The client's perspective

Tristram Kennedy Harper
Shell International Trading and Shipping Company Limited (Shell Trading)

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1. Introduction

In this chapter, we examine the development of price review clauses, and the issues that arose, through to their current form, which means that there is now a wide variety of tools to address gas price review claims. We discuss the different approaches available to contemporary price reviews, including tactics and potential solutions, and best practice for an organisation and its in-house counsel to adopt to ensure that the outcome is one for which it is prepared.

2. The origins of price review clauses

In the early days of the North Sea gas industry, the only way for upstream suppliers, typically operating in consortia, to underpin their initial investment in developing gas fields was to enter into long-term gas sales agreements (ie, for periods up to 25 or more years). The North Sea gas industry was nascent, and many upstream suppliers were not able or willing to make the investments themselves, so the typical source of capital was bank finance. The banks required reliable long term income streams to ensure that the projects were able to repay the money being lent: long term sales of gas dedicated to monopsonistic buyers in geographically separated markets suited this requirement.

Given the new market for gas in Europe, the buyer of the gas wanted to ensure that it could sell the gas to customers. Although it had a monopoly on supply in its geographic area, it had to be able to compete against other potential energy sources such as coal or oil. It wanted to ensure that the price it paid the upstream supplier for the gas was competitive. At the same time, the upstream supplier wanted to receive a price for its gas that produced the highest revenue possible.

The mechanism to ensure that both parties' aims were met was twofold:

- linking the monthly gas price to prices of other energy sources (which varied monthly) and therefore tracked those prices: and
- including a price review mechanism for unexpected changes in the market, enabling the price to be reset against any new market base forces.

The initial price agreed would have been (at least) implicitly between the parties agreeable, who were freely able to negotiate and understand the economic risks of the agreement, and enabled the gas to be marketed economically by the buyer.

The price review mechanism used in these contracts dealt with changes in obtainable value of gas that were not captured by the dynamic change in the pricing

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clause. The mechanism evolved from the 1960s agreements in place for the sale of gas from the Dutch Groningen gas field. These were refined into a more or less industry standard during the exploitation of the Norwegian Troll gas field in the 1980s. As the sales were organised through a centralised committee, all producers and the Norwegian government sat in on negotiations, and at the same time buyers organised consortia for negotiating with the Norwegian sellers. This meant that a standardised form of agreement was used, including its price review wording. Even after 2001, in the aftermath of the European Commission's intervention in respect of the consortia's breach of the EU's competition rules, the wording remained and became used in gas sales from other suppliers, such as from Russia and other sources.

3. Flexibility of language

Therefore, the European gas industry had a 'standard' form of wording for price reviews, the wording of which was deliberately accommodating. It suited both buyer and seller – in different price review periods, the buyer might seek a price reduction or, under different economic circumstances, the seller might seek a price increase; and less prescriptive wording enabled the words to apply in most circumstances. In addition, as it was not possible to foresee all changes of circumstance (otherwise they would be reflected in the original pricing discussion), the wording of the clause needed to be flexible enough to cover a wide range of possibilities.

This is not to say that there was no negotiation of price review clauses in new contracts. Indeed, as parties' experience of operating under price reviews increased, their approach developed and, depending on whether the party approaching the negotiation was a buyer or seller, the model wording offered was different.

But the standard model is still relevant today, whether because its operative provisions continue in existing long term gas sales agreements or whether the provisions act as a standard for the wording of new contracts.

It could be suggested that the wording of price review clauses has been undervalued in the past, and the focus of negotiations has not been on these clauses. Thus, their importance and potential future impact has been underestimated, and it has not been recognised that mistakes made in drafting these clauses can have an effect over the whole contract life, in some cases for up to 40 years.

It is also possible that the clauses were ignored to an extent. In a number of European markets the question of price reviews, although raised, was seldom a contentious issue. Solutions were reached through commercial negotiations, not through strict observation of the contractual language and contractual mechanisms.

However, in recent years, the amount of money involved has become so significant that parties are more focused on the price review clauses and their wording, and resulting disputes have had much more legal input and direction.

The result is that parties cannot afford to underestimate the importance of wording in clauses, as many disputes may end up in a legal forum for resolution, and the tribunal or expert determination will need clear language in order to make awards consistent with the objective purposes and intentions of the parties involved.

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Example 1: An example of the negotiation on meaning in price review language

In the 1990s and into the 2000s, buyers and sellers debated whether gas-to-gas competition was included in the words 'change in economic circumstances'.

Buyers sought to include the following into price review clauses:

If the economic circumstances, including, without limitation gas to gas competition, … in the market of the Buyer … should change significantly compared to …

Another issue concerned the place in which the change of circumstances occurred. Buyers sought to define this as the 'market of the buyer' in order to cover any territory in which the buyer currently sold gas, whereas sellers sought to restrict this to the country in which the price was originally set – to avoid taking price risk for markets that the buyer chose to sell into later.

Sellers would propose language like this:

If the economic circumstances in the country of the Buyer*, which are beyond the control of the Parties, should change significantly …*

The counterbalance to this proposal is that the seller may prefer broader geographic scope if it expects the buyer to sell into the highest price market available; and a buyer may prefer a more limited scope if it does not intend to market/use the gas elsewhere.

