to serve a Variation Notice is in a sense surplus to requirements, because no loss would flow from a breach of Clause 6.4(1) so long as the Sellers could continue to deliver up to 130% of the TRDQ which they had set. However, that may just be a consequence of a failure by British Gas to negotiate terms which obliged the Sellers to serve a Variation Notice instead of giving them a choice. It would also be the consequence of a set of facts arising which I doubt any of the contracting parties expected to occur at the time when they entered into these contracts. It would have been reasonable for them to have assumed that, as and when it became apparent that the Reservoirs were no longer going to be able to produce 130% of the TRDQ the Sellers *would* serve a Variation Notice, because it was not contemplated that so much gas would be "borrowed" under the STACA arrangements that there would be enough available to enable them to continue to meet up to 130% of the TRDQ in the long term once it became impossible for them to do so from their own resources. Nevertheless, and however unlikely they may have appeared, the parties must live with the circumstances that actually occurred.

95. Mr McCaughran QC submitted that the correct approach to assessing the loss would be to assume that the Sellers *did* have the capacity to deliver 130% of the TRDQ (because then there would have been no breach of Clause 6.4(1) and ask how they would have performed the contract, and then compare it with what actually happened during the period whilst they were in breach (which is already known).

96. If they did have that capacity throughout the period when they were in breach, there would have been no reason for them to serve a Variation Notice, so *ex hypothesi* the TRDQ would have remained the same and the Sellers would have delivered whatever was nominated by reference to that quantity (because they would have had the capacity to do so). Comparing that scenario with what actually happened, whilst the sellers *could* have decided to serve a Variation Notice to reduce the TRDQ so as to avoid the consequences of being in breach of contract, they did not do so. If they did not have the Outstanding Amount to fall back on they may well have acted differently, but in fact they were able to maintain the delivery of the contractual quantity by using repaid gas, as they were contractually entitled to do. Therefore, British Gas were no worse off in consequence of the breach.

97. Although initially it appeared to be counter-intuitive to make an assumption that the Sellers could do something which it was impossible for them to do, i.e. produce 130% of the TRDQ, on reflection I find those arguments compelling. When putting the injured party into the position in which they would have been if the contract had been performed, one must assume that the relevant breach did not occur. In a commercial contract for the manufacture and delivery of goods, the situation may arise in which the supplier is unable to make the goods because he cannot source a key ingredient. The buyer's damages are based on comparing the situation in which the seller did produce and supply those goods to him, with the situation that actually occurred, in which he was unable to do so. For the purposes of that exercise, the fact that he could never have delivered those goods is irrelevant.

98. For those reasons, although the end result is a Pyrrhic victory for British Gas, I agree that the cross-appeal should be allowed.

Lord Justice Peter Jackson:

99. I have had the great advantage of reading the judgments above in draft.

100. The appeal and cross-appeal in this case concern the interpretation of a single sentence in the context of contracts running to some 250 pages:

> "6.4(1) … the Seller shall provide and maintain a capacity (herein referred to as the **" Delivery Capacity ")** to deliver Natural Gas from the **Reservoirs** on each Day at a rate of not less than the **DCQ** applicable for such Day multiplied by one hundred and thirty (130) percent…"

101. The Buyer's appeal concerns the correct interpretation of the words "Natural Gas from the Reservoirs". As to that, I am in complete agreement that, for the reasons given by Males LJ, the appeal should be allowed.

102. The Sellers' cross-appeal is more difficult. If both appeal and cross-appeal succeed, the law will have given with one hand and taken away with the other. This Pyrrhic victory for the Buyer is at first blush a surprising outcome. It runs contrary to the conventional expectation that parties who break contracts should face consequences. That expectation is harder to shake off where the defaulting party had the power to alter the contractual obligation so as to avoid being in breach, and harder still where the breach is not isolated but continuous.

103. By way of explanation, this contract contains a careful internal tension linking performance on both sides with production capacity. The Sellers' obligation is not simply *to deliver gas* from the Reservoirs at 130% of the TRDQ but *to provide and maintain the capacity to deliver gas* from the Reservoirs at 130% of the TRDQ. This 'capacity obligation' requires them to maintain the physical capacity to meet the prevailing contract quantities. They could have honoured the contract by further exploitation of the Reservoirs and/or by serving Variation Notices. Yet it is common ground for present purposes that (although they have been coy about the details) the Sellers have for some considerable time been unable to meet the capacity obligation from gas from the Reservoirs, and that this will remain the case. This breach can occur with impunity, provided that they deliver enough equivalent gas to meet the Buyer's nominations. Indeed, they could theoretically have breached it for the majority of the contract period. Looking backwards in time, they could have served no Variation Notices at all following the end of the Minimum Plateau Period in 1997; that may not have been realistic in practice, but that cannot affect the analysis. Looking forward, they may seek to remain in continuous breach until the end of the contract in 2025. They may not extract another cubic metre from the Reservoirs, yet the Buyer is said to be locked into taking and paying for gas that it does not want on grounds of price. That, says Mr Bools for the Buyer, is absurd.

