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To use 'reasonable endeavours' – a common sense interpretation by the HCA

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***Electricity Generation Corporation v Woodside Energy Ltd; Woodside Energy Ltd v Electricity Generation Corporation* [2014] HCA 7**

A recent High Court of Australia (**HCA**) decision examines the phrase to '*use reasonable endeavours*' in the context of the supply of supplemental gas to a buyer under a long term Gas Supply Agreement (**GSA**). The HCA takes a no-nonsense approach in confirming that '*reasonable endeavours*' is not an absolute or unconditional obligation and the extent of the obligation is inherently conditioned by what is reasonable in the circumstances.

In the context of an obligation under the GSA to '*use reasonable endeavours*' to supply a supplemental quantity of gas, the HCA found the sellers were not obliged to forgo or sacrifice their business or economic interests (in using '*reasonable endeavours*') to make that supplemental gas available for delivery to the buyer.

Background

The HCA Decision

The HCA case involves a long term GSA between Electricity Generation Corporation trading as Verve Energy (**Verve**) and various gas suppliers in Western Australia, including Woodside Energy Ltd (**Sellers**). Verve, a major generator and supplier of electricity for the south west WA market, purchases natural gas under the GSA for use in its power stations. Separate contracts between Verve and each of the Sellers are contained in the GSA.

Pursuant to the GSA, the Sellers were required to deliver to Verve a maximum daily quantity and to use *reasonable endeavours* to supply a supplemental

maximum daily quantity. An explosion on 3 June 2008 at a production facility operated by a third party, Apache (**Apache explosion**), reduced the supply of gas to the WA market by 30 - 35% which led to demand exceeding supply. This drove up the price for gas considerably. Over the period June to September 2008, the Sellers informed Verve that they could no longer provide supplemental gas under the GSA, instead offering to sell gas under short term gas sale agreements at a much higher price. The price for gas delivered under these new arrangements was the prevailing market price. From 30 September 2008, the Sellers recommenced the supply of supplemental gas to Verve pursuant to the GSA.

Verve claimed the Sellers breached their obligations under the GSA to '*use reasonable endeavours*' to supply the supplemental gas to Verve between 4 June and the end of September 2008.

WA Supreme Court Decision (Le Miere J)

In the initial decision, Verve argued that once it had nominated the supplemental maximum daily quantity under the GSA, the Sellers were required to use their reasonable endeavours to make available for delivery gas up to the amount of the nominated supplemental maximum daily quantity. They argued the '*reasonable endeavours*' obligation focusses on whether the Sellers are '*able*' to supply the supplemental maximum daily quantity, not whether they wished to (i.e the relevant clause did not confer on the Sellers an '*option to supply*').

The Sellers argued that the obligation to use '*reasonable endeavours*' relates to the *practical steps* that can reasonably be taken to make gas available for supplemental delivery, if the supplemental gas is to be supplied and under the terms of the GSA they are given *a right to determine their own ability to supply* supplemental gas on any given day (and the criteria by which they are to make that determination is clearly spelt out). Thus, the Sellers argued, the word '*able*' takes its meaning from the terms of the GSA which provide that the Sellers may take into account *all relevant commercial, economic and operational matters*. In doing so, they only need have regard to their own interests. The requirement that they must use *reasonable endeavours* takes account of practical matters relating to the supply and delivery of gas on that day. The trial judge did not enter into any analysis of what constitutes '*reasonable endeavours*' but found that the Sellers did not breach the relevant provisions of the GSA.

WA Supreme Court of Appeal Decision

The Court of Appeal overturned the trial decision, and found that the meaning of the word '*able*' does signify capability or capacity. The Court of Appeal found that the phrase '*all commercial, economic and operational matters*' *does not* give the Seller a discretion to make available the supplemental maximum daily quantity if they consider it in their interests to do so. It must be noted that both the initial decision and Court of Appeal decision dealt with various matters in dispute not relevant to this case note.

The HCA overturned the Court of Appeal decision for the reasons set out below.

