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The international journal of commercial and treaty arbitration
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Gas price reviews: is arbitration the problem?

6 March 2014

A series of recent, high-profile gas price review arbitrations have led to big successes for buyers but will this trend turn suppliers away from arbitrating their price reopener disputes? **Richard Power**, head of oil & gas disputes at Berwin Leighton Paisner in London, considers what suppliers can do to get the most out of such cases.

In November 2013, Italian oil and gas group Eni claimed up to US$10 billion from Norway's Statoil in a price review arbitration concerning a long-term gas supply agreement. This is the latest in a line of high-profile, buyer-driven gas price review arbitrations, sparked by the 2012 Edison v Rasgas and Edison v Sonatrach arbitrations, and last year's RWE v Gazprom Export award.

Most gas supply agreements contain a mechanism for determining the contract price for the supply of gas, usually by reference to various specified factors. Gas supply agreements also normally contain price review mechanisms to deal with changes in circumstances over the contract term. When triggered, these provisions require the parties to attempt to renegotiate the contract price to reflect those different circumstances or, failing agreement, to refer the request for a price review to arbitration.

Oil linkage and the new wave of price review arbitrations

Many gas supply agreements, particularly older ones, link the contract price for the supply of gas to oil prices. This is for historical reasons: gas was not easily transported and there were few spot- and forward-markets for the trading of gas, to which the contract price could be linked. Natural gas was often extracted along with oil, so its extraction and infrastructure costs would be similar to those for oil, which had more mature market pricing indicators; and tying the gas price to oil made it competitive with a competing alternative product.

The problem with such linkage is that the gas market has transformed over the last 20 years, with gas trading hubs such as the National Balancing Point, a UK-based virtual trading platform, or the Belgium-based physical trading hub at Zeebrugge coming to the fore. The boom in shale gas, primarily in the US, has also eroded the link between oil and gas production, with better facilities for liquefied natural gas (LNG) export and import providing more liquidity in the gas market. Consequently, gas supply agreements that link the contract price to oil prices risk departing significantly from the real market conditions affecting the parties. Over the last few years, that is exactly what has happened – European spot gas prices have fallen relative to oil prices, but buyers are still tied into lengthy and expensive gas supply agreements.

As a result, an increasing number of buyers have triggered the price review mechanisms in their gas supply agreements and sought to renegotiate the contract price by disconnecting it from the oil price. Some suppliers have been sympathetic; others have dug in their heels and taken the dispute to arbitration, perhaps confident that the wording of the contract required that, whatever else changed, price was to be determined by reference to oil prices.

Edison and *Gazprom*

The first sign that this confidence in the wording of their contracts might have been misplaced came in 2012, when Italian utility company Edison obtained awards of around €350 million from LNG supplier RasGas, and a similar amount from Algeria's Sonatrach, following gas price review arbitrations. Although the awards remain confidential, in each case the tribunal severed the oil price linkage in the gas supply agreement and awarded Edison substantial rebates on the price that they had been paying pending the award.

The industry also detected a more general willingness among tribunals to depart from the parties' bargain following the RWE v Gazprom Export award in June 2013. In that case, an ICC tribunal partially upheld RWE's claim to adjust the contract price formula by removing the link to the oil price and substituting a link to gas spot prices. The tribunal also awarded RWE compensation for the resultant overpayment made since May 2010.

It appears that the trend is continuing: reports indicate that Eni has commenced arbitration against Statoil and is defending an arbitration brought by Edison. Meanwhile, Edison has also commenced arbitration against Gazprom. It is difficult not to connect this rash of new claims with the recent Edison and Gazprom awards.

The consequences of the awards

To the supplier – usually the party which has invested in the production and transmission of the gas – the uncertainty caused by these awards makes arbitration less appealing and shifts the balance of power in negotiations to the buyer.

