THE ENERGY REGULATION AND MARKETS REVIEW

SEVENTH EDITION

Editor
David L Schwartz

THE LAWREVIEWS

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PREFACE

In our seventh year of writing and publishing *The Energy Regulation and Markets Review*, we have seen dramatic changes in global energy policies. Europe has experienced a strong economic rebound, which has allowed many countries to dedicate increased resources to the infrastructure needs of the energy sector, including for renewables. While the United States commenced efforts to withdraw from the Paris Agreement, the signatories to the Paris Agreement countries have continued to make efforts to reduce greenhouse gases (GHGs). There is still a significant need to invest in infrastructure, and we have seen significant investment throughout the supply chains in the oil, gas and power sectors globally. The 2011 Fukushima nuclear incident continues to impact energy policy in many countries, and we continue to see extensive liberalisation of the energy sector. Oil prices have started to rebound somewhat, which presents some hope to those countries that remain dependent upon oil prices for national revenue.

I CLIMATE CHANGE DEVELOPMENTS

With respect to climate change efforts, the Paris Agreement was placed into effect on 4 November 2016, but President Trump announced last year that the United States would be withdrawing from the Paris Agreement. Nonetheless, we continue to see significant carbon reduction efforts, such as increased development of renewable resources, as well as energy efficiency and demand reduction measures, globally, including in the United States.

Following the Brexit vote, the United Kingdom closed its 'renewable obligation' programme to new generation, and limited new contracts for differences, which has significantly reduced new renewable construction this year. France has announced a plan to close all coal-fired power plants within five years, double the capacity of wind and solar renewable generation and prohibit shale gas production and all new searches for hydrocarbons. Denmark continues to seek to have renewable energy meet all of its electricity demands by 2050, and over the past year has initiated an effort to improve the output of solar and wind resources through technology improvements. The Netherlands has a goal of reducing GHGs by at least 25 per cent by 2020, and has announced its intent to close all coal plants by 2030. While Germany will likely miss its 2020 renewable energy goals, it has an ambitious goal to achieve 65 per cent renewable generation capacity by 2030. Belgium has continued its effort to develop offshore renewable wind resources (including the development of an offshore grid), but has reduced historical green certificate subsidies. Italy is seeking to reduce carbonisation by having a goal of relying on renewable resources for 28 per cent of its energy needs by 2030. Switzerland has continued to promote the development of renewables and is supporting the development of large-scale hydroelectric resources through state subsidies.

Spain is seeking to reach 20 per cent renewables by 2020, and has initiated new auctions for 6,000MW of new renewable installed capacity. Turkey seeks to have 30 per cent renewables by 2023.

China released a plan to have 15 per cent of its energy supplied by non-fossil fuels, 20 per cent from natural gas and no more than 58 per cent from coal by 2020. Korea's goal is to cut GHGs by 37 per cent by 2030, and it is seeking to have 95 per cent of all new installed capacity come from clean energy sources and to shut down coal power plants that are more than 30 years old. India's announced goal to have at least 40 per cent of its installed electric capacity powered by non-fossil fuels may be overshadowed by the fact that it is developing and constructing 50,000MW of new coal-fired generation capacity. Japan is looking at offshore wind and a variety of other new renewable energy sources to assist with the reduction of capacity following the shutdown of most of its nuclear generation capacity. Malaysia has been working hard to reduce its overdependence on coal and natural gas, and to encourage the production and use of renewable energy in an effort to meet its target of 50 per cent renewable resources by 2050. As of last year, 33 per cent of the installed capacity in the Philippines was from renewable resources, and 35 per cent was from coal generation. The United Arab Emirates continues its efforts to reduce its carbon footprint, announcing a goal of having 25 per cent of its capacity from renewables by 2030, and 75 per cent by 2050. South Africa relies upon coal generation for 85 per cent of its generation capacity but has taken steps to increase the development of renewable resources. Australia is adding significant new renewable resources to meet its 2020 renewable energy targets.

While the Trump Administration is seeking to reverse the Obama administration's Clean Power Plan, we are seeing continued significant investment in renewable energy development in the United States. Individual states are moving forward to achieve reduced reliance on fossil fuels and greater reliance on renewable energy, including California and New York, which are seeking a 50 per cent renewable portfolio standard goal by 2030, and Hawaii, which is seeking 100 per cent reliance on renewables by 2045.

II INFRASTRUCTURE DEVELOPMENT

For many countries, reliable energy supply is the primary concern, regardless of fuel source. Rural electrification and system reliability remain priorities in India, Indonesia, Myanmar, Mozambique, Angola, parts of Nigeria and Central and West Africa and we are seeing significant efforts to pursue electric generation and transmission projects in those regions. Turkey seeks to increase energy industry infrastructure in the power sector and the oil and gas sectors, in light of an estimated 6 per cent demand growth per year through 2023. Denmark has a new North Sea Agreement to secure future exploration and production of hydrocarbons from the North Sea. Panama continues to seek to attract foreign investment to assist with badly needed transmission and generation infrastructure needs. The 8 May 2018 announcement by President Trump that he intends to withdraw from the Iran nuclear deal and institute significant new sanctions is expected to present a significant roadblock to further foreign investment in the Iranian energy sector.

