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Of Saints and Sinners and Gas Price Reopeners: the European Experience

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"The only difference between the saint and the sinner is that every saint has a past, and every sinner has a future."

Oscar Wilde

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Background

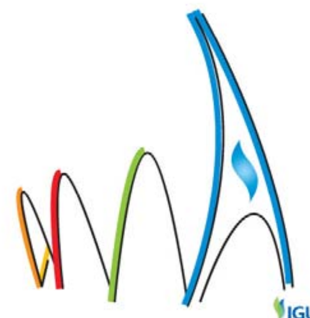
Changes in European gas markets have produced a marked increase in gas price negotiations and arbitrations in recent years. Given that many major European GSAs have terms of at least 15-20 years and that economic circumstances can of course change significantly over this period of time, a GSA's price review clause generally provides for change by adopting a formula rather than a fixed amount, which goes some of the way - but not all of the way - in dealing with change. As a result, the clause also generally contains a provision for regular review.

The spate of price reviews witnessed recently is often a reflection of the fact that the old oil-linked price formulae no longer reflect the drivers for the price of gas in wholesale and end-user markets. The "new world" as it were sees gas to gas competition driving prices by reference to levels and structures found at regional gas hubs (there is of course a debate on this point as well as where we are in terms of movement to these new conditions).

Aim

The aim of this presentation is to consider the interpretation and effect of price review clauses, which are critical for European gas buyers and sellers engaged in gas price negotiations and arbitrations.

The first part of this presentation will consider the commercial context of price review clauses generally. The second examines typical (to the extent one can say there are similarities of approach) contractual terms for triggering a price revision and adjusting the contract price. Finally, certain distinct issues arising in price reviews are discussed.



Methods, Results and Conclusions

I. THE COMMERCIAL CONTEXT

Contractual provisions in long term GSAs seek to resolve the tension between stability and responsiveness to change in two ways:

- First, on the question of stability, by guaranteeing payment and minimum flows of gas.[1] The "take or pay clause", for example, assures producers and lenders that their investment can be reimbursed while also giving the buyers the benefit of security of supply. In some cases, a buyer may insist on "supply or pay" or related provisions for firmer guarantee of regular supply.[2]

- Second, on the question of responsiveness to change, one has the price review clause, and on some cases a more general hardship style clause. The thinking behind these is that the long term nature of GSAs distinguishes them as "relational" - characterized by the parties' cooperation[3] - as opposed to "discrete transactions"[4], which presuppose multiple buyers and sellers transacting on an *ad hoc* basis to secure supplies and sales. This relational aspect can also mean that most price review disputes are settled through commercial negotiation, with arbitration as a last resort.[5]

II. THE TRIGGER STAGE

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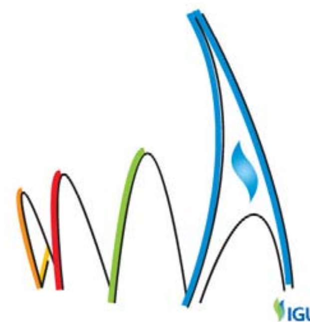
[1] As one US court put it (albeit the reference to "price" at the end may mislead): "The seller bears the risk of production. To compensate seller for that risk, buyer agrees to take, or pay for if not taken, a minimum quantity of gas. The buyer bears the risk of market demand. The take-or-pay clause insures that if the demand for gas goes down, seller will still receive the price for the Contract Quantity delivered each year." Universal Res. Corp. v. Panhandle E. Pipe Line Co., 813 F.2d 77, 80 (5th Cir. 1987). *See also* P. Carpenter and T. Brown, "Price Re-Openers in Natural Gas Supply Contracts: Avoiding Costly Mistakes in Arbitration", in *The Brattle Group: Energy* (2010), p. 3 ("A long-term contract with gas production and take-or-pay commitments gives the parties in an arbitration the contract stability and certainty of supply, which is desirable in the context of sunk investments in assets such as pipelines and production fields.").

[2] These clauses provide that the seller must compensate the buyer for gas volumes that are requested but not delivered. The compensation may be calculated, for instance, based on the difference between the contract price and the price at which the buyer is or would be able to purchase the non-delivered gas in the market, but can also be greater, including rare cases where it is the full value of the gas.

