

# TAMING PRICE REVIEW CLAUSES: LESSONS FROM THE TRANSACTIONAL AND ARBITRATION BATTLEFIELDS

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## ABSTRACT

While certain gas markets have longstanding and deep experience with price review clauses and the related disputes, other markets and a number of the newer players have less experience, if any, swimming in these troubled waters. Failure to appreciate the necessity for and complexity of LNG price review clauses has exposed some parties to the commercial and political consequences of unaddressed and/or unanticipated market swings, which can be deep and painful. Indeed, recent events have underscored the challenges of relying on “simple” or “traditional” price formulae to adjust automatically to changing as well as changed circumstances.

Given the magnitude of the effects of failing to address these issues properly upfront, it is worth stepping back to identify and assess recent trends as well as some of the key battle-tested lessons learned at the negotiating tables and in arbitration hearings with the ambition of applying these lessons in the next generation of agreements and avoiding the substantial exposure and uncertainty of a price review dispute.

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## INTRODUCTION

Agreeing a price formula for the entirety of a long term gas sale agreement ("GSA") over, for example, a 15-20 year term often will carry with it a level of risk which is unacceptable for both parties. Even with indexation, structural changes can have a fundamental impact on the initial bargain, and there can be material changes over time to the competitiveness of the price.

By way of example, events of recent years in North West Europe have shown how important price review or price reopener clauses are in a GSA:-

- The gas market has changed beyond recognition in the last six years. Deregulation combined with the global financial crisis and an increased number of sources of supply has led to a downward pressure on natural gas prices. This has resulted in divergence between oil-indexed prices traditionally used in GSAs and gas hub prices.
- GSAs tend to be structured so that sellers take the price risk and buyers take the volume risk. Sellers' insistence on maintaining this structure by requiring adherence to take-or-pay obligations has resulted in a wave of price reviews in recent years. Those reviews have often involved buyers requesting a shift towards gas hub reference prices given the growing importance of gas hubs as liquidity in spot markets has increased and the substantial losses being incurred in many, oil-indexed GSAs.
- With the recent drop in oil prices, the number of price reviews might have been expected to drop. However, many buyers still want to proceed with price reviews in order to eliminate "basis risk". Many consider now is a good time to achieve a structural solution through a switch to gas hub pricing (whether through arbitration or settlement), aligning price under the GSA with the price achievable in the market of the buyer. There has been some resistance on the seller side to the move to hub pricing, including some suggestions that gas hubs are not yet sufficiently mature or liquid to provide a reliable price signal. Current oil prices may encourage a re-think of this position.

Although the majority of price review disputes over recent years have concerned the sale of gas into Europe, there is growing scope for disputes to arise in other markets, in particular, Asia. Price renegotiations have been seen in Japan and South Korea in the past decade, and they are the world's two largest LNG importing countries. Market reform in Japan, some deregulation in Korea and increasing sources of supply are factors which may lead to further price renegotiations.<sup>1</sup> Traditionally, GSAs for supply of LNG to Japan have provided expressly for the resolution of price disputes through arbitration. With structural change and the possibility in the future of an Asian gas trading hub developing, it is likely that there will continue to be renegotiations and it may be considered prudent to include such provisions in GSAs with a long term.

In relation to both supply and demand, there are a number of factors which will contribute to uncertainty over how markets will develop. It is anticipated that new significant sources of supply will come on stream in the near future. The most notable of these in volume will be in Australia where LNG exporting capacity is expected to quadruple between 2015 and 2018.<sup>2</sup> In the US, LNG exports are forecast to start in the first quarter of 2016 and grow in capacity until at least 2020.<sup>3</sup> In relation to demand, both China and India are already importers of LNG and, given the scale of their energy demands, their increased participation in the market could be

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<sup>1</sup> See International Energy Agency, *Developing a Natural Gas Trading Hub in Asia*, 2013; Mark Agerton, *Global LNG Pricing Terms and Revisions: An Empirical Analysis* (James A. Baker Institute for Public Policy, Rice University, 23 September 2014); and Gaffney Cline, *All Change for LNG! The Energy Market Reform Train Arrives in Japan* (14 July 2015)

<sup>2</sup> David Ledesma, James Henderson and Nyrie Palmer *The Future of Australian LNG Exports: will domestic challenges limit the development of future LNG export capacity?* (Oxford Institute of Energy Studies, September 2014)

<sup>3</sup> Federal Energy Regulatory Commission at [www.ferc.gov/industries/gas/indus-act/lng.asp](http://www.ferc.gov/industries/gas/indus-act/lng.asp); Brookings National Gas Task Force, *Issue Brief 4: An Assessment of US Natural Gas Exports* (July 2015); and Ed Crooks, *Cheniere Energy's shipment turns US into gas exporter* (Financial Times, 10 July 2016)

influential. Additional regasification terminals are under construction, which suggests that they will import more LNG in future but, at this stage, the likely levels of future demand and approach to pricing are unclear.<sup>4</sup>

As a whole, markets for LNG continue to grow in complexity. As markets have developed and trading at hubs become more liquid, greater reliance has been placed on hubs for pricing.<sup>5</sup> The current volatility in the oil price may lead to a greater concentration on gas-to-gas pricing with a move away from oil indexation. As these developments take effect, price review provisions will continue to be included in GSAs to ensure flexibility, and reviews will continue to be triggered.