III NUCLEAR POWER GENERATION

Seven years after the Fukushima disaster, Japan has stopped operations for 43 out of its 48 nuclear power stations, and 14 nuclear power stations are in the process of complying

with new safety standards for possible restart. Germany continues to phase out all nuclear generation by 2022. Belgium is seeking to dismantle all nuclear plants by 2025. France is seeking a reduction of nuclear power generation to 50 per cent of total electricity production within five years. Switzerland and Korea are planning to limit the life of their nuclear generation units, with Korea abandoning the construction of six new nuclear power plants and cancelling the extension of others.

On the other hand, Turkey is continuing with development of the Akkuyu nuclear power plant (first unit estimated to be operational in 2023), and the United Arab Emirates is almost finished with the construction of the Barakah nuclear power plant, both of which are expected to be operational in 2020. South Africa is facing substantial resistance to its efforts to develop 9,600MW of new nuclear generation capacity. India's goal of 40 per cent non-fossil fuel generation is expected to require a substantial ramp-up of nuclear generation capacity.

In the United States, the early retirement of certain nuclear plants has been driven by cost and power market considerations, rather than safety concerns. Some nuclear owners in the United States have sought state subsidies in New York, Illinois, Ohio and Pennsylvania, among others, in order to avert premature retirements. Illinois and New York have implemented legislative and regulatory payment programmes for nuclear facilities in those states, but they are currently being challenged on constitutional grounds and remain pending before US federal circuit courts of appeal.

IV LIBERALISATION OF THE ENERGY SECTOR

We have seen significant energy sector regulatory reforms in many countries. Italy is seeking to reduce the gap between price and cost of energy, compared to the rest of Europe. Portugal continues to work on liberalising its electricity and gas markets. Japan has now fully liberalised the retail electricity sector. And we are seeing continued efforts to encourage further privatisation of the electricity sector in the United Arab Emirates and in certain countries in Central and West Africa. Turkey is seeking to privatise its generation assets. Brazil has seen significant privatisation, including the auction of four hydroelectric plants. Given Switzerland's interest in promoting the use of renewable resources, it has suspended a planned 49 per cent divestiture of its state-owned hydroelectric fleet. China has made moves to deregulate energy pricing. In a move away from privatisation, Colombia ordered the liquidation of Electricaribe (owned primarily by Gas Natural Fenosa), which is now in arbitration.

I would like to thank all the authors for their thoughtful consideration of the myriad of interesting, yet challenging, issues that they have identified in their chapters in this seventh edition of *The Energy Regulation and Markets Review*.

David L Schwartz
Latham & Watkins LLP
Washington, DC
May 2018

Chapter 3

GAS PRICE DISPUTES UNDER LONG-TERM GAS SALES AND PURCHASE AGREEMENTS

John A Trenor[1]

I INTRODUCTION

Global production and consumption of natural gas has more than doubled since the early 1970s.[2] A significant portion of this increased demand for natural gas is supplied pursuant to long-term gas sales and purchase agreements (GSPAs). Under these long-term contracts, gas is imported from gas exporting states into many countries in Europe, Asia, South America, and elsewhere, either transported via pipeline or shipped as liquefied natural gas (LNG).

Over the past decade, there have been a growing number of disputes between the parties to such agreements regarding the price to be paid for gas supplied thereunder. This increase in price disputes shows little sign of abatement.

In this chapter, we explain some of the key elements often seen in long-term GSPAs (including price review mechanisms), some of the recent market developments that may have contributed to the substantial increase in gas price disputes, and some of the issues of contention between parties that may arise in these disputes. Finally, we comment on the possible future of gas price dispute resolution.

II LONG-TERM GAS SALES AND PURCHASE AGREEMENTS

Despite recent growth in hub trading of natural gas and shorter-term supply contracts in some markets, long-term GSPAs remain the principal mechanism for securing gas where demand exceeds domestic supply in many countries.

For more than 50 years, these long-term GSPAs have played a substantial role in enabling the transport of gas from its place of production to the major points of consumption. The long-term nature of these contracts provides significant benefits to both sellers (or exporters) and buyers (or importers). The long-term guaranteed revenue streams that such contracts provide to sellers help to facilitate the enormous costs of exploration, production, and development (as well as the construction of pipelines and other essential infrastructure such as liquefaction and regasification facilities, to the extent the seller bears such costs).[3] The guaranteed supply of natural gas that such contracts provide to buyers helps to facilitate

1 John A Trenor is a partner at Wilmer Cutler Pickering Hale and Dorr LLP.

2 See 2017 Key World Energy Statistics, available at www.iea.org/publications/freepublications/publication/KeyWorld_Statistics_2017.pdf, at pp. 14, 34 and 40.