[3] See the list of factors characterizing the "extreme transactional pole" and the "extreme relational pole" of the spectrum of contractual relations in I. Macneil, "Contracts: Adjustment of long-term economic relations under classical, neoclassical and relational contract law", *Northwestern University Law Review*, Vol. 72 (1978), p.854

[4] It has been suggested that GSAs are in fact better defined as a sociological arrangement that builds on mutual trust and the parties' readiness to share risks and balance interests. *See, e.g.,* P. Griffin and F. van Eupen, "The future for price reviews", in *Gas Price Arbitrations* (M. Levy, ed.) (2014), p. 147.

[5] Another often cited reason why the majority of price reviews are settled through negotiations is that the parties are reluctant to let arbitrators decide over such an important aspect of their relations. The suitability of arbitration to settle price review disputes is discussed in Section V.C below.



Although price review clauses will be tailored to each GSA, it is probably safe to say that they share basic trigger mechanisms for price review, after which one turns to the adjustment exercise. The process is generally commenced by way of service of a notice of claim, or "trigger letter".

A. Trigger letter

A trigger letter instigates a price review at the written request of one or both parties, specifying the grounds[6] for a period of negotiations between the parties to discuss that request and contract price adjustment.[7] The first occasion for requesting a price review is usually specified by date, and subsequent reviews are then fixed at certain intervals. At a minimum, a party is often required to identify "the circumstances in the request, so as to enable the other party to determine whether it is appropriate to enter into price review negotiations about such circumstance(s)". [8]

Parties should consider that:

- in submitting a detailed justification of their price request in the trigger letter, they may – depending on how the clause is drafted - well be limited to the grounds cited in that trigger letter; but
- GSAs generally do not require trigger letters to include the requested price formula and the parties will as a result usually not be penalized for its absence.[9]

B. Trigger conditions

In the majority of price review clauses, two basic trigger conditions are found:

- A "significant" or "substantial" change in economic circumstances as compared to what existed and/or what the parties reasonably expected at the time of contracting on the last price review.[10]
- A reference to a change in the value or price of gas in the buyer's market.

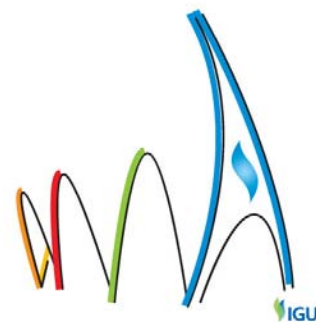
i. A significant or substantial change in economic circumstances

Significant or substantial

[6] Final Award in Case 9812 (August 1999), p. 73.

[7] The parties sometimes decide to postpone the formal triggering of a price review to give themselves more time for commercial negotiations, but they nevertheless maintain the original trigger date as the beginning of the reference period, discussed below. *See* M. Leitjen and M. de Vries Lentsch, "The trigger phase", in *Gas Price Arbitrations* (M. Levy, ed.) (2014), p. 36.

[9] *Cf.* M. Leitjen and M. de Vries Lentsch, fn. 7 above, p. 36 ("[I]t could be argued that [the obligation of] substantiating the request [in a trigger letter] would also involve the actual adjustment that the requesting party seeks.").



The "significant" or "substantial" quality of the changes in circumstances provision is hard to quantify beyond a comparison to what existed (and/or what the parties reasonably expected) at the time of signature of thereafter, the last price review.[11] One tribunal assessed "significance" by reference to the amount of the requested price adjustment, which examined the significance of economic changes through the parties' lens.[12] Expert reports may also provide an objective assessment of "significant" or "substantial".[13]

Changes in circumstances

The "changes in economic circumstances" trigger condition is usually expressed broadly as involving matters "beyond the parties' control" (a result of concerns when incumbents had a quasi-monopoly over their own markets), but invites a quantitative comparison of circumstances between two dates (the reference period), usually marked by the end of the previous price review's reference period.[14]

Circumstances taking place before or after the reference period are generally outside the scope of a price review,[15] but may be admissible in arbitration in certain circumstances; for example:

- Later statistical reports written on developments within the reference period.
- Events occurring after, but announced within, the reference period, causing a change in economic circumstances.[16]

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11 *See, e.g.,* M. Frisch, "Current European Gas Pricing Problems: Solutions Based on Price Review and Price Re-Opener Provisions", International Energy Law and Policy Research Paper Series 2010/03, p. 15 ("Continental European price review clauses are normally based on three main principles. The first of these principles relates to the economic condition or circumstances in the buyer's market area for gas and how these conditions changed over time.").