104. Moreover, this outcome effectively short-circuits the protection contained in Article 17 of the contract ('Default'), which provides a detailed regime for the Buyer to be entitled to cheaper gas later on if the Sellers fail to deliver the nominated amount of gas on time, the amount by which the Sellers's deliveries have fallen short being classified as 'Shortfall Gas'.

105. This outcome results from a legal analysis that is, as Andrews LJ says, counter-intuitive. As in any other case of breach of contract, the Buyer is entitled to be placed, so far as

money can do it, in the same position as it would have been in had the contract been performed by the Sellers. That baseline obligation is one that the Sellers have rendered impossible in reality.

106. For all these reasons, the proposition that no loss has been sustained in this case is not straightforward. Nevertheless, after careful thought, I have come to the conclusion that it is correct for the reasons given by Males LJ and Andrews LJ, to which I add these concurring reasons.

107. As Andrews LJ says, this contract is unusual in giving one party the prerogative to set the parameters of an obligation that binds both parties. It is this that in my view leads to the unusual outcome. Every contract contains certain levers of power. The way in which the levers were distributed in this contract arose from a commercial negotiation between parties who were well able to look after their own interests. Their agreement has in this respect led to a result that may be considered unexpectedly beneficial to the Sellers and detrimental to the Buyer, but the yardstick for construction is what was agreed, not what might have been agreed.

108. Here, the judge's undisturbed conclusion in relation to the implication of a term requiring the Sellers to serve Variation Notices tracking capacity is fatal to the Buyer's case on loss. It means that the Sellers' contractual obligation was to provide and maintain the capacity to deliver gas from the Reservoirs *at 130% of the TRDQ*, and not in some other quantity. The fact that they could change the quantity is, as Andrews LJ says, an irrelevant distraction.

109. I would therefore accept Mr McCaughran's submission that this is in truth a claim for damages for the Seller's failure to serve Variation Notices, something that they were under no obligation to do. That submission is supported by the way in which the Buyer has pleaded its case in relation to causation and quantification of loss at paragraph 19, and at 25 and 26 of the Amended Particulars of Claim, which show that its case rested on an obligation to serve Variation Notices:

> "25. As a result of the Sellers' breach of their obligation under Clause 6.4(1) to maintain a Delivery Capacity of 130% of the DCQ, BGT has suffered loss and damage.
>
> 26. The best particulars BGT can give, pending disclosure, as to its loss and damage are as follows.
>
> (l) Since l October 2009, the TRDQ has been maintained by the Sellers at 83.41 TJ/day.
>
> (2) Since (at least) in or around October 2011, alternatively 7 April 2014, the Reservoirs have been incapable of providing and maintaining a Delivery Capacity (being 130% of DCQ) based on a TRDQ of 83.41 TJ/day.

> (3) Had the Sellers not breached their obligation under Clause 6.4(1) to maintain the Delivery Capacity of 130% of DCQ, they would have served Variation Notices, the best particulars of which the Claimant can provide pending disclosure are that the Sellers would have served Variation Notices:
>
> (a) In or around March 2009, notifying BGT in respect of Contract Year 2011/12 of a reduction in the TRDQ to ~~83~~78.67 TJ/day to reflect the Reservoirs' actual production capacity;
>
> [and similar notices were pleaded in the following subparagraphs in respect of the years 2010 to 2017]
>
> (4) As a result of the Sellers' failure to serve the Variation Notices referred to in sub-paragraph 26(3), BGT has been required to take or pay for a larger quantity of Natural Gas under the Principal Agreement than, but for the Sellers' breach of contract, it would have done.
>
> (5) [Pleads the quantities actually delivered between 2011 and 2018.]
>
> (6) As a result, BGT has suffered loss and damage, being the difference between the price at which BGT bought the quantities of gas particularised in sub-paragraph 26(5) and the price for which it could have bought equivalent gas. [Particulars are then given.]"