Despite the fact that the need for a price review provision in a GSA for LNG is largely accepted in the industry, and whilst many price review clauses will share common features, there is no standard form. The scope and effect of different provisions can vary enormously depending on the wording adopted.

The inclusion of a mechanism for reviewing price provides comfort to the parties because it means that they should not be tied into continuing at an uneconomic price. However, if a review is triggered and a negotiated resolution not achieved, the determination of a fundamental element of the contract is put in the hands of third parties, i.e. arbitrators. This gives rise to enormous uncertainty and risk while the process is ongoing. Parties involved in a review will be eager to reduce that uncertainty and mitigate the risk.

In this paper, we address: (a) the typical features of a price review clause and relevant considerations with respect to each; (b) issues that may arise in resolving price review disputes through arbitration; and (c) potential alternatives to arbitration as a means of resolving price review disputes.

## **A. TYPICAL FEATURES OF A PRICE REVIEW CLAUSE IN A GSA**

Price review clauses in GSAs vary widely in their drafting. They range from the concise to extremely detailed, lengthy provisions. They will tend to include the following features:-

- A "trigger" which permits the review procedure to be invoked either automatically at some defined periodic anniversary date, plus in some cases an entitlement to a certain number of "wild card" price reviews, or upon satisfaction of a threshold test (for example, related to evidencing a certain level of change in a particular market or markets).
- A procedure for negotiation and then (should negotiation fail) a form of binding dispute resolution, commonly arbitration.
- Criteria are provided against which possible revisions to the price formula are to be assessed, including an "in any case" clause. (Such a clause typically requires that the price should allow the buyer to market the gas economically.)
- Once the new price is determined, provision is made for accounting adjustments, including any balancing payments, typically so as to give retroactive effect to the adjusted price from the price review date.<sup>6</sup>

The effect of the clause will depend on the construction of the meaning and effect of the words used. If the dispute results in arbitration, each word will be the subject of in-depth

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<sup>4</sup> Anupura Sen, *Gas Pricing in India* and Michael Xiaobao Chen, *Gas Pricing in China* both in Jonathan Stern (ed), *The Pricing of Internationally Traded Gas* (Oxford, 2012)

<sup>5</sup> See also Jonathan Stern, *Conclusions* in *The Pricing of Internationally Traded Gas*, *ibid*

<sup>6</sup> The typical features of price review clauses are also discussed in: Susan Farmer, *LNG Sale and Purchase Agreements* in Paul Griffin (ed), *Liquefied Natural Gas* (Globe Law and Business, 2006) and Mark Levy, *Drafting an Effective Price Review Clause* in Mark Levy (ed), *Gas Price Arbitrations* (Globe Law and Business, 2014)

scrutiny, so the clause needs precise drafting and careful review to consider how it works as a whole and the possible constructions that might be advanced.

### **PRICE REVIEW PROVISION TO BE DRAFTED AND CONSTRUED IN CONTEXT**

In addition to precise drafting and careful review of the price review clause itself, it is important that the price review clause is not drafted or considered in isolation. Price review provisions are negotiated as part of a wider transaction, and, when it comes to their application, they should be viewed in the context of the GSA as a whole.

To understand the price review clause, it may be helpful to know in preparing for negotiations or an arbitration:

- the strength of the position of each party in negotiating the GSA;
- the key interests of the parties (i.e., flexibility, security of supply of a high volume, maintaining price at a certain level, ability to supply a particular sector/industry);
- the positions adopted by the parties in negotiations and whether one party suggested particular words should be used; and
- the nature of the market for LNG when the original deal was struck.<sup>7</sup>

A price review clause which is effective and favourable in one GSA may be ill-suited to another. For example, it is important to consider:-

- The governing law of the contract as it may import certain provisions, and it will be relevant to the approach to contractual construction. The law of the seat of the arbitration may have an impact on procedural issues that arise. Choices of both can have a significant impact on the resolution of a price dispute.
- The other commercial terms and the flexibility they offer. In particular, provisions concerning the volume of LNG that must be delivered and taken, the degree of flexibility allowed (for both parties), the effect of take-or-pay provisions and the term of the GSA will be significant.
- How will the gas be used? Is it to be used in power generation, sold on to retail customers, supplied to the network or used as feedstock for fertilizer or chemical production? Is the gas intended to be used in a particular market? Is flexibility contemplated at the receiving facility? Does the GSA permit it to be diverted or resold and with what ease and what cost? How do these factors impact on the value of the gas?
- Particularly from the seller's perspective, what is the source of the gas? What proportion of the seller's production or the LNG train's capacity does it represent? Is there a back-to-back supply agreement for some or all of the gas? What are the costs of supply that need to be taken into account?

As a result, although reviewing previously used price review clauses will be helpful in drafting a new one, their use will have limits. Whilst it is useful to ensure that certain elements are included in a clause, unless GSAs are being entered into in very similar circumstances, there can be no such thing as a model price review clause.