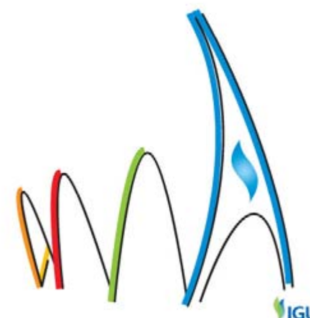
12 Final Award in Case 9812 (August 1999), p. 71 ("Not every relevant change in economic circumstances triggers the application of [the price review clause]. The change also has to be significant, which means that a less important change is excluded. . . . [T]he Arbitral Tribunal considers that a change, which implies an adjustment of P_0 with approximately 15 per cent, is without any doubt a significant change in the terms of the [Contract]."). *Cf.* D. Mildon, "Gas Pricing Disputes" (July 2012), available at: http://www.eisourcebook.org/cms/Gas%20Pricing%20Di sputes.pdf, p. 4 ("The context in which questions about significant change arises is a debate about the value of gas. A change which has nothing to do with value is hardly going to qualify as significant.").

13 As many an after-dinner speaker has noted, US Supreme Court Justice Potter Stewart used the phrase "I know it when I see it" to assess whether certain video material was pornographic and thus not protected speech under the US Constitution's First Amendment. *See* Jacobellis v. Ohio, 378 U.S. 184 (1964).

14 *E.g.*, if the reference period of one price review ends on 30 September 2012, the reference period in the next price review should start on 1 October 2012.

15 *See, e.g.,* A. Stanic and G. Weale, "Changes in the European Gas Market and Price Review Arbitrations", *Journal of Energy & Natural Resources Law*, Vol. 25, issue 3 (2007), p. 340. Here again, however, the writer has seen clauses which do not fit these criteria, and where, for example, one takes a 'snapshot" of the situation in determining whether a change is required. In some clauses I have seen, the start and end dates for a review period were not in fact specified.

16 For a possible example of this type of evidence, see M. Leitjen and M. de Vries Lentsch, fn. 7 above, p. 38 ("Before, a typical example would be new legislation which has been announced to enter into force at a later date. If it comes into effect after the review period, technically this change would fall outside the review period. However, as market participants usually start adjusting their behaviour in anticipation of such new



- Certain future events that help assess the reasonableness of the buyer's margins under a claimed price formula (whether the claimant is a buyer or seller, this debate arises often where a contract has a condition that the buyer be able "in any case" to market the gas economically).

ii. Changes in the value of gas in the buyer's market

A change in the value of gas in the buyer's market can operate as a trigger condition either independently or in combination with the more general reference to changes in economic circumstances.

Here, the question of determination arises as to the value of gas. European gas markets have evolved substantially since the first European GSAs were concluded in the 1960s, when gas to gas competition did not exist[17] and gas was priced to render gas an attractive option and to thereafter create consumer apathy to switching to alternative fuels.[18] Due however to the recent emergence of virtual trading points ("hubs") and a boom in US shale gas production,[19] European gas buyers now tend to demand market-based pricing formulae for their GSAs to reflect value. Some price review clauses for example now provide that gas should be determined by pricing in the "end-user market", whose users can operate at the wholesale or retail level. Parties will often argue over the relevant market level and position on the gas chain for calculating gas value.

iii. "In any case" provisions as a possible trigger mechanism

As noted above, many price review clauses provide that the GSA's price "shall in any case allow the gas to be economically marketed based on sound marketing operation".[20] This clause could be set out in an independent paragraph (arguably, some would say, acting as an independent trigger) allowing "the buyer to economically market the…gas" independent of changes in economic circumstances or value of gas in the buyers' market.[21] The clause is frequently seen as part of the adjustment mechanism allowing the buyer to seek a price which gives it some form of margin (sellers, on the other hand, have argued that it applies only when there is a price increase, rather than reduction, albeit with limited success it seems). To date, no buyer has – to the writer's knowledge - prevailed in the argument that

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legislation before it enters into force, this adjustment in behavior may qualify as a change in the economic circumstances within the review period if it affects the value of the gas.").

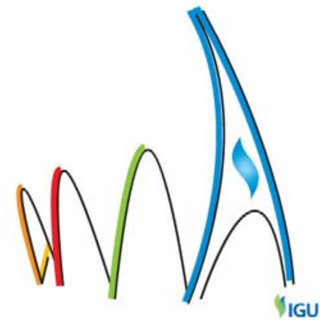
[17] *See, e.g.,* P. Heather, "Continental European Gas Hubs: Are they fit for purpose?", Oxford Institute for Energy Studies (June 2012), pp. 22-25. The gas market liberalization has progressed more quickly in some European countries than others.

