Contract pricing disputes

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1. Introduction

Contract pricing disputes in the energy industries typically arise in the context of long-term contracts under which an initial price agreed by the parties must be adjusted over the life of the contract to reflect changes in the underlying market price or prices for the product. Where there is a readily ascertainable market index against which such an initial price can be tracked, problems rarely arise, unless that index itself is discontinued or for some reason ceases to be relevant due to structural changes in the relevant market. However, as market indices for the price of gas or LNG in many end-user markets have not traditionally been available, it has been necessary for price formulae under gas and LNG supply contracts to resort to tracking the prices of other competing fuels on the assumption that fluctuations in these prices will themselves reflect the market price for gas, albeit in an imperfect way. In seeking to anticipate events, and also to balance the interests of buyer and seller following negotiation, such formulae are inevitably complex and prone to controversy as to how they were intended to work when the assumptions on which they were based (which may not have been shared) change over time.

1.1 The gas and LNG markets

Historically, producers have sold gas under long-term sale and purchase agreements (SPAs) either for the lifetime of the field or for a fixed period of up to 20 years. The price formulae used to determine the price over this period applied a multiplier to an initial fixed price with a view to escalating the price over time in line with changes in a weighted average of published prices of an agreed selection of other fuels over the contract year and often also annual inflation. In the United Kingdom, such fuels typically included one or more of electricity, fuel oil, gas oil and sometimes coal. In other parts of the world, notably continental Europe, prices were escalated by reference to crude oil prices, usually Brent. The reason for indexing against other fuels was that there was little or no gas to gas competition in end-user markets, which were dominated by state-owned utilities. In the absence of market competition, there was no published 'market price' for gas against which the sale price of the gas to be supplied could be indexed.

As a result of the liberalisation of key gas markets in Europe and the development of an international trading market in LNG, the position has now changed significantly. Markets are now interconnected, although pricing can be significantly different in end-user markets depending on whether there is an active trading and

spot market and whether the particular market where the gas is sold is still a relatively isolated market.

We are now in a period of significant price volatility. Since the global economic downturn in 2008, benchmark oil prices have remained significantly higher than they were when many SPAs were entered into. However, gas prices in end-user markets have fallen as a result of reduced demand, as well as increased supply from new sources, including unconventional gas, and the development of spot markets in which gas trades significantly below long-term prices. The consequence is that prices linked to oil based prices under many long-term SPAs have not tracked market prices for gas in end-user markets.

1.2 Long-term SPAs and pricing formulae

Long-term take-or-pay agreements which require the buyer to take delivery of a minimum quantity, or pay in any event, continue to be the standard in the industry. As their pricing provisions endure for the life of the contract, it is essential that they accommodate the competing interests of buyer and seller for them to remain viable in the long term. The seller will generally have to make a significant capital investment and will therefore seek a secure and guaranteed income stream from sales to underwrite the cost and provide an acceptable return on investment. Over and above that, the seller will also want a price which reflects an increase in the value of the gas in the market and so maximises that return. The buyer, on the other hand, commits to taking or paying for defined volumes of the gas and so will be concerned to ensure that it will be able to sell it, or convert it into power, at a price which will give it the maximum possible profit margin and avoid a loss.

Although these are the traditional motivations of buyers and sellers, there is an obvious tension between the two and buyer and seller will negotiate hard for a formula which they believe will favour their long-term interests.

Most long-term energy supply contracts also contain provisions to allow the parties to reset or renegotiate the contract price either at regular intervals or on the occurrence of a particular event or circumstance. These take two forms: indexation and price reopener clauses.