### **ENTITLEMENT TO PRICE REVIEW / TRIGGER REQUIREMENTS**

The trigger for a price review can set out requirements to be satisfied or can provide an automatic right to commence a review after a defined period of time (typically every 3-4 years since the last review). The clause will normally require the party seeking the review to serve a

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<sup>7</sup> Whether any of the information listed could be adduced as evidence in an arbitration will depend on the governing law of the GSA and applicable procedural laws/rules, as different legal regimes have different approaches to the evidence that is admissible in construing the words used in a contract.

notice on the other party requesting that review. It may provide that certain information has to be given in that notice. Whether the claimed basis for the price review and the requested change to the formula have to be set out in the notice will depend on the requirements of the clause.

The first question that often will arise in a price review is whether the party seeking the review is entitled to do so, that is whether the trigger requirements have been met. In these circumstances, the trigger requirements will be the subject of detailed scrutiny. In drafting the requirements, it is necessary to balance, on the one hand, the desire for certainty and, on the other, providing the parties with flexibility to deal with unanticipated developments.

A number of points will need to be considered when drafting trigger requirements.<sup>8</sup> The most significant include:-

- Should the change required to trigger the review be assessed mechanically (e.g., whenever the price generated by the formula changes by more than X% or if the specified collar/cap is exceeded for more than a specified period) or be more fluid (e.g., "significant change" in the energy market of the buyer since the contract commencement date or last price review)? Both have their advantages and disadvantages. In particular, where the more fluid approach is taken, there will be a great deal of scope for debate over what is meant by significant change and the market of the buyer. For example, in an ICC award in 2014, the question arose and the tribunal determined that a sustained 25% increase in Brent Crude prices during the review period was a significant change.<sup>9</sup> On the other hand, the more mechanical approach may be too inflexible to deal with fundamental changes to the market.
- For what period? Whichever approach is taken, a sustained rather than short term change may be required to trigger a review for obvious reasons. The period considered in assessing whether a review can be triggered may differ from the period considered when determining how, if at all, the price should be adjusted. Subject to the terms of the clause, the price review generally will focus on the position as at the review date, and will set a new contract price from that date. However, it may be necessary to look back to determine whether events that the requesting party claims constitute the triggers have occurred and qualify as the relevant changes for adjusting the price.<sup>10</sup>
- In what market? If the trigger requirements refer to a market, then some definition of that market will normally be provided. In doing this, many clauses will refer, for example, to the end-user market of the buyer or the wholesale market of which the GSA is part. Even with such a definition, there can be disputes over the scope both geographically and its nature: is it the whole of the market or certain segments (e.g., industrial users v household or certain competing fuels)? To achieve greater certainty, it is tempting to specify more precisely the geographical scope or the nature of the market, but this can lead to its own problems if that changes over the term of the GSA.
- Unforeseeable/outside party's control? The inclusion of such a requirement can be intended to address two issues: one is to avoid reviews being triggered for changes already catered for in the existing price bargain for the reference period; the second is to prevent a change which has been brought about by the actions of one of the parties to the GSA being relied upon by that party. In both cases, finding evidence to establish the facts definitively may be challenging.
- Joker/wild card reviews? Many GSAs provide the option of a number of additional reviews that can be triggered outside the normal cycle and as a result of different factors. Including provision for such reviews may be attractive to allow greater

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<sup>8</sup> See also the discussion in Michael Young, *Procedural issues in price review arbitrations in Gas Price Arbitrations*, above n 5

<sup>9</sup> ICC Case No 15051, ICC International Court of Arbitration Bulletin (2014) 25(2)

<sup>10</sup> Marco Loreface, *Crossroads in Gas Price Review Arbitrations* in J William Rowley QC, Doak Bishop and Gordon Kaiser, *The Guide to Energy Arbitrations* (GAR, 2015)

opportunity to re-open the price, to avoid being stuck in an uneconomic position. However, the impact of undertaking reviews too frequently and having a number running simultaneously or in quick succession should be considered in drafting such "wild card" provisions.

## **PROVISION FOR PERIOD OF NEGOTIATION**

Price review clauses will normally require the parties to negotiate for a specified period of time, following service of a price review notice, before an arbitration can be commenced.

In drafting such a provision, the first questions to consider are how long the period should be and whether it is intended to be mandatory (i.e., arbitration cannot be commenced until the period has come to an end or the parties have agreed that arbitration may be commenced)? In determining the length of the period, it should be remembered that the recipient of the notice may have a significant amount of work to do on receiving the notice to prepare itself to participate effectively in negotiations. This will need to be balanced with the need of the party serving the notice to proceed without undue delay as the price may be impacting its financial health. Of course, this period can be extended by agreement between the parties, if meaningful negotiations are ongoing at its expiry. On the question of whether the negotiating period is mandatory, this is a question of construction of the words used. If the words used require a period of negotiation before an arbitration may be commenced, the tribunal's contractual authority to start work before that date may be challenged. Whilst negotiation periods are often expressed in a way so that they are mandatory, this may have the effect of delaying progress towards a resolution if one party is refusing to engage in the negotiations.

In most cases, strenuous efforts will be made to try to reach an amicable settlement given the long term relationship between the parties and the risk and costs associated with resolving the dispute through arbitration. In addition, a negotiated settlement will allow greater latitude in the agreement that could be reached. Whereas a price review clause generally will deal only with price, a negotiated settlement can cover a variety of other things such as take-or-pay relief, rights of diversion and even changes to the price review clause itself which will not normally be achievable through arbitration.