[18] The prices of alternative fuels in the end-user market were "netted back" to the GSA's delivery point by subtracting costs (such as storage, transport, and overhead) and a profit margin. *See* P. Roberts, *Gas and LNG Sales and Transportation Agreements: Principles and Practice* (2014), para. 5-006.

[19] *See, e.g.,* "Gas Pricing in Europe: Careful what you wish for", The Economist (24 July 2012).

[20] Energy Charter Secretariat, *Putting a Price on Energy: International Pricing Mechanisms for Oil and Gas* (2007), p. 155.

[21] The tribunal in ICC Case 9812 (August 1999) came to the opposite conclusion, finding that the "in any case" provision did not constitute an independent trigger mechanism; the tribunal noted that the provision was included in the same sub-clause as the price review clause's trigger conditions. *See* Final Award in Case 9812 (August 1999), pp. 72-73.



an "in any case" provision constitutes an independent mechanism for triggering a price review.[22] But once again, it's all in the drafting.

III. THE ADJUSTMENT STAGE

If, following service of the trigger letter, the parties' adjustment negotiations are unsuccessful, one or both may generally refer such matters to arbitration, for a tribunal to adjust the contract price.

A. Criteria for adjusting the contract price

Price review clauses themselves provide few specific and detailed criteria for adjusting the contract price once the trigger conditions are satisfied (indeed many feel they should not; the clause is after all about dealing with the unexpected). That being said, tribunals often look at the following when the parties disagree on the adjustment:

- A reflection of the value of gas in the buyer's market.
- Whether the price review clause provides that the price level or structure in other gas import contracts should be taken into account (the approach of comparing contracts can prove challenging given (a) the confidentiality of pricing terms in GSAs and (b) the at times questionable reliability of certain publications providing gas import prices).[23]
- The "in any case" clause. The concept of economically marketing gas has been interpreted by buyers as a guarantee to earn a positive net margin on the sale of gas received, while sellers often argue that the buyer should not be protected from foreseeable losses in the market. There is often a debate (not always that helpful) whether a "common industry interpretation" of "in any case" clauses exists, which remains to be seen.[24]

B. Relationship between trigger and adjustment

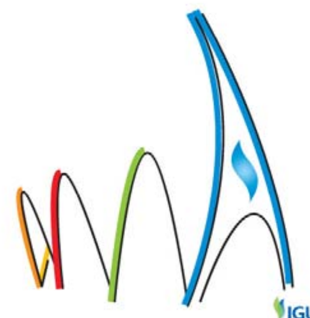
A causal link usually exists between the trigger and adjustment since the "changes in economic circumstances" that satisfy the trigger stage explain the kind of price modification that would be "appropriate" at the adjustment stage.[25] Some clauses will also contain

[22] See fn. 21 above.

[23] Eurostat data does not, for example, reflect retroactive price adjustments either agreed between the parties or imposed by an arbitral tribunal. In a time where gas price reviews abound, retroactive adjustments could have a material impact on the published data.

[24] It could be argued that gas industry practice in drafting and interpreting price review clauses should be taken into account as "trade usages" under Article 21(2) of the ICC Rules of Arbitration.

[25] *See also* D. Mildon, "The adjustment phase", in *Gas Price Arbitrations* (M. Levy, ed.) (2014), p. 131 ("Such a clause [which would require the parties to re-start the pricing exercise from scratch at the adjustment stage] would be unusual. We suggest that one of the reasons why this approach tends not to be favoured is that it would involve an elaborate inquiry, even in cases where the market change which had triggered the review could be addressed using a minor adjustment to the existing formula.").



express wording linking the economic circumstances that triggered the price review to those that should guide the price formula's adjustment.[26] Other cases can provide, implicitly or explicitly, that the review exercise is unfettered by the trigger conditions.

