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LNG Price Review Disputes

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A. Introduction

Historically, long term contracts for the sale and purchase of liquefied natural gas ("LNG") have been entered into, with such contracts having a duration of 15 years or longer. Such long term contracts give comfort to investors that they will be able to recover the large amounts of capital typically required for the construction and operation of gas production plants, and also provide stability for purchasers by allowing them to commit to purchase a firm quantity of gas which can then be on-sold.

This type of long term contract will typically provide a formula for calculating the price of LNG over the life of the contract, by reference to market factors. Many contracts include in the formula references to the market price of crude oil, thus linking the price of LNG under the contract to the oil market. However, although these formulae attempt to allow for adjustment of the price of LNG in accordance with market conditions, there are inevitable difficulties in attempting to set a price (or price formula) when a contract will last for such a long period.

Accordingly, most long-term LNG contracts also include a price review clause which allows one or both parties to instigate a review of the contractual price formula in response to

unforeseen changes in the market (for example, in recent years, the increasing divergence between gas and crude oil prices).

B. Drafting and interpreting price review clauses

(i) Introduction

There is no "standard" form of a price review clause. Parties will negotiate a clause which suits the particular circumstances of their relationship and transaction.

A general price review clause should be distinguished from other clauses which provide for a review of the price or other conditions of the contract in response to certain issues or events (such as hardship clauses, which allow for a review if a party is experiencing substantial hardship as a result of a significant change in circumstances, and can involve a review of all terms of the contract, rather than just the price; and clauses which address legislative or taxation changes).

In contrast, price review clauses tend to be of a more general nature, and respond to changes in the market rather than dealing with a specific issue. Difficulties can arise in drafting and interpretation given the wide variations between clauses, and the relative paucity of publically available judicial or arbitral decisions.

An effective price review clause will contain the following elements:

• A "trigger" event (or events) allowing for the invocation of the price review mechanism;
• A procedure to be followed in carrying out the price review (including what happens if no agreement is reached); and
• Methodology of the review (including parameters for the amendment of the price formula, and when any amendment takes effect).

A price review will follow a two stage process – firstly, a party must establish that a price review has been "triggered" in accordance with the provisions of the clause, then the parties will determine whether and how a price review is to be effected and through what channels.

(ii) Example price review clause

"a) If the circumstances beyond the control of the Parties change significantly compared to the underlying assumptions in the prevailing price provisions, each Party is entitled to an adjustment of the price provisions reflecting such changes. The price provisions shall in any case allow the gas to be economically marketed based on sound marketing operation.

(b) Either Party shall be entitled to request a review of the price provisions for the first time with effect of dd/mm/yyyy and thereafter every three years.

(c) Each Party shall provide the necessary information to substantiate its claim.

(d) Following a request for a price review the Parties shall meet to examine whether an adjustment of the price provisions is justified. Failing an agreement within 120 days either Party may refer the matter to arbitration in line with the provisions on arbitration of the Contract.

(e) As long as no agreement has been reached or no arbitration award has been rendered all rights and obligations under the agreement – including the price provisions – shall remain applicable unchanged. Unless otherwise agreed or decided by the arbitral award, differences to the newly established price shall be retroactively compensated inclusive of interest on the difference calculated at a rate reflecting the conditions on the international financing market."

(iii) Triggers

A typical price review clause will provide for period or special triggers, or a combination of both.

Periodic

Under a periodic trigger, parties can agree either that the price will be automatically reviewed at certain dates during the life of a contract (ie, every three years) or that parties have the right to elect for a price review to take place at certain milestones. The advantage of this is that the operation of the trigger is relatively simple and thus it avoids disputes as to whether the price review clause has been invoked. However, the mechanical nature of such a trigger means that it does not always deal speedily with market issues affecting the contract.

Special trigger

Parties will often combine a periodic trigger with a special trigger, or include only a special trigger, which allows parties to respond more quickly to changes in the market.

A price review will be triggered where the following conditions are met:

• Circumstances have occurred outside the control of the parties;
• Which have induced a significant or material change in the market; and
• Such changes were unforeseeable.