110. The Sellerss' response is at paragraphs 45(3) and (4) of the Defence:

> "(3) The first sentence of paragraph 26(3) is not understood. If the Sellers had not breached Clause 6.4(1) (as alleged) that would mean they had been able to provide and maintain the Delivery Capacity (130% of the DCQ, i.e. 108.43 TJ/Day) and there would have been no reason to serve a Variation Notice proposing a reduction in the TRDQ. The relevance of the particulars given in paragraph 26(3) is denied."
>
> (4) Without prejudice to the foregoing, it is not admitted that Variation Notices would have been served proposing a reduction

> in the TRDQ to track the Reservoirs' actual production capacity, or in any event on the dates and to the levels alleged in paragraph 26(3)(a). The Sellers may have decided not to serve Variation Notice(s) and either (i) have made further investment to increase production; or (ii) have taken the risk that the Sellers would be unable to meet BGT's nominations."

111. The judge approached the pleading issue in this way:

> "86. I turn finally to the Sellers' contention that the only relevant obligation pleaded by BGT is to maintain a delivery capacity of 108.43 TJ/day, which was to all intents and purposes achieved. This is not, in my view, a fair categorisation of BGT's pleaded case. BGT has pleaded that the Sellers failed to maintain a capacity physically to deliver gas at a rate of 130% of the DCQ (paragraph 19 of the AmPoC) and that as a result of that breach of clause 6.4(1) BGT has been required to take or pay for a larger quantity of gas under the Principal Agreements than, but for the breach, it would have done (paragraphs 25 and 26 of the AmPoC). This is not an issue that can be disposed of at this stage.
>
> 87. It follows from this that the losses allegedly caused to BGT by the Sellers' breach of Clause 6.4(1) are not, in my judgment, to be calculated on the assumption that the Reservoirs would have had a physical capacity of 108.43 TJ/day."

112. With respect to the judge, the flaw in this reasoning arises where he states that the Buyer's case is that it was required to take or pay for a larger quantity of gas as a result of the breach of clause 6.4(1); in fact the case as pleaded at paragraph 26(4) of the Amended Particulars of Claim is that it is a result of the failure to serve Variation Notices. That the judge understood this can be seen from this earlier passage where he made clear that the existence of an obligation to serve the notices was an essential condition for his conclusion on this issue:

> "84. … If the Delivery Capacity did in fact reduce over time and if (notwithstanding my findings in relation to the Implied Term Issue) the Sellers were indeed under an obligation to track that reduction by the service of Variation Notices under clause 6.3 then the timing of and manner in which the Sellers did so, had a discretionary element. In order to put BGT in the same position as it would have been had the alleged breaches not occurred it would in my judgment be necessary to work out how the Principal Agreements would have been performed had the Sellers performed in accordance with their obligations."

Here, the judge is saying that damages should be assessed, not on the basis that the party in breach had performed its obligation, but as if the party in breach had taken steps to avoid being in breach of contract in the first place. This is the error identified by Males LJ at paragraph 77 above.

113. I also agree that on a correct analysis the counter-factual exercise that was identified in *Durham Tees Valley Airport Ltd v Bmibaby Ltd* has no part to play in this case. As its treatment in *McGregor on Damages* 20th Ed. at 10-110 shows, the *Durham Tees* inquiry is appropriate in a case where there is uncertainty about the extent of the claimant's loss in circumstances where the defendant has a discretion as to how a contract can be performed. A contract of this kind was considered by this court in *Abrahams v Herbert Reiach Ltd* [1922] 1 KB 477. Publishers undertook to republish the claimant's magazine articles in book form, paying a royalty on each copy sold. The form, price, publication date and number of copies to be printed was left to their discretion. They then refused to publish the book and the issue was what would have amounted to sufficient publication to constitute performance of the contract.

114. The present case is different. The Sellers had a single obligation to provide and maintain the capacity to deliver gas from the Reservoirs at 130% of the TRDQ, whatever that was at the time. They had no discretion as to how much daily gas they had to deliver. As already noted, and the distinction is a subtle one, the power to change an obligation is not a discretion as to how to perform it. Accordingly, once the obligation is identified and the breach established, the only remaining question is what if any loss has flowed from the breach. There is no uncertainty about definition of the loss, though its quantification may be complex, depending on the circumstances.

115. I would therefore also allow the cross-appeal. I am conscious that we are differing from the judge not once but twice, but that is no reflection on his judgment, which dealt clearly and succinctly with three difficult issues. It should also be noted that his undisturbed finding on the third issue (no implied term) has had a decisive effect on the outcome and that his decision and ours have by different routes arrived at the same destination.