C. Scope of the contract price adjustment

- One question that has arisen recently concerns the extent to which a modification can take place. Is it limited to price level (which may not in fact cure the disconnect which exists, as the price clause fails to reflect end markets), or can one rewrite the clause to track, for example, gas to gas competition as reflected at regional hubs? The permissible scope of a price modification is of course frequently dependent upon the precise wording of the price review clause.[27] Buyers have recently argued that a replacement of the existing price formula is not only allowed but necessary to reflect new market realities.
- The governing law of the GSA should also be taken into account and legal concepts such as hardship and unexpected changes in circumstance (*imprévision*) may also have an impact on the scope of permissible contractual changes

Parties should also be mindful of a possible challenge under Article V (1) (c) of the New York Convention to an award exceeding the price review terms.[28]

IV. SELECT ISSUES IN GAS PRICE ARBITRATIONS

There are several distinct issues which arise when conducting gas price arbitrations, of which I limit myself to a couple of reflections. The first arises at the evidence and/or production stage, where confidentiality concerns may constrain the use of market data as evidence. The second can be recurrent, if parties continue to revisit their GSA's price provisions, as the same GSA may be interpreted and applied by subsequent tribunals. This calls into question whether an earlier tribunal's award will have a preclusive (*res judicata*) effect on a subsequent tribunal's award. These issues open the debate about the suitability of arbitration to decide price review disputes.

A. Production of evidence

In international arbitration, each party is required to discharge its burden of proof for the facts on which it relies.[29] However, as long as the European gas markets remain opaque (and for example there may in fact be competition law constraints on what information can be shared), a party may struggle to obtain and produce reliable evidence on pricing and

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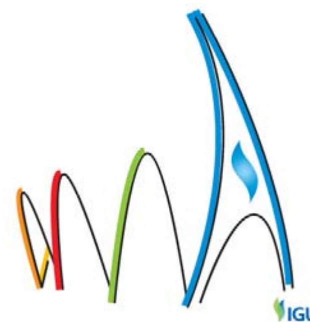
[26] Typical price review clause is cited in M. Vinall, *Denton Wilde Sapte* (2009), p. 16.

[27] *See, e.g.,* B. Holland and P. Ashley, "Natural Gas Price Reviews: Past, Present and Future", *Journal of Energy & Natural Resources Law*, Vol. 30, No. 1 (2012), p. 38 ("Crucially, the arbitral tribunal will need to decide whether the words in the price review provision mean that it is mandated only to amend an existing price formula . . . or whether it is entitled to start with a blank sheet of paper.").

[28] *See* G. Born, "Recognition and Enforcement of International Arbitral Awards", in *International Commercial Arbitration* (2014), pp. 3551-3552.

[29] *See, e.g.,* A. Redfern, "The Practical Distinction Between the Burden of Proof and the Taking of Evidence: An English Perspective", *Arbitration International*, Vol. 10 (1994) p. 321.



development, and arguments therefore arise about whether such a party has discharged that burden.

Evidence concerning, for example, ongoing price reviews and (for different reasons) sales margins may be restricted. When discussing margins in relation to the "in any case" clause, the buyer will claim a reduction in contract price with reference to its sales figures, seeking a reasonable margin, while the seller may claim an increase, reducing or eliminating the same. The buyer's margin is calculated, of course, from the difference between the GSA contract price and the buyer's sales figures, and since the latter's data is confidential, the buyer may resist sharing the sales figures with the seller. As a result, it may be necessary to have an independent audit of the buyer's sales portfolio.[30]

Economic experts can also aid counsel in determining the reasonable operating costs of a "prudent and efficient" gas company, or assessing comparable sales margins.

It has been argued that the standard of proof should be adjusted to reflect the availability of evidence.[31] If the available market data is based on a small sample, for example, the suggestion that a tribunal should take a more realistic approach to this standard has merit, although a party should still be required to use its best efforts to locate evidence for production, and any relaxation of the burden of proof must have limits.

B. Preclusive effect of price review awards

In the face of arbitral awards imposing structural change on the price formula, as well as adjusting contract price, one question for lawyers is whether the price review process should be renewed with each arbitration under that GSA, or whether the previous tribunal's interpretation is binding and thus preclusive, by virtue of *res judicata,* on the current tribunal's award.

The International Law Association has summarized the doctrine as follows:

> The term *res judicata* refers to the general doctrine that an earlier and final adjudication by a court or arbitration tribunal is conclusive in subsequent proceedings involving the same subject matter or relief, the same legal grounds and the same parties (the so-called "triple-identity" criteria).[32]

Arbitral awards are usually given more preclusive effect in common law systems. Civil law systems maintain the principle that only matters decided in the *dispositif* (i.e., a tribunal's operative order) and arguably the reasoning behind the same, are precluded from re-determination, thus leaving scope for legal and factual issues within a claim to be re-arbitrated. In contrast, common law jurisdictions are said to be broader in preventing a party

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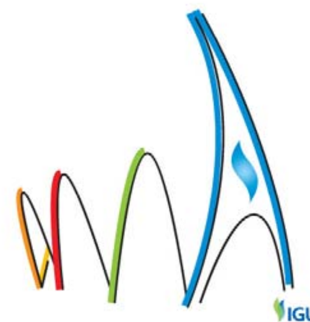
30 An asymmetry of access to information also can exist the other way around: sellers usually conclude GSAs with several buyers in a particular region and may therefore have better information about wholesale prices and pricing structures than buyers.