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4. Evolution

By the mid-2000s, as access to transportation infrastructure became available and market restrictions were being removed, the real impact of deregulation of the European gas market began to be felt. Parties with existing positions in the gas market were able to realise additional value around the longer term gas supply agreements. The ability to source or supply gas outside the traditional trading partnership had value, and the ability to transfer gas from areas of oversupply to areas of demand had an arbitrage value. In addition, the emerging hub trading facilities offered pricing but, given the low levels of liquidity, they again provided an arbitrage opportunity. Shrewd buyers and sellers began to trade off the back of the existing supply agreements, and these separate arrangements were generally of a short term nature.

New contract forms developed, and for these shorter term agreements, typically for less than one but up to three years in length, the commercial drivers were to avoid the typical drawn out nature of price reviews. Furthermore, given the short term nature of the agreements, the parties agreed to not include any price review mechanism as they were confident that there were few potential unforeseen events that would undermine the agreed pricing mechanism in the period of supply/sales. Or, if price review mechanisms were included, they tended to be detailed and specific in nature, as the events concerned were thought to be predictable, although the effect on pricing was not.

5. Some lessons learned for the future

For parties who had both sales and supply contracts, the lower risk solution in applying price review clauses was to ensure that the price review wording was the same in both the purchase and the sale contracts. Thus, if a buyer of gas was also

selling gas and it received a request from its seller to increase the price, citing economic changes which had increased the value of gas in the buyer's market, the buyer would seek to pass on its cost increase to its own buyers by requesting a price review on its sales contracts, citing the same set of circumstances. It would therefore not be left squeezed in between an increase in costs which it couldn't pass on to its buyers, but also note that unavoidably the inherent risk remained that the negotiated settlements or adjudicated awards would not necessarily be identical.

Another determining factor in successfully negotiating price reviews was to ensure that the teams involved in the negotiation (and the wording of the clauses initially) were the best available. Further, the individuals involved needed to understand how the selected dispute resolution process would work in practice, so that the process would deliver what was expected later on. Otherwise, there could be a mismatch between the deal the parties thought they had negotiated and what they actually signed up to.

This important combination – understanding the nuances of wording in the price review clause and the skills in applying them to the facts at hand – ultimately drives an organisation's ability to establish its case logically and evidentially. So, this means that the economic evidence must also to be as robust as possible, and engaging suitable experts at an early stage (at the negotiation stage, before any formalistic legal dispute resolution process) is a key element in increasing the chances of a successful outcome for the party concerned.

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Example 2: Some simple 'dos and don'ts' in drafting and negotiating price review clauses

- Do make sure the trigger and measurement language is broad and flexible, and not too specific. Otherwise, the trigger may never be achieved; and the discussion should be focussing on the substantive merits of the claim, not whether the trigger was valid.
- Do have simple and easy to measure/calculate items in price review clauses. It will not be easy to establish the price review claim if they are difficult to measure or prove. For example, it can be difficult to get the parties to attribute changes in value to specific changes in circumstance.
- Do ensure that the clause can address structural change in the market. For example, a review calculated on a change between the contract price and a price benchmark may not capture events which have an effect on value (such as changes in sales methods or development of alternative price sources).
- Don't make the language and mechanism too complicated, as this will increase the chance of the mechanism failing or ambiguities arising, which may lead to unnecessary disputes.
- Don't forget to consider how the price review clause fits with the pricing clause itself. And ensure that the pricing clause itself does not create a barrier to calling price reviews.
- Don't presume that the same wording will be useful to apply to any contract in any market.

6. Why call for a price review?

The buyer's and seller's positions may be different in the consequent negotiation, but we are presuming that, when either party calls for a price review, they are seeking a review and change of the existing contract price. It is possible that a party may have another motive, such as the termination of the existing agreement or an extension of certain terms (or of the whole agreement), and the options they will be considering from the outset may be very different from the standard position in a price review – these other negotiation tools/tactics are considered later.

However, generally, the price review clauses are used by both the seller and the buyer over the duration of the contract, although perhaps with a greater focus and emphasis than they had in the past, for the reasons highlighted above – that is, the money involved has become so significant and parties are relying more on the legal options available under the contract itself.

7. The position of the party calling a price review

Before calling for a price review, a party will look at combined effect of its contractual terms and the context in which the price review clause sits. It may look at other contracts with the same counterparty to see whether there are synergies to bring into the negotiation (eg, same pricing for different contracts) or areas of distinction that it wishes to maintain (a slightly different time period for review may mean that different pricing is appropriate), and it will look at the operational aspects of the existing agreement. Are there other areas that the party wishes to bring into the negotiation at the same time, for example, problems in nomination times, changes in delivery points or accrued levels of make-up gas?

There may be other outstanding claims under the contract, problems with payment (or a desire to introduce provisional billing for its proposed price change), or a range of other non-contractual issues that can also be brought into the negotiation.

These will all be considered from a value perspective – that is, what the value of obtaining the various changes would be, and whether it is worth including any/all of them in the ensuing negotiation.

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Example 3: A party (through its affiliates) has two different contracts for gas supply

(1) Sale – from Norwegian supply to a European market at a fixed delivery point to a specific seller (including arrangement of delivery).

(2) Purchase – from the same counterparty, for the same Norwegian supply, into a different country at a virtual point.

Differences in the contracts:

- duration – (1) is until 2029, (2) is until 2018;
- volumes – sell more under (1) than purchase under (2);
- tax regimes of the affiliates is different for sale and purchase;
- governing law is different;
- price review periods are different;