Indexation clauses are designed to adjust the contract price annually by the automatic application of the price formula. As noted above, such formulae operate to apply a multiplier to an initial price by reference to a basket of alternative fuel indices, or crude oil, and possibly inflation. The multiplier is calculated as a fraction in which the denominator represents the alternative fuel prices at an initial point in time and the numerator reflects alternative fuel prices over a recent review period. The multiplier therefore represents the relative increase in the price of the alternative fuels since the base period. The calculation is therefore as follows:

$$\text{Contract price} = \text{Initial fixed price} \times \frac{\text{Value of alternative fuel(s) in the review period*}}{\text{Value of alternative fuel(s) in the base period*}}$$

** An inflation index may also be applicable*

Some pricing provisions adopt two formulae so as to limit the upward or downward effect of price movements. These are known as ‘top-stop’ or ‘bottom-stop’ formulae. Alternatively, LNG contracts which escalate the gas price against movements in crude oil often provide for a maximum and minimum oil price to be used. This type of formula, often described as an ‘S-curve’, breaks the linear relationship between the contract price and a nominated fuel price into three separate relationships so that, effectively, three different formulae apply depending on the level of that particular fuel price. For example, different formulae might apply when the crude oil price is below $x per barrel, when it is between $x and $y per barrel and when it is above $z per barrel. The price will decrease more slowly below $y per barrel and increase more slowly above $z per barrel (the ‘inflexion points’ or ‘pivot points’ in the price formula). S-curves are attractive to a buyer because the price rises more slowly above the upper pivot point, which helps to maintain the buyer’s onsale margin when the nominated fuel price is high. Equally, they are attractive to a seller because the slower decrease in the price below the lower pivot point will provide comfort to the seller that its revenues will be maintained and it will be able to meet its debts and operating costs even when the nominated fuel price is low.

Potential disputes will arise if changes are made to some element of an index used in the formula or if it ceases to exist, and these clauses will generally include provisions specifying how and on what basis the parties should seek to agree either to amend or replace the index or, in default of agreement, to refer to the issue to expert determination or arbitration. The wording of such provisions can vary widely and, of course, their meaning and effect can also vary depending on their proper construction.

Price reopener clauses oblige the parties to review price when circumstances change (the ‘trigger event’) and set parameters for that review. They are often drafted in general and open terms which give little guidance as to what changes constitute a trigger event, how value is to be measured or how the price formula should be revised to reflect changes. This lack of particularity is often intentional so as to allow, as far as possible, for future unforeseen or unpredictable events and address any situation which may arise over the life of the contract. The corollary, however, is that they are often open to interpretation when unforeseen events do arise leading to disputes as to their meaning and to the relevance or application of underlying market and other factual data.

The financial implications of the outcome of a pricing dispute are usually significant.

Complex price reopener disputes are now more frequent and an increasing number are being taken to arbitration. Typical areas of dispute and uncertainty (which we deal with further below) tend to fall into four categories, concerning:

- whether the trigger event has arisen (or is necessary);
- the definition of the ‘comparator’ or relevant market and the analysis of the relevant change; the methodology for revising the price; and
- the scope of the revisions which the expert or arbitral tribunal can make.

2. Forms of dispute resolution

It is highly unusual for the parties to choose to resolve disputes by litigation in the national courts. Such disputes are by their nature multinational and frequently involve nationally strategic issues which are more suitable for determination either by arbitration or by expert determination. However, there may be scope in some cases for at least the issue of whether a trigger event has occurred to be referred to the courts if the clause is drafted (often inadvertently) in such a way as not to confer jurisdiction on the expert or arbitrator to decide this threshold issue.

2.1 Expert determination

Expert determination is a flexible, confidential dispute resolution procedure that is binding by agreement. It can be highly effective where, at the contracting stage, the parties anticipate a specific type of technical dispute arising in which the expertise of the decision maker is considered to be a critical part of the dispute resolution process. It is also a less adversarial form of dispute resolution and therefore appropriate for a long-term contract where the parties will have an ongoing commercial relationship. It was therefore common to refer indexation disputes to expert determination.

Given the very specific reason why the parties have chosen to refer the dispute to an expert, such expert determination clauses may require the expert to have specific technical or industry experience in the particular subject matter of the dispute. This will normally make agreement on the identity of the expert easier, as it avoids a divergence of opinion between the parties at the time the dispute arises as to the particular expertise required.