31 *See* P. Pinsolle, "Confidentiality in gas price reviews", in *Gas Price Arbitrations* (M. Levy, ed.) (2014), p.59 (suggesting that "the standard of proof should be adjusted in view of the scarcity of the information.")

32 International Law Association, "Interim Report: '*Res Judicata*' and Arbitration" (2004), p. 2.



from both re-submitting a claim already decided in an earlier award and re-arguing issues of fact or law determined in such an award (the writer confesses that in his experience, many of these distinctions fade away). In Resolution No. 1/2006, the International Law Association recommended a *res judicata* approach to arbitral tribunals involving a compromise. In any event, the scope of the doctrine will be more limited on issues of fact; one need only consider, for example, changes in markets and different reference periods.[33]

C. Suitability of arbitration to decide price review disputes

Despite their relational aspect, the volumes of gas transferred under European GSAs necessitate clear dispute resolution mechanisms, and accordingly such GSAs normally contain an arbitration agreement covering their price review clauses.

The more controversial arbitral awards, notably *Atlantic LNG v. Gas Natural*[34] (although in the writer's view the criticism has been somewhat disproportionate), have caused concern about the adjudication of complex and high-value disputes by a tribunal usually lacking industry expertise.[35]

However, the concerns have probably dissipated to some extent over time, as specialized counsel and arbitrators have emerged who understand the fundamentals of the gas industry and gas pricing.

Finally, one can ask whether arbitration is inevitably commercially expedient for price review disputes, particularly if one is still ongoing when a further price review is triggered. Could mediation or expert determination yield a more efficient and reliable resolution of price disputes, even if an expert's determination is only likely to advance, rather than settle, the negotiations? There is nevertheless some doubt as to what a mediator – even an industry expert – could offer over and above the companies' negotiators.

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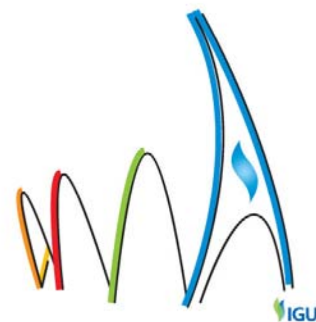
33 International Law Association, Resolution No. 1/2006, Annex 2, Recommendations: 4. An arbitral award has conclusive and preclusive effects in the further arbitral proceedings as to: 4.1 determinations and relief contained in its dispositive part as well as in all reasoning necessary thereto; 4.2 issues of fact or law which have actually been arbitrated and determined by it, provided any such determination was essential or fundamental to the dispositive part of the arbitral award.

34 In the much-discussed case of *Atlantic LNG v. Gas Natural*, Atlantic LNG of Trinidad and Tobago commenced a price review arbitration against Spain's Gas Natural in 2005. Atlantic LNG claimed a price increase because Gas Natural had been selling gas received under the parties' GSA in the United States, rather than in Spain, for some time. The tribunal awarded a dual pricing structure (with one price for sales in the US and another price for sales in Spain) that neither party had requested. Atlantic LNG unsuccessfully challenged the award before the US District Court for the Southern District of New York, arguing that the tribunal had exceeded the scope of its authority. *See* Gas Natural v. Atlantic LNG, 2008 WL 4344525 (S.D.N.Y. Sept. 16, 2008).

35 One of the consultants who worked on the original drafting of the Atlantic LNG GSAs, for example, commented on the award in *Atlantic LNG v. Gas Natural* that "[t]his case is clearly extreme, but a significant proportion of arbitrations on LNG price (and there did not used [*sic*] to be that many) end up with uncomfortable results which are well out of line with normal industry practice. This is almost inevitable as the arbitrators, although formidably learned, cannot be expected to become expert on the gas industry over the course of the hearing." ("Gas Natural v Atlantic LNG: a rare glimpse into price reopener clauses", *LNG Business Review,* July 2009).



References

Included within the text as footnotes.