A trigger needs to be general in order to catch as many as possible of the circumstances which may have a substantial impact on the price, and thereby make the clause effective. However, such generality can also lead to difficulties in interpreting and establishing whether the trigger has in fact been invoked.

Significant/material

Particular difficulties are experienced in determining whether there has been a "material" or "significant" change in the market. However, dealing with this at the drafting stage can reduce the disputes arising from this, for example, by considering whether an objective or subjective test should be employed, and whether benchmarks should be included to assess whether a change is material or significant (ie, link changes to external criteria, such as indices (retail price index/inflation), prices (oil/gas) or actual costs (overheads, transportation costs, etc)).

Definition of "market"

Clearly, in order to establish whether there has been a "significant" change in the market, it is necessary to define precisely what constitutes the relevant "market" for the purposes of the contract. This may be by reference to geographical location, user or some other factor.

The importance of doing so was highlighted in *Gas Naturals v Atlantic* (discussed further below) in which the supplier sought a price review on the grounds that while the contract provided for two geographical markets, the purchaser was only supplying to that market which commanded the higher price. In that case, contrary to the submissions of the parties, the arbitrators imposed a revised two-part pricing scheme which catered for both geographical markets.

Requirement for comparators

One area that is often overlooked at this juncture is the use of comparators, which will often require expert evidence. Establishing whether there has been a significant change in the market will require comparison of the present circumstances with a historical period – whether this is the date of entry into the contract, the last price review, or some other agreed date. However, simply taking a snapshot of the circumstances on one date will often not be sufficient as it is unlikely to be representative of the period as a whole. A more accurate picture will be derived from looking at a spread of dates, and using the average as a comparator. Unless this is agreed in the contract, deciding which period and spread of dates is to be used can lead to disputes.

(iv) Procedural requirements

A typical price review clause will normally provide the parties with a period of time to come to an agreement on the price review between themselves, and if no such agreement can be reached within that period (usually set at six months), the dispute will be referred to a third party for a decision. A price review clause may also include a requirement that the parties engage in mediation or another form of alternative dispute resolution; however, they will almost never provide for recourse to litigation (although parties may seek to challenge an award of an arbitrator in the courts).

While attempts to resolve any dispute over a price review through non-contentious channels are to be encouraged, parties should ensure (particularly where a contract provides for periodic reviews) that such processes cannot and do not take up such time that a reluctant party can drag the process out until the next periodic price review milestone.

Parties should also note that the enforceability of a requirement that parties should negotiate and attempt to reach agreement on a revised price structure will depend on the governing law of the contract. Very few legal systems will in fact uphold such an "agreement to agree".

Expert v arbitrator

The majority of disputes which cannot be resolved between the parties will find themselves being resolved in arbitration.

While there are some good reasons for a price review being conducted by an expert (not least on the basis that the process can be quicker and cheaper, and an expert will normally have the

requisite knowledge of the industry and market), parties will generally prefer that disputes are referred to arbitration, not least for reasons for enforceability of any award.

Any arbitral tribunal considering a price review clause will firstly have to establish whether the trigger provisions have in fact been satisfied; and if so, the extent of their powers in arriving at a revised price formula.

During the course of an arbitration, expert advice will often be used extensively, particularly in establishing review has been triggered, and the existence of a significant/material change in the market.

(v) Methodology

Finally, an effective price review clause will set out the basis on which a review of the pricing formula should take place, and in particular, whether there are any limits on the nature or provisions of any revised pricing formula. Where a price review clause is kept deliberately vague, this can lead to unexpected (and perhaps unwanted) results for the parties (see, for example, the decisions in *Gas Naturals v Atlantic and RWE v Gazprom* (discussed further below)).

The imposition of guidelines or limits is of greater significance where a dispute is referred to arbitration (or another form of dispute resolution) for determination by a third party. At the time of drafting the contract, parties may well consider it prudent to include parameters and limits on the power of a decision maker to revise the existing pricing formula.

Parties should also consider the date on which a revised price structure should take effect – whether this would be from the date of notification that a price review is required, the date of decision, or a date relating to the market changes.