Expert determination is occasionally undertaken on a non-binding basis. However, this carries with it a real risk of polarising the positions of the disputing parties, wasting time and costs if either or both parties choose not to be bound by the determination. A further disadvantage is that the primary issue in dispute is often the interpretation of the clause and, if the expert is technically rather than legally qualified, the outcome will be less predictable.

The appointment of the expert, his terms of reference and powers will be governed by agreement between the disputing parties. Many expert determination clauses in long-term contracts do not contain detailed provisions as to the process and usually the parties will draw up separate agreements after the dispute has arisen to appoint the expert (the terms of engagement) and then to set out the agreed procedure in the terms of reference.

2.2 Arbitration

It is rare for price review disputes to be referred to expert determination. Such disputes tend to be under SPAs between parties from different countries, so giving rise to enforcement issues, and where expert determination is not an established method of dispute resolution. Arbitration is also a more formal and regulated method and better suited to resolving legal rather than purely technical issues.

Arbitration offers neutrality and autonomy to the parties in their choice of procedure (institutional or *ad hoc*), of place (so as to ensure a jurisdiction favourable

to arbitration) and of arbitrators (to ensure that they have the right qualifications and background). It also provides the comfort of enabling the parties to select a country which is a party to the New York Convention in order to ensure that the award can be enforced.

Although desirable, arbitrators will not necessarily have specialised knowledge of the relevant gas or LNG markets or of pricing mechanisms and practice in the industry. One frequent complaint made in relation to price review arbitrations is that arbitrators who do not have the relevant technical expertise will avoid a decision which makes any substantial change to the price and will often find what they perceive to be a 'middle ground' which may be unsupported by any clear commercial or economic rationale and which is out of line with industry practice. The constitution of the arbitral tribunal is therefore an important consideration. The appointment of a tribunal of three arbitrators as opposed to a sole arbitrator allows the parties to nominate an arbitrator with relevant expertise in the light of the issues in dispute and to balance the parties' nominations and their expertise with a suitably qualified chairman.

We deal with some of the strategies for managing the risks in price indexation or price review disputes below.

3. Key components of price review clauses

Price review clauses can be structured in numerous ways, but they usually comprise the following elements:

- a 'trigger' event;
- the methodology for determining the price adjustment;
- a process for negotiation; and
- the scope of the price review.

Traditionally, although not always, contracts also provide for a staged approach. First, the trigger event must be established to entitle either party to seek a revision of the contract price. The right to commence a review will ordinarily be conditional on service of a notice which must be compliant with the provisions of the SPA. These generally require a notice to be served specifying, first, the trigger event which it relies upon and, second, the proposed revised price formula and the evidence to support it. There will then be a period of negotiation which, if unsuccessful, will be followed by the determination of an expert or arbitral tribunal. If it is established that a trigger event has taken place, the clause will provide for the price to be revised to reflect the change and the effect that change has had on the value of the gas sold under the contract.

3.1 Trigger event

Price review clauses typically provide for a review to take place automatically at a specified time or at regular intervals during the life of the contract. For example, they may occur on the third anniversary of the commencement date of deliveries under the SPA and on each three-year anniversary thereafter. The advantage of this is certainty, although the specified interval needs to be sufficiently long so as to avoid too frequent reviews which would destabilise the contract price.

Even with frequent reviews, however, the parties may be prevented from adjusting the contract price when the underlying economics would otherwise warrant doing so. In order to accommodate this possibility, clauses may therefore also provide for a 'special' review to take place on the occurrence of a particular change in circumstances. It is also common to limit each party's right to initiate a 'special' price review to a specified number over the course of the contract.

Triggers can be drafted by reference to the occurrence of one or more objective events, such as a fall in a party's rate of return or, most commonly, by reference to benchmark crude price indices, using a formula or ratio so that a change in index will give a right to change the price. Often this is specified as a magnitude of change. However, while the change is in theory easily quantifiable, in practice the operation of these clauses is often sufficiently complicated to generate disagreement. For example, the formula may inadvertently refer to elements which are themselves too vague or unspecific, such as taking 'fuel price data…covering all the competing fuels…in the immediate region'. In some cases, an attempt to achieve certainty may therefore be counterproductive and a cause of greater uncertainty. Objective triggers also need to be considered in the context of the long-term duration of the contract to allow for short-term fluctuations without triggering frequent reviews. That, too, can be difficult to define and can be a source of dispute when considering whether the trigger has been satisfied and also when applying the methodology for adjusting the price.