To allow the best chance of reaching a resolution, on the best terms possible, the settlement negotiations should be treated with the same focus as the arbitration process. A dispassionate review of the strengths and weaknesses of the position should be undertaken and supportive evidence gathered. Given the importance of expert evidence in an arbitration, it is often worth getting an expert on board early so that their views can be taken into account in developing the negotiating position. This will have the benefit of providing a view from outside the organization. Care should be taken not to undermine such an expert's independence in a subsequent arbitration by involving them too closely.

Even at this stage, disputes can arise and those disputes can undermine the likelihood of reaching a negotiated agreement as well as influencing a subsequent arbitration. Disputes may arise over:

- the adequacy of the notice; and
- the admissibility in the arbitration of documents exchanged or of comments made in the negotiation period.

Whether the notice is adequate is principally a question of compliance with the requirements of the price review clause. Notices are frequently kept very concise because the party seeking the review wishes to keep its options open on the points to be advanced in support of its position or it has not done enough work to be able to set out detailed reasoning nor a specific requested revised price. This can give rise to challenge on the basis that the notice has not identified why the review is required and/or the trigger conditions met. Under English law, compliance with the requirements of the clause will be carefully reviewed, but the authorities

demonstrate a reluctance to see challenges succeed on the basis that, for example, insufficient detail of reasons has been given.<sup>11</sup>

It often will be expressly agreed that the discussions and materials exchanged during the negotiation period will be confidential and subject to without prejudice privilege (so they cannot be deployed in the arbitration or any legal proceedings). If this is intended to be the case, to ensure certainty that expectations on both sides are matched so that there are frank and full exchanges in the negotiations, and to give the best chance of keeping evidence of those communications out of the arbitration, putting in place a written agreement which sets out the basis on which communications may or may not be relied upon in the arbitration can be helpful. On the other hand, sometimes, in the clause itself, it may be agreed that the party requesting the review should provide material supporting the request on an open basis. The argument goes that this allows the negotiations to take place on a consistent basis with the position that will apply in the arbitration and, arguably, will lead to the requesting party giving greater thought and undertaking more analysis before the review is commenced.

### **EXTENT OF AMENDMENT OF PRICE FORMULA**

The price review clause will determine the scope of the review that may be undertaken. As noted above, if a negotiated resolution is achieved, the parties may agree to amend the GSA more broadly to take into account changing circumstances. If the price review cannot be agreed and it falls to be resolved by an arbitral tribunal, the tribunal's authority to review and amend the price will be determined by the terms of the GSA.

In drafting the price review clause, the fact that there may be a dispute as to the scope of the tribunal's mandate should be borne in mind.<sup>12</sup> So as to limit the scope for dispute, it is important to provide clarity as to what the tribunal is empowered to do and how it should go about doing that.

Disputes may arise, for example, as to whether the words in the price review provision mean that the tribunal is mandated only to amend an existing price formula so far as is necessary to reflect the changes proven or whether the tribunal is entitled to start with a blank sheet of paper. Parties may contend that the base price ( $P_0$ ) should be changed and/or that there should be adjustments to other aspects of the formula, such as the indexation element. Issues may arise as to whether the tribunal has the power to change the basis of indexation: for example, is oil-indexation locked in, or is the tribunal permitted to order an amendment from oil indexation to hub based pricing?

The scope of the review that is undertaken may be influenced by the respondent's reaction to the service of a price review notice. In some cases, the respondent will decide not just to oppose the change sought by the claimant but to put forward a different change. For example, a buyer receiving a price review notice from a seller may not just defend the seller's attempt to increase the price but may claim that the price should, in fact, be decreased. In those circumstances, it may be necessary to determine whether the buyer can put forward such a change in the course of the review commenced by the seller or whether the buyer needs to serve its own notice.

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<sup>11</sup> British Gas Trading Limited v Amerada Hess Limited, Perenco UK Limited [2006] EWCA Civ 900 and see Marnix Leitjen and Martje de Vries Lentsch, *The trigger phase in Gas Price Arbitrations*, above n 5

<sup>12</sup> Michael Polkinghorne, *Predicting the Unpredictable: Gas Price Reopeners* (June 2011)

## APPROACH TO ADJUSTMENT OF PRICE FORMULA

When an arbitral tribunal comes to consider the adjustment of the price formula in default of agreement between the parties, it will need to settle on the approach that it should take to that adjustment. To an extent, that will be determined by the scope that it is permitted (as discussed above). If it has a fairly broad scope, it will need to decide how it should go about adjusting the price formula, and this turns on what it is trying to achieve in making the adjustment.

There are a number of approaches that the Tribunal might take or which the clause might direct the tribunal to take, for example:-

- The tribunal could seek to peg the price to market movements so that the price revision reflects proven changes in the market. In doing this, the tribunal would need to determine any delta between the contract price and market price when the deal was struck (or the price last reviewed) and maintain that in the revised price. This exercise would have the effect of valuing the change and seeking to reflect it in the revised price, rather than valuing the gas afresh. It is necessary to identify a market price at the date that the deal was struck and an equivalent market price at the date of the adjustment. This can be difficult when factors such as guaranteed volume, flexibility and term have to be built into identifying a market price - especially as comparable agreements are likely to be confidential.
- Alternatively, the tribunal could establish the revised pricing provisions by reference to named benchmarks or criteria. Unless this is how the parties originally arrived at the price and that can be established, the tribunal may take a different view on the benchmarks than the parties, if the provision is lightly drafted.

