

Michael Howe, counsel at WilmerHale in London, explores the impact of the global oil and commodity price declines for commercial disputes

# THE COMING WAVE OF ENERGY DISPUTES

It is difficult to open a newspaper without reading about the oil price. A barrel of Brent Crude has declined from a high of USD 115 a barrel in June, 2014 to a low of USD 27 in January 2016, as oil-producing nations have chosen not to adjust supply in light of falling demand. This reduction in price is expected to last; many experts predict that prices are likely to stay lower for longer, as the increasing cost-effectiveness of US shale oil operates as a cap on prices.

Less widely discussed, but no less important, has been the end of what some economists label the ‘commodities super-cycle’, the 15-year bull market in many commodities driven primarily by strong Chinese demand. As this demand has slowed, prices have fallen; iron ore has dropped from USD 190 per tonne in 2011 to USD 40 per tonne in December 2015, while a pound of copper has reduced from USD 4.50 in early 2011 to less than USD 2 in late 2015.

These twin developments are not only geopolitically significant, but also have important implications for commercial disputes. This article suggests certain areas where the volume and type of commercial disputes are likely to be impacted by these developments.

### Disputes between states and production companies

The first likely impact is an increase in disputes between resource-rich states and production companies. (The term ‘production companies’ is used as a shorthand for (i) exploration and production companies in the oil and gas industry, and (ii) mining companies.) Many resource-rich states depend on revenues from development of natural resources for much of their income. As oil and commodity prices have fallen, state budgets have become strained. For example, the **International Monetary Fund** has estimated that the combined budget of the oil-rich states in the Gulf Cooperation Council

(GCC), which consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE, will swing from a combined surplus of more than 10% of GDP in 2013 to a deficit of 13% of GDP in 2015 and 2016. A similar trend is apparent in oil-rich nations elsewhere: Nigeria’s budget deficit was expected to double in 2016, while Brazil’s budget deficit was at its highest level for five years. The resulting pressure on state budgets could lead to a variety of disputes.

First, non-payment claims brought by production companies against states are likely to increase. In circumstances where the state and the company have entered into a kind of service contract – where the company is paid a fee but does not receive a share of the production – fiscal pressures on states could lead to an unwillingness or inability to make payments. Invoices are likely to be challenged much more frequently. In these circumstances, the likelihood that the parties will assert differing interpretations of the applicable contractual terms will increase, which in turn will make disputes more likely.

Second, investor-state claims based on a failure to provide fair and equitable treatment are also likely to increase. Many states seek to attract inward investment with specific contractual promises; for example, that investors in a certain sector would be provided with subsidies or guaranteed a certain minimum price for the product sold. Alternatively, a state may seek to attract inward investment by passing specific laws or making specific pre-contractual promises to potential investors. In circumstances where state budgets have been constrained, governments may be tempted to abandon such policies. Newly elected governments in particular might feel they have a mandate to remove expensive subsidies or to increase taxes on foreign companies to free up funds for more popular domestic purposes. A company impacted by such a change in policy may choose to seek compensation by commencing arbitration under an investment

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- ▶ treaty, alleging a breach of the ‘fair and equitable treatment’ standard.

Judicial review proceedings – where the legality of government action is challenged in court – are also likely to increase. In circumstances where the investor is based in the same state as the impugned government; or no investment treaty exists between the state of the investor and the host state, challenging the legality of government action by judicial review might be the best available means to reverse the impugned decision and obtain compensation.

In contrast to the above, it is less clear whether expropriations (and the investor-state claims that often result therefrom) are more or less likely in the new environment. On the one hand, political pressure to expropriate foreign-owned assets tends to increase where the public takes the view that a foreign investor has got a much better deal than the state. It could be argued that such perceptions are more likely to arise where prices are high and the company is perceived to be making ‘excess’ profits. On the other hand, a cash-strapped government whose revenues from natural resources have fallen might be tempted to expropriate foreign-owned assets to obtain a larger piece of a smaller pie. It is difficult to draw general conclusions: the approach ultimately taken by each government will depend on the particular dynamics of each situation.

### Disputes between production companies and service companies

The second likely impact is an increase in disputes between production and service companies, for example, oilfield services providers. There is no question that production companies are suffering as a consequence of the twin developments. Looking at large integrated oil companies, for example, **BP** suffered a USD 5.2 billion dollar loss in 2015, while **Royal Dutch Shell**, **Chevron** and **Exxon Mobil** saw their earnings reduced by 80%, 76% and 51% respectively. The picture is similarly negative for mining companies: **BHP Billiton** suffered a USD 5.7 billion net loss in the first half of its current financial year (compared with income of USD 4.3 billion in the same period of the previous year), while **Rio Tinto** suffered a net loss of USD 866 million in 2015 having made net income of USD 6.5 billion in 2014.

This strain makes disputes of at least two types more likely. The first, once again, is non-payment. In circumstances where earnings have fallen dramatically, production companies are more likely than in previous years to dispute invoices submitted by their service providers. As noted above, this will increase the likelihood that differing contractual interpretations will be asserted; if these differences cannot be resolved commercially, disputes are likely to develop.