3 See Steven P Finizio, 'Destination Restrictions and Diversion Provisions in LNG Sale and Purchase Agreement', in J William Rowley QC (ed.), *Global Arbitration Review: The Guide to Energy Arbitrations* (2015), at p. 182.

the onward sale of gas to end users and resellers in the buyers' domestic markets and other (frequently adjacent) markets to meet energy needs for heating, electricity generation, industrial use and other consumption (as well as the buyers' own consumption).

Long-term GSPAs have evolved substantially over the decades and today are often lengthy contracts. The specific terms can vary widely from contract to contract.[4] Each contract is negotiated in light of the parties' particular needs, their relative bargaining power, and the circumstances surrounding their contractual relationship and the relevant market.

Any given provision in a particular GSPA cannot be interpreted in the abstract. It must instead be construed against the background of the parties' whole agreement and the parties' particular bargain struck therein regarding how the risks inherent in the production and sale of gas are balanced between them. Although details vary, there are a number of provisions that often appear in these contracts in some form or another.

i Supply commitments and 'take-or-pay' obligations

The basic purpose of a long-term GSPA is to secure a commitment by the seller to supply specified volumes of gas and a corresponding commitment by the buyer to take those volumes. Parties can adopt a variety of approaches regarding the details of those basic commitments.

The contracts generally specify an annual contract quantity – the maximum amount of gas that the seller will have to supply to the buyer, upon request, each year under the contract, subject to detailed quality specifications. It is this obligation, sometimes coupled with penalties for failure to deliver requested volumes up to the annual contract quantity, that creates security of supply for the buyer.

In addition, parties may also specify a minimum annual quantity – the volume that the buyer commits to take delivery of (or pay for if it does not take). This quantity is often expressed as a percentage of the annual contract quantity and varies from contract to contract, usually in the range of 80 to 95 per cent and often in excess of 90 per cent. The requirement to take the minimum annual quantity, or otherwise pay for it, is called the 'take-or-pay' obligation.

Contracts often have 'make-up rights' for the buyer if it does not take its annual take-or-pay volumes (for example, allowing the buyer in future years to take the volumes that it previously failed to take, subject to specified conditions).

The volume of gas specified in the contract can vary greatly. Volumes may be as great as 30 billion cubic metres/year and as small as 1 billion cubic metres/year or even less.[5]

ii Flexibility rights

Sometimes parties agree to provide the buyer with a degree of flexibility regarding when it may elect to take gas and how much it elects to take at any given time. Flexibility can offer a buyer considerable advantages, including enabling the buyer to align its supply with the demands of its own customers (whether end users or resellers) or with its own use.

4 Although there is no commonly adopted standard-form long-term GSPA, several organisations such as the Association of International Petroleum Negotiators offer a number of model contracts, including model gas supply agreements with price review clauses, that are influential in the oil and gas industry.

5 See Anne Neumann, Sophia Rüester, and Christian von Hirschhausen, 'Long-Term Contracts in the Natural Gas Industry – Literature Survey and Data on 426 Contracts (1965–2014)', DIW Berlin Data Documentation 77 (2015), at p. 18, and Annex A-1.

The flexibility terms – if any – can vary considerably by contract and whether the gas is supplied by pipeline or by LNG tankers, also known as LNG carriers. Where gas is supplied via pipeline, parties can agree to provide for yearly, seasonal, quarterly, monthly, daily or even hourly flexibility (or any combination thereof). Parties may also agree to provide buyers with the limited ability to reduce their take-or-pay volumes in a particular year (i.e., to reduce the minimum annual quantity). Other contracts offer the buyer no flexibility, requiring the buyer to take delivery of the same volume of gas each hour of every day of every year and providing no option to vary the minimum annual quantity. With respect to long-term LNG contracts, parties typically agree on a scheduled volume per shipment but may negotiate upward or downward flexibility, subject to logistical constraints such as cargo capacity, storage and capacity at the reliquefaction facility. The parties can also agree to other flexibility regarding scheduling or destination, again depending on logistical constraints.

Parties also sometimes agree to provide varying levels of discretion to the seller as well or in the alternative. In particular, in some contracts, parties may provide the seller with a certain amount of 'optionality' (e.g., the ability to choose not to deliver requested volumes in certain circumstances, or to deliver at the times that it chooses, without any contractual penalty).

iii Contractual term

The term (i.e., the duration) of a long-term GSPA can vary widely. Many contracts provide for a term falling somewhere in the range of 10 to 30 years, with contractual terms of 20 or 25 years perhaps the most prevalent.[6] Some contracts that have been agreed more recently have somewhat shorter terms, with 10 to 15 years becoming more common,[7] and even shorter terms becoming prevalent for LNG sales.[8] Some contracts may contain an express provision for incremental limited extension of the term for a number of years (either by agreement, or at the election of one party).

iv Pricing provisions

The price that the buyer must pay for gas under a GSPA is heavily tied to the terms of the contract more generally and is part of the overall bargain reached between the parties.