The GSA provisions

The GSA contained standard provisions normally found in agreements of this nature. The key provisions were as follows:

- *Clause 3.2* provided for the maximum daily quantity (**MDQ**). The Sellers had an obligation to make available for delivery on any day gas up to the MDQ (subject to the relevant nomination arrangements).
- *Clause 3.3(a)* provided that if the Buyer's nomination for a day exceeds the MDQ the Sellers ***must use reasonable endeavours*** to make available for delivery up to an additional 30TJ/Day of gas in excess of the MDQ (**Supplemental MDQ**).
- *Clause 3.3(b)* provided that in determining whether the Sellers are able to supply Supplemental MDQ on a day they may take into account *all relevant commercial, economic and operational matters.* Nothing required the Seller to make available for delivery any quantity by which a nomination for a Day exceeds MDQ where any of the following circumstances existed in relation to that quantity:
    - there was insufficient capacity available in the Seller's facilities (having regard to existing commitments and obligations regarding maintenance, safety and integrity);
    - the Sellers form the reasonable view that insufficient notice was given by Verve of the requirement for that quantity to ensure that the facilities were ready to deliver the required quantities;
    - the Sellers have an obligation to deliver to other customers, which obligations may conflict with the scheduling of delivery of that quantity to the Buyer (Verve).
- Take or Pay (**ToP**) arrangements apply under the GSA whereby Verve must pay the Sellers for an Annual Minimum Quantity of Gas (**AMQ**) whether or not Verve takes that quantity. ToP arrangements only apply to the MDQ, not Supplemental MDQ.

- The Sellers were able to supply gas to buyers other than Verve and Verve could purchase requirements above the minimum quantities set out in the GSA from suppliers other than the Sellers.
- Verve was not obliged to nominate a Supplemental MDQ, and the Sellers were not obliged to reserve daily capacity in their plants to supply Supplemental MDQ to Verve nor to refrain from agreeing to sell gas to third parties.

The main arguments

The **Sellers** argued that clause 3.3 imposed an obligation to ***use reasonable endeavours*** to supply Supplemental MDQ which was qualified by the Sellers' entitlement to take into account *their own commercial, economic and operational interests* in relation to that supply of gas. Thus, the Apache explosion and the consequential business conditions in the market were matters which the Sellers were entitled to take into account - having regard to their capacity and business interests - in determining whether they were in fact '***able***' to supply the nominated Supplemental MDQ to Verve.

Verve argued that clause 3.3, correctly interpreted, obliges the Sellers to supply the nominated Supplemental MDQ to Verve notwithstanding the fact that the prevailing market price for gas was much higher than the price under the GSA. The word '***able***' as it occurs in clause 3.3 should be construed to mean the Sellers' capacity to supply, not the Sellers' *willingness* to supply. Thus, the Sellers' actions were a breach of their obligation to use reasonable endeavours to supply Supplemental MDQ.

What constitutes '*reasonable endeavours*'

The HCA noted that terms within a commercial contract are to be determined by what a reasonable businessperson would have understood them to mean,[1] not in a nonsensical manner. The HCA set out three general observations about the obligations that *'reasonable endeavours*' clauses attract:

1. Firstly, the obligation '*is not an absolute or unconditional obligation'*; [2]
2. Secondly, the extent of the obligation is inherently conditioned by what is reasonable in the circumstances.[3] The *'reasonableness'* qualification is aimed at situations in which there would be a conflict between the obligation to use best efforts and the independent business interests of the Sellers and has the object of resolving those conflicts by the standard of reasonableness. Thus, the interests of the Sellers cannot be paramount in every case and that in some cases the interests of the Buyer would prevail; and
3. Thirdly, some '*reasonable endeavours*' clauses contain their own internal standard of what is reasonable.

Analysis of clause 3.3 of GSA

The HCA held that the *chief commercial purpose* of the GSA was for Verve to obtain a secure supply of gas (which the Sellers were obliged to make available for delivery up to the specified MDQ) and Verve had an obligation to pay for the gas, if not taken, in respect of the specified AMQ. This arrangement insulates the parties from the respective fluctuations in demand and price often associated with the resources industry. *A supplementary commercial purpose* was the supply of the Supplemental MDQ. Verve was not contractually bound to buy Supplemental MDQ and the Sellers were not contractually bound to reserve capacity in their plants for this additional gas. Clearly, the obligation to use '*reasonable endeavours*' to supply Supplemental MDQ provided in clause 3.3(a) can be contrasted with the unconditional obligation to supply MDQ in clause 3.2.

