

Introduction

As a result of the ongoing conflict in the middle east, energy prices have surged in recent weeks, bringing with them inflation fears, a real potential for a “higher-for-longer” interest rate environment and dramatic shifts in the forward and swap curves for various underlying assets. At the centre of the energy crisis lies Iran and the Strait of Hormuz, one of the world’s most critical energy chokepoints. The article examines the impact on pricing of derivatives transactions, and identifies the key provisions to review in existing derivative arrangements in light of the current conflict.

The Role of Derivative Transactions in Hedging Risk, and the Potential Impact of Current Conflict on Pricing

Derivative instruments allow market participants to transfer, manage or redistribute risk. In the context of energy markets, the fundamental purpose of hedging is to protect against adverse price movements that could disrupt business planning, erode margins or create cashflow difficulties.

As a result of the geopolitical shocks in the Middle East, the forward curve for oil has experienced a dramatic shift and has moved into a state of steep backwardation (that is, where near-term prices are significantly higher than future prices). This has been more significant for shorter tenors, suggesting that traders are betting that the current crisis will be shorted lived. As countries around the world are planning releases from emergency reserves, this is starting to reshape the forward curve.

As of mid-March 2026, the interest rate swap curves have experienced significant, sharp upward shifts, reversing the declining trend seen earlier in the year. These upward shifts have been driven by the geopolitical shocks in the Middle East that bring with them inflation fears and a real potential for a “higher-for-longer” interest rate environment, and so the market is pricing in a potential hold, or even a scenario where anticipated rate drops do not occur.

Those contemplating new derivatives positions in the current environment should consider the relevant forward and swap curves, and how they are changing, what current pricing might mean for cash flow management, terms of any margin requirements, and choice of counterparty.

Reviewing Existing Derivatives Transactions Documentation: Key Provisions To Consider

For those with derivative portfolios, whether governed by an International Swaps and Derivatives Association (ISDA) Master Agreement or a similar framework agreement or bespoke derivatives documentation, the current climate raises several important contractual issues. For the purposes of this article, we reference provisions of the 2002 ISDA Master Agreement, and where defined terms are used herein but not defined, they are as defined in the 2002 ISDA Master Agreement. We expect there will be equivalent terms in other forms of documentation.

Credit Support and Margining Obligations

Rapid and large price movements result in significant movements in the mark-to-market of derivatives transactions, and, where there are margining obligations under those transactions, this will generate correspondingly large margin calls. Where derivatives transaction are documented under bespoke documentation, dealer counterparties may have more flexibility and discretion to call for larger amounts of margin, without an express obligation to return that margin when prices become more stable.

The ability to meet these calls depends on available liquidity, the types of eligible collateral, and the operational capacity to transfer collateral within the required timeframe. Failure to satisfy margin calls could trigger a ‘Failure to Pay or Deliver’ Event of Default under an ISDA Master Agreement or an equivalent event under other documentation. It is important to consider the specific terms of the derivatives documentation, including any credit support annex (CSA) that forms part of a 2002 ISDA Master Agreement or the equivalent, and understand the margining obligations.

Force Majeure

The 2002 ISDA Master Agreement includes a ‘Force Majeure Event’ as a Termination Event. Under this provision, a ‘Force Majeure Event’ may be triggered if a force majeure or act of state beyond the control of a party’s office, a party or its credit support provider prevents performance or compliance (or would be so prevented if such payment, delivery or compliance were required on that day) or renders performance or compliance impossible or impracticable (or it would be impossible or impracticable to perform, receive or comply if such payment, delivery or compliance were required on that day) by that office, party or credit support provider, and the office, party or credit support provider could not, after using all reasonable efforts (but without any obligation to incur a material loss), overcome the relevant event. This only applies after giving effect to any other applicable provision, disruption fallback or remedy under the relevant agreement and confirmation.

Parties should be aware of the 'Waiting Period' mechanism in the 2002 ISDA Master Agreement. During the Waiting Period, payments and deliveries that would otherwise be due are suspended until the earlier of (i) the expiry of the Waiting Period and (ii) the date on which the 'Force Majeure Event' Termination Event is cured. Only after the expiry of the Waiting Period, if the event persists, may the affected transactions be terminated.

It is also worth noting a potential area of uncertainty: where one party considers the event that has occurred to trigger an Event of Default (for example, a 'Failure to Pay or Deliver' Event of Default) and the other party argues that it constitutes a 'Force Majeure Event' Termination Event, the contractual outcome and available remedies may differ significantly. This is a particular risk in the current environment, where supply disruptions, sanctions and military activity may simultaneously affect multiple counterparties in different ways.

The 2002 ISDA Master Agreement does not define the term "force majeure," leaving the question to the governing law of the agreement. Under English law, force majeure is not a term of art and has no general common law definition.