Given their duration, long-term GSPAs often do not set a fixed price but instead use a pricing formula pursuant to which the price may vary over time. One type of price formula commonly agreed sets forth a negotiated base price (P0), which is indexed to the prices for a basket of competing alternative fuels (often including oil products such as gasoil or heavy fuel oil, although some contracts have been priced by reference to wholesale electricity prices, coal and other indices). Under these formulae, the contract price varies as the prices of these alternative fuels vary.

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6 See Anne Neumann, Sophia Rüester, and Christian von Hirschhausen, 'Long-Term Contracts in the Natural Gas Industry – Literature Survey and Data on 426 Contracts (1965–2014)', DIW Berlin Data Documentation 77 (2015), at p. 16.

7 See Luca Franza, 'Long-Term Gas Import Contracts in Europe: the Evolution in Pricing Mechanisms', CIEP Paper (2014), at p. 18.

8 See Steven P Finizio, 'Destination Restrictions and Diversion Provisions in LNG Sale and Purchase Agreement', in J William Rowley QC (ed.), *Global Arbitration Review: The Guide to Energy Arbitrations* (2015), at p. 182.

Over the past decade, following the emergence of gas trading at physical or virtual hubs in certain markets (like the NBP in the United Kingdom and the TTF in the Netherlands),[9] the parties to some contracts have agreed to include (to varying degrees) hub pricing in the price formulae (e.g., by indexing the contract price (or a portion of it) to a specified price on a specified hub).

Other possible variations include the adoption of a 'price corridor' or 'price bands' or 's-curve pricing', which act in various ways to address potential variation between the oil-indexed contract price and a designated hub price or other benchmark.

Changes in price formulae can often be negotiated in connection with other amendments to the contracts, such as revisions in the flexibility terms or volume, or in connection with other contracts.

v Price review clauses

Given the long-term duration of these GSPAs, most have price review clauses – also variously called price revision clauses, price reopener clauses, price adjustment clauses, etc. – to permit the parties to periodically revise the contract price formulae. These clauses balance the certainty of long-term guaranteed supply with the recognition that circumstances may change over the duration of these contracts and therefore that the price formulae may need to be revised to restore the parties' agreed bargain.

The terms of these price review clauses can vary. Some early clauses provided little more than an obligation to periodically reconsider the applicable price in good faith. Most price review clauses, however, now provide a more detailed mechanism setting forth a right to some revision of the contract price formula in defined circumstances, either by agreement of the parties or through mandatory dispute resolution procedures such as arbitration, if the parties are unable to agree.

Price review clauses may include a number of elements, including provisions stipulating how frequently a request for a price review can be made, what must occur to 'trigger' a price review, what standards or requirements any revision to the price must meet, what procedures must be followed to obtain a price review, and what process follows in the event the parties are unable to reach agreement (normally, the dispute can be referred to arbitration).

Because GSPAs and disputes relating to them are almost always confidential, there is little publicly available information regarding the exact language that parties have adopted in their price review clauses. One exception is the text of the clause used in the 1995 contract for the sale of LNG between Atlantic LNG Company of Trinidad and Tobago and Gas Natural Aprovisionamientos, SDG, SA, made public in 2008 in conjunction with an action in a US federal court seeking to confirm an arbitral award (and a related motion to vacate). Again, although clauses vary widely, this clause contains elements sometimes seen in gas review clauses in other GSPAs. Although somewhat long, the full text of the price review clause in the Atlantic LNG case is set forth below, both to understand how a complete clause functions and to contrast the language there with other formulations discussed in the remainder of this chapter:

9 A physical hub is a distribution point located on a natural gas pipeline system – and a virtual hub is a virtual trading point – at which gas is bought and sold in spot and forward trades for standardised gas products without flexibility.

(a) If at any time either Party considers that economic circumstances in Spain beyond the control of the Parties, while exercising due diligence, have substantially changed as compared to what it reasonably expected when entering into this Contract or, after the first Contract Price revision under this Article 8.5, at the time of the latest Contract Price revision under this Article 8.5, and the Contract Price resulting from application of the formula set forth in Article 8.1 does not reflect the value of Natural Gas in the Buyer's end user market, then such Party may, by notifying the other Party in writing and giving with such notice information supporting its belief, request that the Parties should forthwith enter into negotiations to determine whether or not such changed circumstances exist and justify a revision of the Contract Price provisions and, if so, to seek agreement on a fair and equitable revision of the above-mentioned Contract Price provisions in accordance with the remaining provisions of this Article 8.5.