Fundamental to this question is to understand the role of the tribunal in resolving the price review dispute. Is it one or more of the following:

- to impose a fair and equitable price on the parties in all of the circumstances;
- to put itself in the position of the parties and try to recreate the deal which they might have reached if they had been able to agree; or
- to preserve as far as possible the deal which the parties originally reached, albeit adjusted to reflect the changed circumstances;
- to reflect given criteria as best it can?

For some, reading this list will give rise to discomfort or, at least, pause for thought. The idea of embarking on a process where three independent people (more often than not, lawyers) are given the power to adjust the most critical commercial element of a long term GSA is remarkable and worrying.

The starting point for determining the scope of the exercise is the price review clause in the GSA. It may set out what the tribunal is to aim to do in adjusting the price. GSAs will sometimes include some form of recital (either to the GSA as a whole or to the price review clause) which describes the approach originally taken by the parties in agreeing the price formula and their expectations of how it should be reviewed over the life of the GSA. This can assist the tribunal in deciding on the approach that should be taken to the adjustment of the price.

If it is not clear from the face of the GSA, then other factors may be relevant in determining the approach that the tribunal will take. The context of the GSA and its other terms may be influential. The governing law of the GSA and the background of the arbitrators may have an impact on the approach that they are prepared to take and the evidence that they are open to considering.<sup>13</sup> For example, under English law, it will be inadmissible to adduce evidence

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<sup>13</sup> Philip Spencer Ashley and Ben Holland, *Gas Price Reviews: past, present and future*, Global Arbitration Review, Vol 6 Issue 5

of pre-contract negotiations to establish the subjective intentions of the parties in drafting the price review clause but this will not be the case for some other legal systems. The positions advanced by the parties and the evidence adduced may focus the tribunal into taking a particular approach.

Although the results of gas price disputes are rarely known, because they are confidential, from the limited number that are in the public domain, it is instructive to see the variety of approaches adopted by tribunals and the breadth of the authority which they have been able to exercise. Examples include:-

- *Atlantic LNG v Gas Natural* (2007) - the Tribunal was given a broad discretion in the clause to come up with a "fair and equitable revision" and changed the approach from focussing on the price of LNG in Spain to reference to either Spain or New England depending on where the majority of the LNG was delivered in any period.<sup>14</sup>
- *RWE v Gazprom* (2013) - the tribunal introduced an element of indexation to spot gas prices, when the contract originally provided for oil indexation.<sup>15</sup>
- *Edison v Eni* (2015) - the tribunal changed the indexation from oil to spot gas prices in the buyer's market.<sup>16</sup>

An issue which may arise in connection with the tribunal's approach concerns the period taken into account when adjusting the price. The start of the period will normally be the date of commencement of the GSA or when the last review took effect and should be uncontroversial. The provisions of the price review clause will be the most important factor in determining the cut-off date for the information that should be considered in undertaking the price review.<sup>17</sup> If the tribunal is allowed to consider evidence from after the date of the price review notice, prices may move in the meantime before the tribunal makes its determination and this may incentivize delay, which is often seen as undesirable.

### **"IN ANY CASE" CLAUSES**

In many cases, the price review clause will require that the buyer should in all instances be able to market the gas economically in its own market. For most buyers, this provides indispensable protection designed to avoid the price under a GSA becoming out of step with the market in which they operate. As is true of many of the issues that arise in relation to price review disputes, what appears at first sight to be relatively straightforward can give rise to disputes.

The first point that may arise is the relationship between the requirement that the buyer should be able to market the gas economically and the triggers for a price review. For instance, does the requirement to be able to market economically only become relevant when the tribunal reaches the stage of considering how the price should be adjusted, or does the buyer have an overarching right to trigger a price review if it is not able to market economically?

The term "market economically", or the alternative formulation used in the relevant GSA, can be the subject of debate. For example, questions that may arise include:

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<sup>14</sup> *Gas Natural Aprovevisionamientos v Atlantic LNG Company of Trinidad and Tobago* (2008) WL 4344525 (SDNY)

<sup>15</sup> Christoph Steitz and Vera Eckert, *Gazprom dealt pricing blow as loses court case to RWE*, Reuters, 27 June 2013 and Bernhard Guenther, *RWE CFO reported in Natural Gas Europe* on 10 July 2013

<sup>16</sup> Douglas Thomson, *Edison wins €1 billion in gas price review*, Global Arbitration Review, 30 November 2015

<sup>17</sup> Michael Young, *Procedural issues in price review arbitrations* in *Gas Price Arbitrations*, above n 5 and Mary Levy and Rishab Gupta, *Gas Price Review Arbitrations: Certain Distinctive Characteristics* in *The Guide to Energy Arbitrations*, above n 8

- Does the clause guarantee a margin? Or, for example, is it such as to put a prudent and efficient operator into a position to make a profit?<sup>18</sup>
- If it does provide a margin, how do you establish what the margin should be? Should the margin be consistent with what it was when the deal was first struck or with what other operators are able to achieve? How do you demonstrate what other operators are able to achieve?
- If it is to be judged by the objective standard of a prudent and efficient operator, should a subjective element be included to take account of the buyer's actual circumstances (including its existing range of customers and the contracts that it has entered into to sell the gas)?
- Over what period should the standard be judged? For example, where there has been volatility over the life of the GSA, should past profitable times be taken into account?