The HCA noted the following key points:

- Clause 3.3 provides for a balancing of interests if the business interests of the parties in respect of the supply of Supplemental MDQ do not entirely coincide, or if they conflict.
- What is a '*reasonable*' standard of endeavours is conditioned both by the Sellers' responsibilities to Verve in respect of Supplemental MDQ and by the Sellers' express entitlement to take into account '*relevant commercial, economic and operational matters*' when determining whether they are '*able*' to supply Supplemental MDQ. The expression '*commercial, economic and operational matters*' refers to matters affecting the Sellers' business interests.
- The relevant ability to supply is thus qualified, in part, by reference to the constraints imposed by **commercial and economic considerations**. The non-exhaustive examples of circumstances in which the Sellers will not breach the obligation to use reasonable endeavours to supply Supplemental MDQ under the GSA are not confined to '*capacity*' (or capacity constraints).
- The effect of clause 3.3(b) is that the Sellers are not obliged to forgo or sacrifice their business interests when using '*reasonable endeavours*' to make Supplemental MDQ available for delivery. The word '*able*' relates to the Sellers' ability,

having regard to their capacity and their business interests, to supply Supplemental MDQ. This is the interpretation which should be given.

- The construction which has been accepted is consistent with surrounding circumstances known to both parties at the time of entering the GSA, which include the circumstances that the Sellers sell and supply gas to customers and buyers in the market other than Verve, some essential services depend on gas supply, and the prevailing market price of gas at any particular time may be greater (or less) than the tranche 3 price in the GSA.
- Thus, clause 3.3 did not oblige the Sellers to supply Supplemental MDQ to Verve in circumstances where the Apache explosion created business conditions that led to a conflict between the Sellers' business interests and Verve's interest in obtaining nominated Supplemental MDQ at the tranche three price. The Sellers were entitled to decline to supply Verve with nominated Supplemental MDQ in the relevant period and supply gas that was available (i.e. above firm commitments which included MDQ) on a fully interruptible basis and at prevailing market prices.

Key considerations

General contract law implications

This decision affirms the accepted position that the obligation to *use reasonable endeavours* is not an absolute and unconditional obligation and the extent of the obligation is inherently conditioned by what is reasonable in the circumstances.[4] An obligation of *reasonable endeavours* requires the *obligee* to strive to attain the requisite obligation, but will not require the *obligee* to pursue the endeavour if it is in conflict with its own business interests. Therefore, should a conflict arise, it should be resolved by the standard of reasonableness.[5] It is expected that an *obligee* will put its business interests before its obligation under this type of conditional obligation clause, as the Sellers had done in this case, when they decided not to supply the additional gas to Verve after assessing the relevant commercial and economic considerations.

Implications for gas supply agreements

Even in the absence of the qualifying clause 3.3(b) in the GSA, we expect that the HCA would have come to the same conclusion given that this decision reaffirms previous case law that the obligation to use reasonable endeavours does not require a person to achieve this contractual object to the ruin of the company or to the utter disregard of their own business interests (such as the interests of shareholders).

In the context of gas supply arrangements, provisions obliging the supplier to use reasonable endeavours to supply gas will not restrict their freedom to act in their own business interests. Parties to gas supply negotiations should understand the implications of the inclusion of a '*reasonable endeavours*' qualification in respect of any supply obligations.

[1] *McCann v Switzerland Insurance Australia Ltd* (2000) 203 CLR 579 at 589.
[2] *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 118.
[3] *Transfield Pty Ltd v Arlo International Ltd* (1980) 144 CLR 83 at 101.
[4] *Electricity Generation Corporation v Woodside Energy Ltd* [2014] HCA 7 [41]; *Transfield Pty Ltd v Arlo International Ltd* (1980) 144 CLR 83 at 101 per Mason J.
[5] *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 92.

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