(b) In reviewing the Contract Price in accordance with a request pursuant to sub-Article 8.5(a) above the Parties shall take into account levels and trends in price of supplies of LNG and Natural Gas [redacted] such supplies being sold under commercial contracts currently in force on arm's length terms, and having due regard to all characteristics of such supplies (including, but not limited to quality, quantity, interruptability, flexibility of deliveries and term of supply).

(c) The Contract Price as revised in accordance with this Article, shall in any event, allow the Buyer to market the LNG supplied hereunder in competition with all competing sources or forms of energy . . . in the market of the Buyer at the point of consumption, taking into account, inter alia, all appropriate operations, services and risks which are usual in the Natural Gas industry from the points of import for handling and marketing the Natural Gas in all market segments when due regard is given to all characteristics of the LNG supplied under this agreement . . . and on the basis that sound marketing practices and efficient operations on the part of the Buyer are assumed and such Contract Price Shall allow the Buyer to achieve a reasonable rate of return on the LNG delivered hereunder.

(d) Neither Party shall request a Contract Price revision to be effective as of the date which is earlier than twelve (12) Months following the Date of First Commercial Supply and no Party shall request any further revision to be effective as of a date which is earlier than three (3) Calendar Years after the date as of which such Party has last requested a revision to be effective.

(e) Unless the Parties agree otherwise, no price revision shall be effective:

(i) earlier than provided for in (d) above;

(ii) retroactively before the date of notification of the request of such revision; or

(iii) earlier than six (6) months before the date on which agreement is reached or arbitration proceedings are initiated on such revision, whichever is the latest.

(f) If agreement is not reached within six (6) months from the date of notifying the request for Contract Price revision, either Party may submit the matter to arbitration for decision in accordance with the criteria set out in sub-Articles (b) and (c) above.

(g) While, and notwithstanding, the Parties have not reached agreement and no arbitration award is effective, this Contract shall remain in full force and effect and the rights and obligations of the Parties, including, without limitation, the obligations of the Seller to sell and deliver and the obligations of the Buyer to take and/or pay for LNG at the Contract Price shall remain in effect.

(h) Each Party shall provide all necessary information to substantiate its own claim. No Party shall be required to disclose any business secrets or breach any confidentiality undertaking nor to provide such information as the other Party may need to substantiate its claim.[10]

10 *Gas Natural Aprovisionamientos, SDG, S.A. v. Atlantic LNG Company of Trinidad and Tobago* (2008 WL 4344525, at *1 (S.D.N.Y.)), and also Exhibits A and B to the declaration of George von Mehren in support of motion to confirm arbitration (petition), filed with the S.D.N.Y. in the same case (available on

The elements of price review clauses and the various issues that can often arise in gas pricing disputes are discussed in more detail in Section IV, below.

vi Dispute resolution

As noted above, long-term GSPAs often specify that disputes are to be referred to arbitration (although in a few instances they may specify alternative dispute resolution mechanisms, such as expert determination). In some contracts, parties may agree on a dedicated dispute resolution mechanism specifically for disputes under the price revision clause. Otherwise, the general dispute resolution clause applicable to the GSPA as a whole will typically apply in the case of a price revision dispute. Arbitration clauses in these contracts frequently specify institutional arbitration such as ICC (although other institutions are also agreed), but *ad hoc* arbitration, whether adopting the UNCITRAL Rules or purely *ad hoc*, is also not uncommon.

III THE RECENT INCREASE IN GAS PRICING DISPUTES

As noted above, the price for gas being bought and sold under these long-term GSPAs has often been set via a price formula in which an agreed base price (P0) is indexed to the published market prices for a basket of competing alternative fuels (often including oil-based fuels). This approach to pricing is said to reflect the relationship between natural gas and oil products, including the fact that natural gas prices in end-user markets have traditionally been priced by reference to the price of competing oil-based fuels.

Over time, many countries have made efforts to liberalise their natural gas markets, although the results of these efforts vary by country. For example, the European Union has taken a variety of steps to liberalise gas markets in the Member States and across the EU, commencing with the First EU Gas Directive in 1998 and continuing through the Third EU Gas Directive in 2009. These liberalisation efforts coupled with other factors facilitated the emergence and increased liquidity of gas trading hubs, noted above, on which buyers can purchase certain volumes of gas at a market price. This 'gas-to-gas' competition has led a number of buyers to argue for the introduction of hub pricing in the contract price formulae of their long-term GSPAs.

In addition, in some markets in the late 2000s, a divergence (or 'decoupling') occurred between hub prices for natural gas and the price of oil (and hence between hub prices and the prices payable under some oil-indexed contracts). A number of factors have been said to have contributed to this, including additional volumes of LNG entering the international LNG market as a consequence of increased North American shale gas production and other increased imports. At the same time, the global financial crisis in 2008 contributed to a reduction in demand for gas in a number of markets. These shifts in supply and demand for natural gas had an impact on the price of gas available for purchase at hubs.