In some cases, the clause has been found to cap a seller's increase but not to establish an absolute minimum, though this will depend on what the tribunal consider to be the meaning and effect of the clause.<sup>19</sup>

### **PROVISION FOR ACCOUNTING ADJUSTMENTS AND BALANCING PAYMENT**

The price review clause will normally include provision for accounting adjustments following the adjustment of the price formula. This will include a balancing payment being made to give retroactive effect to the new price formula from the price review date.

If a balancing payment is required as a result of adjustments to the price formula, the tribunal may not have the information available to calculate the total to be paid. This is an exercise that will normally be best left to the parties. The logistics of undertaking such a calculation and then incorporating an obligation to make the payment into an award will need to be given thought.<sup>20</sup>

It may be attractive to include in the GSA a generous rate of interest to the balances ultimately quantified as being payable, as a means of encouraging the process to be conducted speedily. In a GSA which involves large volumes of LNG, the sum payable may be large in any event and adding substantial interest to it may lead to even greater challenges in making such a payment. The scale of the payments that may be involved are emphasized by the agreement reached between Gas Natural and Sonatrach to resolve their price dispute pursuant to which Gas Natural agreed to pay Sonatrach \$1.9 billion and to give Sonatrach the option to acquire a stake in Gas Natural.<sup>21</sup>

## **B. ARBITRATION OF PRICE REVIEW DISPUTES**

Having described the typical features of a gas price review clause, this section addresses considerations in drafting an arbitration agreement in a GSA, the selection of the tribunal to determine the dispute and the procedural issues that may arise in the arbitration of a price review dispute.

### **DRAFTING THE ARBITRATION CLAUSE**

In drafting the arbitration clause in the GSA, as in other circumstances, it is sensible to make provision for:-

- Whether the arbitration is to be institutional (e.g., LCIA, ICC) or *ad hoc* (i.e., with no administering institution) and, if *ad hoc*, the procedural rules that will apply.

<sup>18</sup> Alexis Mourre, *Gas Price Reopeners: is Arbitration Still the Answer?*, Dispute Resolution International, Vol 9, No 2

<sup>19</sup> *Gas Pricing Disputes*, David Mildon QC, 19 July 2012, see para 20 and Mark Levy, *Drafting an effective price review clause* in *Gas Price Arbitrations*, above n 5

<sup>20</sup> *Gas Pricing Disputes*, David Mildon QC, above n 14, see para 28

<sup>21</sup> *Gas Natural pays Sonatrach \$1.9 bln to end dispute*, Reuters, 14 June 2011

- The seat of the arbitration, as this will be the legal home of the arbitration and will have an impact on certain aspects of the arbitration.
- Whether disputes will be referred to a sole arbitrator or a three member tribunal and whether the arbitrator(s) should have any particular qualifications (taking care not to make the pool of potential appointees too narrow).
- If the process for appointment of the tribunal is to differ from the process specified by the relevant arbitral rules, what the process will be. In an ad hoc arbitration, it is sensible to specify an appointing authority to appoint the tribunal in the event of a failure by the parties to agree upon the appointment of the tribunal.

The best approach is normally to keep the arbitration agreement as simple as possible, and it should be borne in mind that it will normally apply to the resolution of all disputes under the GSA not just price disputes. Nevertheless, to assist in relation to price disputes it may be helpful to consider addressing the following points:-

- The target time scale for the arbitration (e.g., by giving an indication as to the period, to the extent possible, in which the award should be rendered). Given that the market can move during the process and price reviews may be triggered every few years, it can be important to highlight the need for the determination to be made in good time.<sup>22</sup>
- In relation to evidence, it is common to see provisions that each party must advance evidence to substantiate its own case but rarer to require a party to provide information that the other party may need to substantiate its position. In arbitration, parties from different legal systems may have differing expectations of the degree to which they may require the other party to produce information. Consequently, it may be helpful to make express provision on this particularly if there is likely to be an asymmetry between the parties in their access to information. (For instance, a buyer is more likely to have access to information about the market in which it participates than a seller.)
- Arbitration is a private process in which only the parties to the GSA are entitled to participate. However, the approach to confidentiality of the arbitration itself, its subject matter and the award vary according to the arbitral rules and the law of the seat of the arbitration. If the confidentiality of the process and the award are important, they should be addressed explicitly in the GSA. When drafting these provisions, it should be remembered that the results of a price review may be so significant that they affect a company materially - if either of the parties is a listed company, it may be necessary to make a public announcement of the determination of the review.

## **SELECTION OF THE TRIBUNAL**

The process for appointing the Tribunal will be determined by the arbitration clause and the relevant arbitral rules. It is common for each party to the dispute to appoint one arbitrator and for those two party-appointed arbitrators to seek to reach agreement on the appointment of a chairperson, failing which the appointment is made by the relevant arbitration institution/appointing authority. Alternatively, the appointment of the entire tribunal can be left to an arbitral institution or appointing authority.