C. Judicial and arbitral authorities

As set out above, disputes in relation to price review clauses are generally dealt with by way of confidential arbitration, especially given the significant amounts of money at stake. However, in recent years, some of these cases have been considered by the English and New York courts following challenges to the arbitration awards, which have opened some disputes up to limited scrutiny.

(i) Gas Natural Aprovisionamientos, SDG, S.A. v Atlantic LNG Co of Trinidad and Tobago, 2008 WL 4344525 (S.D.N.Y. Sept. 16, 2008)

In a decision handed down by the United States District Court (Southern District New York) on 16 September 2008, District Judge Cote confirmed the arbitration award handed down in a price review dispute between Gas Natural and Atlantic LNG, and rejected Atlantic's motion to vacate the arbitration award.

The dispute arose out of a 20-year contract for the sale of LNG between Atlantic, as the producer of the LNG, and a Spanish company which was Gas Natural's predecessor. The contract specified that Gas Natural could transport the LNG to its receiving facilities in Spain or to a facility in New England. Although Gas Natural had an unlimited right under the contract to transport its deliveries of LNG to New England, at the time the contract was

drafted, the parties expected that the LNG would be consumed in Spain, and thus the pricing formula specified in the contract was tied to the European energy market.

The contract contained the following price review clause:

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

Following entry into the contract, Spain's natural gas market was substantially liberalized and Spanish gas prices decreased. Accordingly, the New England market became more attractive and Gas Natural entered into a long term agreement to resell all of its LNG to New England and at the time of the decision, had not delivered any LNG to Spain since at least October 2002. On 21 April 2005, Atlantic notified Gas Natural that it was seeking a revision of the contract price. Following a failure to agree, the dispute was referred to arbitration in accordance with the terms of the contract.

In the Final Award handed down on 17 January 2008, having determined that the requirements for a price reopener had been met, the Tribunal instituted a two-part pricing scheme – first preserving the Spanish pricing formula contained in the contract but revising its base price component; and secondly adding a "New England Market Adjustment" for quarters in which more than a percentage identified in its decision of the LNG is resold for delivery to New England. This pricing scheme was made effective from April 21, 2005, the date on which Atlantic notified Gas Natural that it was seeking a price reopener, and resulted in a payment by Atlantic to Gas Natural of over $70 million for the period from April 21, 2005 through December 31, 2007.

In this case, the imposition of a pricing structure was seen as a particularly significant step – after the Tribunal had found that the trigger provision had been satisfied, it went on to impose its own preferred pricing structure, which neither of the parties had requested in its submissions or approved. This award illustrates the consequences of giving arbitrators a free rein to conduct its own price review in the absence of parameters agreed by the parties.

(ii) Esso Exploration & Production UK Limited v Electricity Supply Board [2004] EWHC 723 (Comm)

On 31 March 2004, the English High Court handed down its decision in *Esso Exploration & Production UK Limited v Electricity Supply Board* [2004] EWHC 723 (Comm), in which the High Court rejected a challenge by the ("ESB") to an arbitrator's jurisdiction.

On 27 November 1997, Esso and ESB entered into a contract for the sale and purchase of natural gas each year for a period of 15 years from the date when deliveries began (which was 1 October 1999). The contract contained a price review clause, and a dispute arose between the parties as to the meaning of that clause. Esso sought to refer the dispute to arbitration, but ESB challenged the arbitrators' jurisdiction on the grounds that certain prerequisites to a valid reference to arbitration have not been satisfied. The matter comes before me by way of an application by Esso for a declaration that the tribunal has jurisdiction to determine the dispute. It is made under section 32(1) of the Arbitration Act 1996 with the consent of ESB.

The contract provided that the price was to be reviewed and adjusted every 6 months by reference to four markers: (i) the price of gasoil (ii) the price of low sulphur fuel oil, (iii) the price of natural gas and (iv) the rate of inflation in Ireland as reflected in the industrial wholesale price index. In addition, a further clause allowed the parties to give Price Review Notices requiring a separate review – a Price Review Notice could not be given by the seller 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 "Comparator" being defined as the market price at the date of the relevant Price Review Notice for natural gas being supplied.