Buyers reacted in a number of ways. Some sought to minimise their offtake under their existing contracts to the extent permissible under their take-or-pay obligations.[11] And some commenced price reviews, seeking a variety of revisions to reduce the contract

Westlaw). Other published language of price dispute clauses is seen in ICC Final Award No. 9812 (extract), dated August 1999, ICC International Court of Arbitration Bulletin Vol. 20 No. 2 (2009), and ICC Case No. 13504 (2007), 20(2) ICC Bull. 93 (2009), at p. 94.

11 See Luca Franza, 'Long-Term Gas Import Contracts in Europe: the Evolution in Pricing Mechanisms', CIEP Paper (2014), at p. 18.

price. The revisions sought have reportedly ranged from basic price discounts to revisions that would modify the contract price formulae to achieve a contract price that includes hub-based elements or, in some instances, is entirely hub-based. Sellers also responded in a variety of ways, with some proposing reductions in flexibility terms or introduction of seller's optionality.

In light of these and other events, including the upheaval in Asian gas markets stemming from the increased demand for LNG in the wake of the Fukushima nuclear power plant disaster, the past decade has seen a proliferation in price review requests. Moreover, many parties have been unable to resolve these price review requests during the contractually specified pre-arbitration stage, and the number of price review disputes that have moved to arbitration for resolution has increased significantly.

IV THE ANATOMY OF A GAS PRICING DISPUTE

Although the provisions of any given price review clause must be construed on their own terms and against the background of the other provisions of the contract in question, there are certain features common to many price review disputes.

i Process and procedure

As noted above, many price review clauses will spell out the procedure to be followed to initiate a price review. Many clauses stipulate that contractual price revisions can occur only periodically; for example, every three years from a party's prior request, as provided in the clause in the *Atlantic LNG* contract quoted above. Under many such clauses, parties may also be entitled to bring exceptional 'joker' or 'wild card' price revision requests earlier than otherwise provided for under the contract. The clause typically specifies a limited number of such joker price revision requests that can be made; for example, two over the lifetime of the contract or one during a specified period and a second during a later period.

Price review clauses may also require that the party seeking a price revision first send a notice for a request for a revision to its contractual counterparty pursuant to stipulated notice provisions. The parties may then be required to seek in good faith to resolve the revision request between themselves for a prescribed period (for example, six months). If no agreement is reached within that period, the price review clause will often provide that the dispute can be submitted by either party to arbitration (or, less commonly, expert determination) pursuant to the terms of the contract's dispute resolution clause.

Once an arbitration has been commenced, the parties may seek agreement on the timetable for the arbitration, subject to any contractual limitations they may previously have agreed. Of course, such limitations can often be modified by further agreement of the parties.

ii Triggering a revision

Price review clauses will generally stipulate what must be established to trigger a revision of the contract price provisions. This can vary considerably from contract to contract.

Some price review clauses require that a change in circumstances of a specified nature or level of seriousness has occurred during a specified period, often referred to as the 'reference period' or 'review period'. Some clauses explicitly require that the change affects the balance of the parties' agreement in a certain way. Some clauses specify the market in which such a change in circumstances must occur or contain other language specifying the nature of the necessary change. Not uncommonly, price review clauses will expressly require that the

change in circumstances be beyond the control of the parties, or not foreseeable or reasonably expected, or both, at the time of the most recent contract price revision. Where such clauses do not expressly provide for such requirements, disputes may arise as to whether the clauses implicitly include such requirements or they are otherwise applicable as a matter of industry practice.

Many of these elements are present in the *Atlantic LNG* clause quoted above. Under that clause, a revision is triggered where 'either Party considers that economic circumstances in Spain beyond the control of the Parties, while exercising due diligence, have substantially changed as compared to what it reasonably expected . . . at the time of the latest Contract Price revision . . . and the Contract Price . . . does not reflect the value of Natural Gas in the Buyer's end user market'.[12]

Some clauses identify specific changes (for example, amendments to certain regulations or laws, or changes in taxes) that will be deemed to satisfy the trigger requirements. Less commonly, some clauses specify that a revision will be triggered if the delta between the contract price and a specified comparator exceeds a stated threshold.