If the parties are each to nominate an arbitrator, they will need to consider what type of candidate ideally to select. Whatever other characteristics the candidate might have, the most important is likely to be that he or she will have credibility with the other members of the tribunal. Of course, the arbitrator need not be a lawyer (economists and those with experience in negotiating/operating GSAs may make good candidates), but lawyers are often appointed in price

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<sup>22</sup> As in any arbitration agreement, making adherence to a specified timetable a condition of the arbitration being a valid process can lead to problems. Hence the recommendation for a target timetable rather than a mandatory one.

review disputes presumably because of their experience with the arbitration process, of construing contracts and evaluating written and oral submissions and evidence. In selecting an arbitrator, two factors which may be considered are the level of knowledge and understanding of GSAs and energy markets and a facility with numbers and formulae. More practically, if there is a desire to move the resolution of the dispute forward quickly, a candidate with good availability and a track record of being responsive will be attractive.

In some instances, a party will wish to meet candidates before making a decision on appointment. This can be done within certain boundaries. To avoid any subsequent difficulties, such as a challenge to the appointment of the candidate or an attempt to overturn the award, care needs to be taken in undertaking interviews.<sup>23</sup>

## PROCEDURAL ISSUES

Parties in a price review arbitration should use the flexibility of the arbitral process to put in place a procedure which best leads to the efficient resolution of the dispute. Each arbitration will give rise to different procedural considerations but questions relating to document production, expert evidence and bifurcation will frequently arise.

**DOCUMENT PRODUCTION.** As mentioned above, in some disputes there may be an asymmetry in relation to access to information with the result that only one party has access to certain key information. This may arise when one of the issues to be considered is the market into which the buyer under the GSA sells gas. In such a case, the buyer is likely to have more first hand evidence of the state of that market. In the light of this, the seller may wish to ensure that it has the opportunity to request that the buyer produces certain documents or categories of documents. Given that those documents will often concern the commercial relationship between the buyer and its counterparties, the buyer may oppose the production of those documents on the grounds of commercial confidentiality. A number of approaches can be adopted to attempt to overcome those concerns, including confidential "data rooms" or "confidentiality clubs" specifying terms of access for a limited category/list of people.

Similar issues may arise if it is necessary for comparator GSAs to be identified, for example to establish the market price or to compare other terms such as volume and flexibility. In these cases, the other GSAs are likely to be commercially sensitive and both the buyer or seller and its third party counterparty will wish to maintain the confidentiality of the other GSA. In some jurisdictions, it is possible for court orders to be sought in support of the arbitration to compel third parties to disclose their contracts for buying or selling gas to establish the market.<sup>24</sup> However, this is done very rarely. Given the limited availability of specific "comparables" in some cases, reliance on aggregated industry data can become important.<sup>25</sup>

**EXPERT EVIDENCE.** Expert evidence will usually be critical in price review disputes. In relation to whether a party is entitled to trigger a review and the adjustment of the price, the Tribunal's assessment may be, in large part, based on economic and market analysis.

Although the tribunal will usually have the power to appoint an expert itself, as in other forms of arbitration, tribunal-appointed experts are relatively rare. This is because the parties will normally need to rely on the assistance of an expert in preparing their submissions because of the need for economic and market analysis and opinion. Consequently, a tribunal-appointed expert is likely to cause the time and cost involved in resolving the dispute to be increased because there will be three experts (one tribunal-appointed and two party-appointed) rather than just two. In addition, the assessment of the economic and market evidence plays such a key part

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<sup>23</sup> For guidance see the Chartered Institute of Arbitrators' guidelines, *CI Arb Practice Guideline 16: The Interviewing of Prospective Arbitrators*

<sup>24</sup> For an example from Australia, see <http://www.redbankenergy.com/media/381945/arbitration%20subpoena%20process%20-%20alinta.pdf>

<sup>25</sup> For example, Eurostat, BAFA, Platts etc

in the resolution of the dispute that a tribunal-appointed expert may become the *de facto* decision maker in the dispute.<sup>26</sup>

The more common approach is for each party to appoint its own expert, who will - to an extent and subject to observing important boundaries - form part of the party's team in the dispute (whilst respecting its duties of independence in the formal arbitration process). If this is the approach that is to be adopted, it will be beneficial for an appropriate expert team to be identified at an early stage in the price review dispute. For a party requesting a review, that may well be before the price review notice is served. The benefit of doing this is that the expert's opinions can be factored into the party's position and submissions from the very start, and the message can be consistent throughout the process. However, the distinction between the expert's opinions being taken into account in negotiations or otherwise, and the expert maintaining independence, must be observed to avoid the expert's ability to testify as an independent expert in the arbitration being undermined.

In appointing an expert, parties should be aware that the number of people specializing in giving expert evidence in gas price review disputes is limited and many will have significant experience of having given evidence in previous disputes. Whilst this experience is, of course, valuable, it is important to discuss whether the expert has appeared in cases previously before any members of the tribunal, as an expert who has previously taken a different position or been discredited before a tribunal member may be less influential in persuading the tribunal.