Any determination of a 'Force Majeure Event' Termination Event in respect of derivatives transactions will need to be considered on a case-by-case basis and on the relevant facts. Although it can be said the events occurring at the moment may be force majeure or acts of state outside the parties' control, with cash settled transactions, it is likely that these events will not prevent performance or compliance, or render performance or compliance impossible or impracticable. However, this may be a different story for physically settled energy commodity derivatives transactions.

Failure To Pay or Deliver

In a period of market volatility, counterparties may face difficulties meeting their payment or delivery obligations under derivatives transactions. This may arise from liquidity constraints, operational disruptions or the inability to source or deliver physical commodities. With the current conflict causing war-risk insurance costs to surge and potentially such insurance not to be available; freight rates to hit record levels; and other disruptions at the Strait of Hormuz, these issues for energy commodities needing to travel through the Strait of Hormuz could have a significant impact on parties' abilities to perform their obligations under physically settled energy commodity derivatives transactions. Under the 2002 ISDA Master Agreements, a 'Failure to Pay or Deliver' Event of Default will arise if a party fails to make a payment or delivery when due under the agreement and such failure continues for the applicable grace period (one Local Business Day, unless amended). A 'Failure to Pay or Deliver' Event of Default triggers the non-defaulting party's right to designate an Early Termination Date and close out all outstanding transactions under the agreement.

Clients with physically settled commodity derivatives transactions should be particularly vigilant. Where delivery is contingent on the availability of transport through disrupted routes, the practical impossibility of delivery may give rise to disputes as to whether the failure is a 'Failure to Pay or Deliver' Event of Default or a 'Force Majeure Event' Termination Event under the applicable terms.

The distinction between a default and a force majeure event may have different consequences.

Where a party might be experiencing financial difficulty or operational disruption, we recommend early engagement with your counterparty.

Bankruptcy

Market volatility and uncertain times may result in cash flow difficulties, which may lead to (i) the need to appoint an administrator, seek reorganisation or relief under bankruptcy laws, seek voluntary bankruptcy or enter into arrangements with creditors, or (ii) an involuntary bankruptcy. The 2002 ISDA Master Agreement includes a 'Bankruptcy' Event of Default, which provides for various insolvency-related events and actions. It should be considered whether any insolvency-related event or action could trigger a 'Bankruptcy' Event of Default, giving counterparties the right to terminate early or close out all transactions, and withhold payment or delivery in accordance with Section 2(a)(iii) of the 2002 ISDA Master Agreement.

Additional Provisions To Review

Sanctions and Illegality

The evolving sanctions landscape relating to the conflict should also be monitored closely. Expanded sanctions on entities, vessels or trade routes could give rise to an 'Illegality' Termination Event, which applies where it becomes unlawful for a party to perform any obligation under a transaction.

Cross-default

Where counterparties have cross-default provisions in their derivatives documentation, a default under a separate financing or trading agreement (for example, a commodity supply contract affected by the crisis) could trigger an event of default under the derivatives documentation. This will depend on the type of arrangements that are caught under the cross-default terms, and the thresholds. Under the 2002 ISDA Master Agreement, the concept of 'Specified Indebtedness' under the 'Cross-Default' Event of Default is standardly limited to obligations in respect of borrowed money. However, some derivatives documentation will extend this to include wider contractual arrangements.

Practical Recommendations

In light of the foregoing, we recommend the following steps:

- **Review derivatives transaction documentation** – Identify which version of the ISDA Master Agreement governs each counterparty relationship, whether a CSA is in place, and whether force majeure provisions have been incorporated.
- **Assess margin exposure** – Model the impact of continued price increases on your margin obligations. Ensure adequate liquidity is available to meet potential margin calls and that eligible collateral is readily accessible.
- **Monitor counterparty credit risk** – Evaluate the creditworthiness and operational capacity of your derivative counterparties, particularly those with exposure to the Gulf region or to commodity markets directly affected by the conflict.

- **Review physically settled transactions** – For any derivatives involving physical delivery of energy commodities, assess whether delivery routes, timelines or sources are affected by the current disruption and whether any market disruption fallbacks could apply.
- **Engage with counterparties early** – Where potential difficulties in meeting payment, delivery or margin obligations are identified, proactive engagement with counterparties is advisable. Early communication can help to manage disputes and preserve commercial relationships.
- **Take legal advice before acting** – The interaction between events of default, termination events and potential disruption fallbacks is complex and fact specific. Before issuing or responding to any notice of default, force majeure or early termination, it is advisable to seek specialist legal advice.
- **Consider discussing pricing with a hedging adviser** – If contemplating new derivatives positions in the current environment, in addition to discussions with dealers, it may be helpful to discuss the relevant forward and swap curves and pricing with a third-party hedging adviser.

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