In addition, some clauses explicitly spell out mandatory considerations or benchmarks that the parties must take into account in assessing a price revision request. For example, in the clause in the *Atlantic LNG* case, the parties are expressly required to take into account 'levels and trends in price of supplies of LNG and Natural Gas . . . being sold under commercial contracts currently in force on arm's length terms'.[13]

Whether the trigger requirements have been satisfied is a matter that can lead to disagreement between the parties. Among other things, it is possible for parties to disagree on:

a whether the asserted change in circumstances occurred within the reference period (for example, in some price review clauses, the reference period is the period between the date of the most recent revision and the date that the price review in question was requested, although the parameters of the reference period can themselves be a source for dispute);

b whether the asserted change meets the degree of gravity explicitly or implicitly required (for example, some clauses may stipulate that the changes must be 'significant', 'substantial', or 'serious' but provide no explicit guidance as to when the specified threshold will be satisfied; other clauses may not expressly stipulate the degree of gravity required, leading some parties to argue for standards implicit in the contract, imposed as a matter of industry practice, or indicated through the parties' prior practice);

c whether the asserted change is of the nature contemplated by the price review clause (for example, some clauses expressly require that the changes must be changes in economic circumstances; even where there is no express stipulation as to the nature of the changes required, parties may raise arguments regarding what types of changes can qualify to trigger a price revision, including arguments regarding the extent to which the change must impact the parties' bargain);

d whether the asserted change was 'reasonably expected' or 'foreseeable', etc. at the time the contract was entered into or at the time of the most recent price revision (this may be disputed where one party argues that the changes in circumstances were a continuation of a pre-existing trend);

12 See Section II.v, above.

13 See Section II.v, above.

e whether the asserted change in circumstances was within the control of one or both of the parties (such an argument may potentially arise where a party arguably is in a position to bring about or to act to prevent the change);

f what weight should be given to any mandatory considerations or benchmarks that the parties must take into account, and how those mandatory considerations or benchmarks are to be assessed in practice;

g what market (e.g., the gas markets in which country or countries) and what market level (e.g., the import level, wholesale level or end-user level) should be considered when assessing the asserted change in circumstances;

h whether the asserted change in circumstances is in fact already reflected in the existing price; and

i whether the asserted change in circumstances 'justifies' a revision of the contract price.

If the parties agree that a price revision has been triggered – or an arbitral tribunal determines this to be the case – the question then turns to determining what revision to the contract price, if any, is warranted.

iii Determining the scope and nature of any revision of the contract price

Often price review clauses stipulate a specific standard or requirement regarding what revision, if any, should be made to the existing contract price formula if the trigger has been met. The specified standard varies among contracts. Some clauses simply state that the revision to the contract price formula must be fair or reasonable. For example, the clause at issue in the *Atlantic LNG* case provides that, if a revision is triggered, the parties are required to reach agreement on – or in the absence of agreement, a tribunal is required to determine – 'a fair and equitable revision' of the contract price. Some other clauses provide that the contract price provisions must be revised to reflect the change in circumstances that was established at the trigger phase or to reflect the value of gas in a defined market or market segment. Other standards also exist.

Some price review clauses require that specified benchmarks or other factors be considered in determining what revision should be made. Such benchmarks can include import prices and whether the gas can be economically marketed under specified conditions, assuming prudent and efficient operations and marketing practices on the part of the buyer.

Again, for example, the clause in the *Atlantic LNG* case provides that the revised contract price shall 'allow the Buyer to market the LNG supplied hereunder in competition with all competing sources or forms of energy'. Such clauses – often referred to as 'in any case' clauses because they begin with those words – vary considerably by contract and require close review.

The adjustment phase can potentially give rise to a number of disputes between the parties, including:

a what the stipulated standard actually means (for example, what is required for a proposed revision to be considered fair and equitable, as in the clause in the *Atlantic LNG* case);

b how any specified benchmarks or other mandatory considerations should be taken into account (for example, what market indices or other sources of data relating to import prices should be considered), what weight should be given to these factors and in which market or at which market levels these considerations should be assessed;

c what the permissible scope of revision is and what limitations there are regarding the revision (for example, some price review clauses state that only revisions to the contract price provisions are permitted in a price review, whereas some occasionally provide that other provisions of the contract may also be revised; parties may also disagree as to whether the particular contract permits a complete replacement of the existing price formula or only adjustments);

d to what extent other provisions of the contract (for example, regarding volume, flexibility, security of supply and term of the contract) must be taken into account in determining what adjustment to the contract price provisions should be made; and

e whether, taking into account the determinations made with respect to the issues identified above, the proposed revision actually satisfies the stipulated standard and appropriately restores the balance of the parties' bargain.

iv Consequences of gas price disputes progressing to arbitration

As noted above, the number of price review disputes that have proceeded to arbitration has increased significantly in recent years. There are a number of consequences for contracting parties that arise when a gas price dispute proceeds to formal dispute resolution, including consequences for the time frame within which the arbitration will be resolved, the nature and scope of the issues to be arbitrated and the nature of the resolution ultimately reached through an arbitral award.