A second possible type of dispute may be

caused by cancellation of projects. As prices have slumped, investments (for example, in offshore drilling) that were economically viable when prices were higher may be cancelled. In circumstances where the work has already commenced (or planning is well advanced), the contract between the production company and the service company would already be in place.

Such contracts often include termination provisions, although it is unclear whether a dramatic fall in the price of the underlying commodity would be specified as a ground for termination. If no such provision was included (either expressly or as part of a force majeure clause), then cancellation of the contract could constitute an unlawful repudiation thereof. Furthermore, even if the contract did provide for termination following a decline in price, the value of such contracts is such that the parties could end up in a dispute over the compensation payable (the calculation of unliquidated damages or the amount payable under a liquidated damages clause).

A variant on the two situations above is where the company in question has entered into bankruptcy. In mid-April, for example, **Peabody Energy**, the largest coal producer in the United States, sought bankruptcy protection; such protection has also been sought by **Alpha Natural Resources** and **Arch Coal**, which also number among the four largest coal producers in that country. The current environment has likewise taken its toll on oil and gas companies, with nine such companies, with debts in excess of USD 2 trillion, seeking bankruptcy protection in the final quarter of 2015 alone.

Bankruptcy can often have a chilling effect on disputes: after all, the purpose of bankruptcy is to provide a company with protection against its creditors. Having said that, corporate bankruptcies do create the potential for different kinds of disputes – creditors can fight among themselves and with the bankruptcy trustee. If a wave of bankruptcies among production companies were to occur, it remains to be seen whether this leads to an increase or reduction in the volume of commercial disputes.

### Disputes resulting from cancelled infrastructure projects

A third likely consequence is an increase in commercial disputes relating to commodity infrastructure projects. Investors – usually governments, but sometimes also commercial consortia – respond to the supply of a commodity at one place and a demand for that commodity at another by building infrastructure to connect the two. Examples of such infrastructure include oil and gas pipelines, railways and liquefied natural gas (LNG) terminals.

The commercial viability of such projects

At present, most electricity worldwide is still generated by the burning of fossil fuels; oil, gas and coal. With prices of each of these fuels currently very low, one can easily foresee circumstances in which a government is tempted to save money by withdrawing promised subsidies and revoking previously agreed contract terms

depends on the transported commodity being commercially competitive when it arrives at the market. The dramatic drop in oil and commodity prices could render many projects uneconomic, as the price that could be obtained in the target market would no longer allow the infrastructure investment to generate a positive return.

Assuming that current predictions are accurate and prices do not quickly recover, a range of projects could become uneconomic and could therefore be cancelled. This could lead to disputes between the investor and the engineer-procure-construct (EPC) contractor that had been retained to build the infrastructure. Assuming that the producer is not building the pipeline itself, it could also lead to disputes between the investor and the producer (who might have invested in new production facilities in expectation of serving a new market).

As noted above in relation to cancellation of projects between production companies and service companies, such disputes could fall into two categories. To begin with, there could be a dispute over the entitlement to cancel the project, although it is at least possible that parties entering into such substantial, long-term contracts in a volatile market would include a right to terminate following a decline in price. Even if provision for termination were included, disputes over the amount of compensation payable – including the enforceability and calculation of compensation under any liquidated damages provision – are highly likely.

### Disputes between governments and suppliers of low-carbon energy

A final possible consequence relates to renewable energy – an area only indirectly related to commodity prices. The shift towards low-carbon, particularly renewable, energy is one of the most notable features of current energy markets. The desire to move towards low-carbon technology, however, is not immune from economic pressures. Although an increasing number of low-carbon electricity projects are competitive with fossil fuels, many governments still have to offer substantial subsidies or minimum prices to attract investment. For example, the UK government has promised **EDF Energy** GBP 92.50 per MW/h for electricity generated by the planned nuclear facility at Hinckley Point C for the next 35 years. This is significantly higher than the UK's current wholesale price, which recently has been in the range of GBP 30 to 40 per MW/h.

At present, most electricity worldwide is still generated by the burning of fossil fuels; oil, gas and coal. With prices of each of these fuels currently very low, one can easily foresee circumstances in which a government is tempted to save money by withdrawing promised subsidies and revoking previously agreed contract terms. A likely consequence is that the aggrieved investor would seek redress either through investor-state arbitration or judicial review. The former has been demonstrated in dramatic fashion by developments in Spain (albeit in a slightly different context), which has been the subject of a number of arbitrations under investment treaties following its retrospective removal of solar energy subsidies.

### Conclusion

The dramatic decrease in oil and commodity prices has negatively impacted governments, production companies, service companies and investors. Such an environment can put significant strains on contractual relationships. Although much will depend on the particular circumstances, the most likely consequence of these decreases is that commercial disputes in a range of energy market sectors will significantly increase. ■

### About the author



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