Following the exchange of expert reports, meetings between the experts of the same discipline may be arranged so that the experts can establish areas of agreement and disagreement. This allows the issues in dispute to be narrowed and focussed by the time of the final hearing.

Witness conferencing (or "hot tubbing", as it is sometimes known) is sometimes used to give the tribunal the opportunity to put questions to the experts instructed by both parties at the same time. Precisely how this is arranged will vary from case to case, but often it will follow the cross-examination of the experts by the parties' advocates. This can be extremely effective in allowing the areas of difference between the experts to be explored by the tribunal.

**BIFURCATION.** It is sometimes suggested that the arbitration proceedings should be split or "bifurcated" to increase their efficiency. Such bifurcation is often considered in the following two ways:-

- If there is a dispute as to whether the criteria for triggering a price review have been met, to resolve that first. If the price review has been triggered correctly, then a second stage to consider what adjustments (if any) should be made to price.
- If the tribunal determines that an adjustment to the price is required, to issue a partial final award which indicates that an adjustment to the price is required and in principle how the price should be adjusted. The parties are then invited to agree or, failing that, to make submissions on how the adjustment to price should be achieved.<sup>27</sup>

In the first case, where compliance with the trigger requirements is considered first, this is intended to avoid the parties spending time and money in addressing how the price should be adjusted unless the trigger requirements have been satisfied. A determination that the trigger requirements have been satisfied may also unlock the resolution of the dispute and encourage the parties to negotiate the adjustment of the price. However, where the evidence and issues in considering the trigger requirements and in adjusting the price are similar, this may lead to duplication and, if it is necessary for the adjustment of the price to be determined by the tribunal, inefficiencies.

In the second type of bifurcation, as explained by David Mildon QC in his 2012 paper, the proposal is that the tribunal should "*describe their preferred solution in a Partial Final Award and*

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<sup>26</sup> Alexis Mourre, *Gas Price Reopeners: is Arbitration Still the Answer?*, above n 13

<sup>27</sup> *Gas Pricing Disputes*, David Mildon QC, above n 14, see para 28

*leave it to the parties to prepare a revised formula which carries that solution into effect, with liberty to apply for a further award in the event of continued disagreement".* This recognizes that the parties are likely to be better placed to effect an adjustment to the formula itself than the Tribunal. As mentioned above, if a balancing payment is required, this may also give the parties the opportunity to calculate and agree on the value of that balancing payment. However, once again, this approach may lead to duplication and inefficiencies.

### **C. POSSIBLE ALTERNATIVES TO ARBITRATION**

Given the ambition of this paper to consider whether the substantial exposure encountered in price review disputes can be reduced, it is worth questioning whether using dispute resolution processes other than the type of arbitration described above might assist.

**National courts** - It is very rare to see price review disputes referred to a national court. Reasons for this include: the lack of ability to choose or, at least, play a role in selecting the decision maker; fears over publicity; and the risk of producing an unfavourable precedent. Moreover, particularly in common law countries, judges will be unfamiliar with the role required of them in imposing an agreement on the parties, as opposed to construing the meaning of what they agreed.

**Expert determination** - Referring the dispute to expert determination is attractive in some respects. The expert appointed will normally have greater knowledge of gas markets and/or economics than a tribunal of three lawyers and can make a decision based on that knowledge and experience as well as the submissions made by the parties. However, the disadvantages can be that the expert may need assistance from a lawyer to resolve issues of contractual construction or procedure. Moreover, if the determination needs to be enforced, the process will be more cumbersome.

**Mediation** - The inclusion of a mandatory requirement to mediate is not common. The reasons for this include: the parties can always agree to mediation if they think it will assist; some will question what it would add where both parties are normally committed to finding a negotiated solution if possible; and obligatory mediations at an early stage tend not to be successful. If they are included they need to be drafted with considerable care to avoid them being used to postpone progress towards resolution.

**"Pendulum" or "Baseball" arbitration** - In this process, each party submits its proposal to revise the price and the tribunal has to choose between them. The advantages of this approach are: it may have the effect of reducing the distance between the parties; and it limits the risk of the tribunal crafting a solution with which neither party is happy. However, it is rarely used in practice because it is better-suited to situations where the issue is one of deciding between two simple figures - rather than the revision of a formula which is more complex. The same goes for so called 'high-low' arbitration, which involves the parties agreeing to a minimum and maximum threshold for the award.

### **CONCLUSION**

Price review clauses have been a feature of GSAs, particularly for supply in North West Europe, for decades. Whilst the risks associated with their use - particularly if a negotiated resolution to a price review cannot be achieved - causes concern to some, it seems likely that they will continue to be included widely in GSAs. Even the move towards hub-based pricing may not see an end to their inclusion, as the way in which markets for LNG across the globe will develop remains uncertain.

Many consider that arbitration still provides the best means of resolving price review disputes, and that the skill lies in drafting the price review clause in such a way that ambiguities are minimized as far as possible and the tribunal has clear guidance as to the relevant principles and limits to apply in undertaking the review. In addition, undertaking an early, thorough and dispassionate assessment of the merits, the deployment of an experienced team to handle the dispute, the appointment of an appropriate tribunal and putting in place an efficient and sensible procedural timetable, will assist in mitigating the risks.