First, the time frame for resolving the dispute is likely to expand significantly. Unless the parties are able to agree up front (or have previously agreed) to some sort of fast-track arbitration (which is not necessarily feasible in practice), an arbitration may take many months, if not years, to finally resolve the dispute. Of course, the parties' efforts to settle their dispute may continue in parallel during the arbitration and, if successful, may shorten this time.

Second, the arbitral process may lead to a much more detailed and formal airing of the issues between the parties than might occur in negotiations between the parties. There are a number of reasons for this. For example, when parties turn from negotiations to more formal dispute resolution, the number of legal issues that must be addressed often expands. Moreover, parties – with much at stake – typically retain the services of large international law firms with experience in gas price disputes and one (or more) experts experienced in gas pricing and other aspects of the gas industry. These legal and industry experts will be able to identify potentially favourable arguments for their clients that the commercial parties may not themselves have focused on, which can significantly expand the scope of issues in dispute.

In addition, in an arbitration, substantial volumes of material (including submissions, witness statements, and expert reports) may be exchanged between the parties far in excess of the volume of material likely to be exchanged in negotiations, providing further opportunity for the parties to litigate a large number of issues. The document disclosure process that often forms part of an arbitration may also lead to orders requiring disclosure of documents that the parties would not otherwise have exchanged in negotiations, further exacerbating the potential for an expansive set of issues requiring determination by the arbitral tribunal.

Third, an arbitration that proceeds to a final award results in a determination by a third party or parties to the contract – namely, the arbitrator or arbitrators – to revise the contract price or contract pricing mechanism applicable between the parties for a number of years. This determination can have significant commercial consequences, which may not be fully anticipated by the tribunal. Although there is a growing set of arbitrators well-versed in

international gas markets and gas pricing disputes, there is no guarantee that the tribunal in a particular case will be so qualified. In any event, even well-versed arbitrators are not experts in the creation and modification of price formulae, and they will not be fully familiar with the particular nuances of the wider commercial relationship between the parties.

Nevertheless, a growing number of parties have in recent years pursued arbitration through to a final award (although others have settled their disputes commercially after the commencement of the arbitration but before the tribunal has issued an award). This suggests that the many benefits that arbitration can bring to commercial dispute resolution (including procedural fairness, party autonomy in the selection of arbitrators and applicable procedural rules, confidentiality of proceedings, finality and enforceability) are significant in the eyes of the parties to long-term GSPAs. Even where disputes settle before an award is rendered, the additional clarity regarding the strengths and weaknesses of each party's position that the exchange of extensive pleadings and related documents brings may also help to facilitate negotiated solutions to the parties' dispute.

V THE FUTURE OF GAS PRICE DISPUTE RESOLUTION

It is not clear what the future holds for gas pricing. However, an end to the recent growth of gas price review disputes and resulting arbitrations does not appear imminent. Indeed, as the number of gas price disputes under existing long-term contracts proceeding to arbitration has increased and parties have become more familiar with the arbitral process and procedure, some parties may now consider arbitration as a well-established step in the price renegotiation process.

In addition, as these gas price disputes and arbitrations under existing long-term contracts continue to occur, it is possible that parties may also reconsider the terms of their gas price review clauses and specifically reconsider how disputes regarding gas pricing are to be finally resolved.

Among the alternatives to traditional arbitration, other gas price dispute resolution mechanisms sometimes discussed include the use of expert determinations, mediation or the use of modified arbitration clauses that substantially constrain the arbitrators' jurisdiction to narrow questions (for example, limiting the arbitrators' jurisdiction to determining only how the base price should be modified or, where the price formula provides for weightings of different elements, limiting jurisdiction to determining what such weightings should be, etc.).

Other modified forms of arbitration have also been proposed. For example, some propose the use of high-low (or 'bounded') arbitration, in which the parties privately agree to a range within which the final price must fall. In the event that the tribunal's decision fixes a price falling outside that range, the price will, by virtue of the parties' prior agreement, be set at the upper or lower boundary of the agreed range. Another possibility is 'baseball' arbitration (also sometimes called 'either/or' or 'final-offer' or 'pendulum' arbitration). In the context of a gas price dispute, this mechanism generally provides that, if the trigger has been met, each party proposes a revision and the arbitrators must then choose one of the two proposals without modification (a process intended to discourage each party from making an unreasonable proposal, because doing so would likely lead to the tribunal choosing the other side's proposal).

None of these alternative mechanisms seems to have found much favour in the industry to date. Although it remains uncertain whether any of these (or other) alternative dispute mechanisms will gain much traction in the future, at present, they seem unlikely to

significantly displace traditional arbitration of gas price review disputes. This suggests that many parties to long-term GSPAs continue to be attracted to the benefits of traditional arbitration over these potential alternatives. And, while traditional arbitration continues to play a central role, it remains for the participants in that process to focus on ways to ensure that it results in the most effective, efficient, and satisfactory means possible to resolve the inevitable price disputes that continue to arise under long-term GSPAs.

Appendix 1

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