The level of change required to trigger a price review is often defined in terms which are open to subjective interpretation, such as a 'significant', 'material' or 'substantial' change in circumstances. A relevant change in circumstance may similarly be loosely defined in terms such as a substantial change in 'economic circumstances', 'market circumstances' or the 'energy market of the buyer (or seller)'. Usually, a causal link must be shown. In other words, it will be necessary for the party invoking the trigger to show that the change is affecting the value of the gas or LNG sold under the SPA:

- in comparison with its value and/or with the value of competing fuels in the relevant market; and
- by reference to an earlier, prescribed date.

Needless to say, buyers and sellers usually have very different views on what comprises the 'market' (be it wholesale, industrial or residential), and the relevant market and any market-based test should ideally be defined quite specifically.

Some clauses will specify that the change must also be anticipated to have 'lasting effect' or will exclude 'short-lived changes', in order to avoid triggering a review in response to a short-term fluctuation. Again, however, it can be difficult to define what is short lived and what is lasting in the abstract. Where state-owned entities are involved or a party has market dominance for some other reason, the clause may also stipulate that the market change must not have been induced by the requesting party.

While loosely defined terms allow for a certain degree of flexibility, such terms are inevitably open to interpretation and accordingly provide fertile ground for disputes, such as those concerning the following questions:

- Is there a clear trigger for a price reopener?
- What constitutes a sufficient change in a market?
- What is the relevant market? For example, is the change referable to the end-user market of the buyer's country and, if so, which market sector or sectors? Alternatively, is the clause directed to the market price of imports? Or both?
- What is the effect of the relevant changes in the market on the value of the product sold and purchased under the SPA and what is the causal link between the two?
- What is meant by 'market value'? Is it the same as market price?
- Does the party requesting the price review have any control over the alleged material change in the relevant market?
- Is the change only a short-lived market fluctuation or can it be anticipated to have lasting effect?
- To what extent does the trigger test remain relevant once it is determined that a review has been validly triggered? Is the tribunal required to refer back to the trigger event in deciding how to revise the price formula?

Not all clauses provide for an objective trigger event; rather, the trigger may be subjective and based only on a belief that trigger event has occurred. However, such a belief or opinion could be either objective or subjective depending on the wording of the clause.

Esso Exploration & Production UK Ltd v Electricity Supply Board [2004] EWCH (Comm) 723 is an example of a case where not applying the right trigger also invalidated the notice under the price review clause.

ESB claimed that Esso's price review notice was invalid because Esso had applied the wrong comparator and therefore no dispute had arisen of a kind contemplated by the contract which could be referred to arbitration. Both parties proceeded on the assumption that service of a valid price review notice was necessary for the arbitrators to have jurisdiction and the court agreed.

The contract was for the sale and purchase of certain quantities of natural gas each year for 15 years. In addition to automatic review and adjustment on a six-monthly basis, the parties were allowed to give four price review notices in relation to the energy charge throughout the life of the contract, at carefully defined intervals. Notice could not be given by the seller (Esso) unless "it is reasonably satisfied in good faith that the Energy Charge…is at the time of giving such Price Review Notice eighty five per cent (85%) or less than the Comparator."

The energy charge contained two elements, one of which was a fixed amount expressed in pence per kilowatt hour, whose initial value the parties had fixed by agreement at a level that reasonably reflected the market price obtainable at the date of the agreement for the sale of reasonably similar quantities of gas:

- over a reasonably similar period;
- on reasonably similar terms and conditions;
- between parties of reasonably similar commercial and financial standing; and
- for use in a reasonably similar type of power station in the United Kingdom or Ireland.