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Without seeing the contracts or the awards, it is impossible to draw too many (safe) conclusions from these cases. However, on the face of it, they are alarming for suppliers - the parties 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. If this penalises one party, that should in itself be irrelevant, unless the contract provides for this link to be broken in certain circumstances, or the tribunal has been given the power to depart from the contract. In most legal systems the concept of pacta sunt servanda (that contracts should be performed as agreed between the parties) is key, even if it produces an "unfair" result.

Perhaps the gas supply agreements in the recent cases provided for severance from the oil price link in the particular circumstances, or maybe the parties' conduct was such that their bargain was deemed to be amended, or the suppliers were estopped from relying on its terms. It is possible that the awards are based upon a mandatory principle of the governing law that renders certain terms unenforceable if, for example, they result in an unequal position or unreasonable hardship for one party. It may be that the arbitration clauses gave the tribunals wide jurisdiction, e.g. to render an award ex aequo et bono, or to decide what agreement the parties should have arrived at if their negotiations had continued. However, in the absence of such factors, it is difficult from the suppliers' perspective to see the justification for departing from the terms of an agreement, particularly if that could have a significant impact on the parties' ongoing relationship.

Is arbitration the problem and, if so, what is the answer?

Arbitral tribunals tend to be more commercially oriented than courts of law because of the arbitrators' disparate legal backgrounds; the flexible procedures and rules of evidence adopted; greater informality of proceedings; and limited scope for an appeal on points of law. So to the extent that there is a problem with uncertainty, arbitration is probably part of the problem.

Turning away from arbitration is not the answer for gas suppliers. National courts will often take longer to hand down judgments, and there are the usual concerns about neutrality (especially when dealing with nationalised and quasi-nationalised entities) and cross-border enforcement. Expert determination is superficially attractive as it encourages the appointment of an industry expert. However, it can lead to more uncertain and legally questionable decisions, which are challengeable on very limited grounds. A refusal to abide by an expert's determination will usually have to be enforced by a claim for breach of contract, rather than being able to take advantage of the New York Convention.

So the answer is to keep arbitrating, but give more thought to the price review mechanism and, in particular, the arbitration clause. Specifically:

- Arbitrators gain their jurisdiction from the arbitration agreement, so if it is made clear that their scope to depart from the contractual formula is limited or non-existent, an award that disapplies certain criteria will be subject to appeal or challenge against enforcement.

• The arbitration clause can expressly exclude the right to render an award ex aequo et bono.

• One can limit the arbitrators' scope for making their award by specifying "high-low" or "baseball" arbitration. In the former, the award will bind the parties unless it exceeds an upper limit (for example, the lowest price which the seller was willing to offer in the renegotiation process) or is less than a lower limit (for example, the highest price which the buyer was willing to offer in renegotiations), in which case the award will be at the relevant limit. In the latter, the tribunal must simply choose between the parties' respective positions at the conclusion of the renegotiation process. The tribunal cannot split the difference or select an alternative position.

• Choosing a governing law that does not recognise hardship or inequality of position as a ground for amending a contract, or that holds pacta sunt servanda as sacrosanct (for example, English law) reduces the likelihood of the tribunal being able to find a legal justification for departing from the parties' bargain. In this regard, it should be noted that article 79 of the UN Convention on the International Sale of Goods provides for excuse of non-performance as the only remedy for unforeseeable change of circumstances causing hardship for a party after entry into a contract – so thought should be given to whether (as is common) this Convention should be completely excluded from the gas supply contract.

• Consider allowing for the award to be appealed to a national court on a point of law. The sums at stake are so huge that the additional layer of cost of an appeal is worthwhile. Parties can specify that they will have input into or control over the identity of the party-appointed arbitrators, rather than leaving it to an appointing institution. One can then research the backgrounds of potential appointees and select an appropriate arbitrator who is less likely to depart from the specified contractual formula.

So, it is boom time for gas price review arbitrations. Current trends are good news for buyers, but suppliers can reduce the uncertainty they now face by giving more thought to the price review mechanisms they include in their gas supply agreements. When billions of dollars are at stake, ensuring the arbitration clause is right from the start has never been more crucial.

This article was first published in the Global Arbitration Review online news, 6 March 2014
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