In November 2002, Esso wrote to ESB requesting a review of the Energy Charge, which was rejected by the ESB on the basis that Esso had based the market price on the price for 12-month contracts rather than long-term contracts. As the parties could not agree, arbitrators were appointed. ESB challenged the jurisdiction of the arbitrators on the grounds that as Esso's market price calculation was flawed, the price review notice was invalid and the therefore the arbitrators lacked jurisdiction. In an application to the English High Court, Esso argued that confidentiality obligations in long terms contracts meant that the parties were aware that obtaining such market information would be difficult, and accordingly a market price such as the one Esso had used was appropriate. Mr Justice Moore-Bick rejected this argument, holding that the arbitrators did not have jurisdiction and dismissing Esso's application.

(iii) RWE v Gazprom (ICC Arbitration)

On 27 June 2013, an ICC Arbitral Tribunal partially upheld RWE's claim to adjust the contract price formula in its long term contract with Gazprom Export.

As is to be expected in such a case, full details of the arbitration, and in particular, the contract at issue, the submissions of the parties and the actual award, are not publically available.

However, a press release issued by RWE provided significant details of the award. In particular, the press release stated *"In its final award, the tribunal awarded RWE a reimbursement for payments made since May 2010 and adjusted the purchase price formula of the contract by also introducing a gas market indexation, which according to the arbitral tribunal reflects the relevant conditions on the gas market at the time of the price revision in May 2010."*

The contracts have not been seen by parties outside the arbitration, and it is possible that the amendment was made on the basis of terms contained in the contract. However, in the

absence of further information, commentators have described the decision in *RWE v Gazprom* as *"a significant and potentially alarming award, for the simple reason that the parties to the gas supply contract did not agree to link the contract price to gas spot prices: they agreed to link it to oil prices, for better or for worse."*

(iv) Recent arbitrations

There have been an increasing number of arbitration cases over the last few years concerning gas price reviews. In the majority of cases, the details of the dispute and relevant documentation have been kept confidential, and therefore little information is available is publicly available.

Notable cases include those between gas suppliers such as Qatar's RasGas, Russia's Gazprom (and subsidiary Promgas), Norway's Statoil ASA, Algerian Sonatrach, and the Netherlands' GasTerra and gas importers like Edison, Eon, Distrigas and Endesa.

Edison

• Edison has commenced a number of gas price review arbitrations against various suppliers, with a number of challenges resulting in a favourable adjustment to the contract price.
o In 2011, Edison successfully challenged Russian gas export monopoly Gazprom to reduce the cost of long-term gas supplies for 2 billion cubic metres.
o In September 2012, Edison, which is owned by France's EDF, won in arbitration a 450 million euro discount on its LNG supplies from Qatar's Rasgas.
o In October 2012, Edison won a dispute with Eni to review the price of its long-term gas contract from Libya, its second gas arbitration victory in less than a month. In a statement, it said that the overall impact on its 2012 accounts was estimated at more than 250 million euros.
o On 23 April 2013, the Court of Arbitration of the ICC (International Chamber of Commerce) decided the award related to the dispute between Edison and Sonatrach for the revision of the price of the long term gas contract from Algeria, finding in favour of Edison. The price reduction will have an overall estimated impact of about 300 million euros on Edison's 2013 EBITDA.
o In July 2013, it was reported that Edison had filed an arbitration claim against Gazprom's unit, Promgas, after seeking price revisions since 2012.

Eon

• In July 2012, Russia's Gazprom agreed to amend long-term supply deals for Germany's EON in July after the utility lost hundreds of millions of euros on contracts linked to oil prices.

Rasgas

• RasGas is still in arbitration with Distrigas over oil indexation of gas prices in their SPA contract.
• RasGas entered into arbitration with Spanish utility Endesa S.A. in July 2012 over oil indexation of gas prices in their SPA contracts.

GasTerra v Eni

• In 2007, GasTerra requested arbitration following failed negotiations with the Italian company Eni. GasTerra was of the opinion that it was entitled to increase its prices for gas supplied from 2006 on, based on market trends for the period from 2003 to 2006. Two arbitrations were commenced under the ICC and UNCITRAL rules.
• In September 2012, the UNCITRAL tribunal awarded GasTerra a price increase worth approximately EUR 850 million, which also applies to future deliveries under the contract. The dispute between the ICC tribunal continues.

