

## Update

# 50 shades of grain

With agricultural commodity prices rising as drought reduces crops in the United States and Eastern Europe, the grain market is eyeing the possibility of Russian export restrictions. Michael Swangard, partner at Clyde & Co, considers the potential implications for grain exporters.

Despite a drought that has reduced the estimated size of its grain harvest by a fifth, Russia currently says it has no plans to repeat 2010's ban on grain exports. However, there is an increasing expectation in the market that by the end of the year Russia will use administrative and logistical measures to slow down the flow of grain exports in order to protect the domestic market. However, as a comparison with Ukraine's 2010 experience shows, the precise form any restrictions take is vital in determining their impact on the grain export trade.

At the start of the year, the Russian agriculture ministry expected this season's grain crop to match last year's 94m tonnes, but recently reduced its estimate to between 70m and 75m tonnes. Despite the sharp drop in the estimated crop, First Deputy Prime Minister Arkady Dvorkovich was quoted by RIA Novosti at the end of August as saying: "As long as I still continue to oversee this field, I will fight any limits on grain exports." However, while Nikolai Fyodorov, the Russian agriculture minister, supported Dvorkovich's statement on an outright ban, he was quoted in the *Financial Times* as saying: "We will use only civilised and effective mechanisms to protect the domestic market."

### When brutal is best

These comments have led to speculation that Russia might instead emulate Ukraine's introduction of a grain export quota system in 2010 or use other more opaque means of restricting export flows such as making export logistics and administrative processes more difficult. Russia's 2010 ban has been described as "brutal", meaning the prospect of subtler restrictions has been welcomed by some, but the experience of the majority of Ukrainian grain traders during the 2010 grain crisis suggests that Russia got it right with an outright prohibition.

While it might appear brutal, an absolute ban has the advantage of affecting all market participants equally and, importantly, triggering contractual protection for sellers unable to fulfil their contracts because of the ban. Most grain from the region is sold on a standard GAFTA grain contract, which contains a "prohibition clause" that states that a seller is excused from performance of its obligations if it is prohibited from exporting by an act of government. In 2010, while Russian grain traders could no longer sell Russian wheat, they were not contractually liable to their buyers for non-delivery.

In comparison, in 2010 Ukraine initially appears to have sought to slow down the flow of grain exports through informal mechanisms. There is anecdotal evidence of trade flows being slowed by the Ukrainian state railway providing insufficient wagons to carry the goods to port, customs agents delaying or not processing export authorisations and state port authorities not allowing vessels to dock. Such measures, however, only worked to the disadvantage of the country's grain exporters. Unable to fully meet their obligations, many Ukrainian sellers ended up being in breach of their contractual obligations, and because prices had moved higher they faced claims for substantial damages.

Ukraine subsequently introduced export quotas, but it was unclear whether the terms of the system were covered by the prohibition clause in the standard GAFTA contract. The problem was that exporters had to apply for a quota for all the contracts a trader expected to export during a season, not for an individual grain contract. If a company was not successful in gaining a quota, which was at the discretion of the government, the reasons it was rejected were not always made clear. It is also easy to see how a discretionary system of that type could provide an incentive for cronyism. If the exporting company did not secure a quota, a buyer would inevitably say there was no absolute prohibition against the export of Ukrainian origin grain (as in Russia) and it was the seller's obligation to obtain customs clearance or any other legal clearances which might be needed in order to perform the contract.

### **Sellers face dilemmas**

Even if a company was successful in obtaining a quota, it was unlikely to be of sufficient size to cover all of its physical commitments, leaving the dilemma of which of the company's sales contracts to default on. One seemingly logical solution would have been for the seller to execute its highest price contracts first. However, this approach is of little use in a rising price environment like 2010, because the seller will ultimately just face a bill for bigger damages based on the difference between the original low contract price and the higher market prices when the contract was meant to be executed.

The dilemma could not generally be avoided by fulfilling some contracts with grain from different origins. Ukrainian export contracts tend to be traded based on domestic grain only and most of the country's sellers are not set up to trade grain from multiple countries. However, the international grain trading companies buying the grain may well have enjoyed this flexibility in fulfilling their contracts with their own end buyers. There is some evidence of opportunistic behaviour by international grain shippers, claiming damages from Ukrainian sellers while fulfilling their own contracts with grain from other origins.

### **Legal disputes likely**

One illustration of the impact of the Russian ban on the grain trade compared with Ukraine's quotas is the amount of legal work each generated. For Clyde and Co. at least, the Russian ban generated little or no arbitration work, while Ukraine's approach generated a considerable amount, both from disputes over informal restrictions and from disputes over the quota system.

Most of the legal disputes arising have been GAFTA arbitrations, the results of which are not published. From our experience, however, the trend has been for these arbitrations to find in favour of the buyers. The inability of some Ukrainian sellers to satisfy their contracts because of either informal restrictions or a lack of export quotas has (in many cases rather harshly) not been deemed as falling under the GAFTA prohibition clause. Arbitrations can also only be appealed if there has been an error of law, not on a question of fact and permission to appeal must be given by a commercial court.

Another alternative to an outright ban would be for Russia to introduce export tariffs to increase the attractiveness of diverting grain into the domestic rather than the export market, which would have the advantage of impacting everyone equally. But if Russia instead opts for quotas and/or less formal restrictions like Ukraine in 2010 this could mean increased uncertainty for traders and consumers and a significant increase in legal disputes.

### **Further information**

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