D. Future Trends

(i) Supply and Demand

In 2012, LNG trade fell by 2% after rising continuously for 30 years. A weak European market, and reduced exports, has been accompanied by an increased supply of LNG to Asia, and particularly Japan, where LNG is making up for the power generation gap caused by the Japanese nuclear situation. Suppliers are realising that they can command higher prices for LNG from Asian markets, where prices are linked to oil, rather than in the European markets.

However, new supply regions are likely to impact on the supply/demand balance in future years. In particular:

US/Canada shale gas: The discovery of large deposits of shale gas in the US and Canada is likely to have major consequences not only for North America (which will transform from a LNG-importing region to an LNG-exporting region), but for the global market.

Iran: Iran's South Pars gas field (an extension of Qatar's North Field) is reported to be the world's largest. While the imposition of sanctions by the US, UN and EU have hampered development of Iran's facilities, and resulted in the departure of multinational companies from the country, it is likely that the recent improvement of relations between Iran and the West will result in increased investment and interest in the country and its gas reserves. In August 2013, Iran signed a gas supply agreement with Oman that Iran's energy minister valued at $60 billion over 25 years.

Australia: Australia is currently the third largest producer of LNG in the world (behind Qatar and Malaysia). It has more plants under construction than any other country which will significantly increase its production, although there are reports that the spiraling cost of building such plants (for example, Chevron has reported that its Gorgon LNG project had seen costs rise from an initial estimate of $37 billion to $52 billion) may lead Australia to delay, cancel or scale down its proposed plans.

Floating LNG terminals: New advances in technology have meant that "stranded" gas fields can now be accessed by floating terminals, which require less infrastructure and are thus significantly cheaper to construct (although have higher operating costs). Royal Dutch Shell is currently constructing the first floating LNG terminal, which is due to come on line in 2017.

Sheikh Khalid bin Khalifa al-Thani, Chief Executive of Qatargas, has stated *"Both producers and consumers are currently in a 'wait-and-see mode' to see how the global supply and demand situation will evolve in the second half of the decade."*

(ii) Decoupling of oil and gas prices

Historically, gas prices have been linked to oil prices. However, in recent years, prices have diverged significantly, in part due to technological developments and increased gas production. While Asia remains (generally) an oil-linked pricing market, Europe is now a mixture of oil-linked and gas-market, and the UK and US have developed gas-on-gas market pricing mechanisms (National Balancing Point and Henry Hub). Asian customers, and in particular Japan which is purchasing massive quantities of LNG, are increasingly seeking to purchase gas at prices not linked to oil in an attempt to reduce fuel costs.

(iii) Emergence of spot market

As discussed, historically LNG supply contracts have been entered into on a long term basis; indeed, such arrangements were required in order to guarantee a return on the large capital investment need to construct the required facilities and infrastructure. However, supply agreements are now more frequently being entered into on a spot or short-term basis, with the International Group of Liquefied Natural Gas Importers reporting that the proportion of cargoes being traded on such a basis has risen from less than 5% in 2000 to 25% in 2012. The spot market boom has mainly been driven by purchases from the UK and Asian countries such as Japan, Korea, Taiwan and China.

Increasingly, companies are seeing the value of putting in place Master Agreements (which contain all the terms relating to LNG supply without any obligation to purchase or sell), and executing transactions by way of a Confirmation Notice (the form of which is usually provided as an annex to the Master Agreement).

While the emergence of a spot market is of benefit to purchasers, who are attracted to its flexibility to respond to changing circumstances and to arbitrage prices between LNG markets, it has raised concern amongst suppliers – without long term contracts guaranteeing the future sale of a guaranteed quantity of LNG, investors have less security that their investment into new production facilities will be returned.

E. Conclusion

It is clear that the LNG market is going through a period of significant development on both the supply and demand side, which will make it difficult to predict with any certainty pricing trends and market requirements in the coming years and decades. Purchasers and suppliers entering into long term agreements for the supply of LNG are advised to ensure that price review clauses are drafted carefully to minimise their exposure.

10th December 2013