# Kluwer Arbitration Blog

## Oil Price Volatility: The Effect on Gas Pricing Disputes

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The phenomenon of "price review" and "price reopener" disputes – whereby a party seeks to adjust the pricing basis under an existing long term gas sales contract – has for a number of years been the subject of lively discussion in energy and arbitration circles. As participants at the GAR Live Energy Disputes event (held at Clyde & Co's London headquarters in May) appeared to agree, the lower market, particularly if it persists is likely to affect buyers and sellers in new ways.

Two short to medium term impacts seem likely: the first upon those already involved in gas pricing disputes, the second on sellers who now feel aggrieved that their oil-linked gas is being sold too cheaply. Meanwhile global demand for gas continues to increase, which is likely to feed market volatility – and provoke further pricing adjustments – over the medium to long term.

**Background**

Global natural gas consumption has risen quickly over the past 35 years; however the contracts under which it is bought and sold have been slower to change. Unlike oil, natural gas prices still show considerable regional variation. At the time of writing, the price of natural gas at a major US pricing point, Henry Hub, is about US$2.80/MMBtu. In Europe it is nearer US$7/MMBtu, while cargoes in Asia are presently changing hands for only slightly more, having fallen (along with oil prices) from a high of around $18/MMBtu in the middle of 2014.

One reason for these disparities is historical: in Asia natural gas is typically sold under long-term contracts indexed to oil prices. In the US, particularly with the advent of shale gas, there is more of a spot market. Over time, oil-linked prices and spot prices have moved apart and, though the amount of gas sold on a spot basis has increased in the past 5-10 years, many long term oil-indexed contracts remain. This has left parties to long term contracts wondering whether they could get better deals elsewhere and has led to a series of high value but typically low profile disputes as buyers and sellers vie to achieve a "fairer" price.

Italian multinational oil and gas company Eni, for instance, has reached agreements with suppliers including Gazprom, Sonatrach and most recently Statoil of Norway which have resulted in significant reductions to the price Eni pays for gas. While Eni was able to reach a deal with Statoil before the appointed arbitration tribunal reached a final decision, fellow Italian company Edison was forced to pursue arbitrations with RasGas and Sonatrach to a final awards in 2012, securing a payout of approximately EUR350m from each.

The pricing disparity has not escaped the European Commission, either: in April 2015 the EC charged Gazprom with market abuse following a three year investigation into allegations that Gazprom was imposing unfair prices through oil indexation. It was reported recently that both Polish and Lithuanian interests have initiated price review proceedings against Gazprom under the SCC Rules.

Against that background, as oil prices fall, those supplying higher cost energy are the most vulnerable. A number of planned LNG projects have recently been cancelled or postponed and the complex technology required for fracking operations, economically justifiable with oil prices in excess of US$100 per barrel, looks less so with prices around US$60. Although the economies of shale are improving, this will necessarily cause some consolidation in the industry and will further reduce shale gas supply.

**Mechanism**

Some contracts have clear price adjustment mechanisms built in, but one should not assume that the financials of contracts without an obvious price re-opening mechanism are set in stone. For instance, parties have successfully negotiated pricing changes on the basis of hardship clauses which either excuse performance – effectively forcing a renegotiation – or provide for the parties to agree a rebalancing of the contract's "economic equilibrium" or a "fair" deal. It is also worth checking the governing law of your contract: some countries' national laws have hardship provisions built-in.

Within this framework there can be considerable complexity. What constitutes fairness or economic equilibrium in a particular contract – one which may have been in place for decades and through a number of market movements – is understandably controversial, especially when there are billions of dollars at stake. Choosing the right comparator is also important, as is locating evidence in a small and often secretive market.

An alternative approach is to price the gas such that the buyer is guaranteed a particular margin on the sale, justified by the notion that the seller is taking the price risk, while the buyer takes the volume risk. Sellers, however, typically complain that the characterisation is commercially inaccurate and leads to further unnecessary complications, such as how to calculate the margin and whether it should be assessed by reference to a hypothetical buyer or the buyer under the particular contract.

Parties therefore tend to call upon the assistance of dedicated legal and market experts to help frame the negotiations and to recommend an appropriate tribunal in the event that the dispute reaches arbitration.

**Current arbitrations**

As oil prices fall, so does the price of gas under oil-linked agreements. So, the first and most obvious effect of the drop in oil prices is that those who are preparing for, or are already involved, in a gas pricing dispute may find that they rapidly need to reassess their overall economic position. In some cases, this could cause a complete reversal of position as the party in favour of an upward revision discovers that its counterparty has a good basis for an opposite change in future.

Such changes can be difficult to manage from a strategic point of view and raise interesting questions for counsel and arbitrators: what elements of a party's previous case, for instance, what may and should an arbitrator take into account when deciding a case and to what extent should the parties attempt to build in a mechanism to cope with a possible return to crude prices at US$100/bbl, or above? To what extent can such mechanisms be put in place if not expressly agreed upon or contemplated by the contract?

**Future proceedings**

It is probably still too early to see price review arbitrations being commenced solely as a result of the recent drop in oil prices, as proceedings tend to be based on historical reference periods, so the trigger mechanism in the typical clause will not have been met by the comparatively recent falls. However not all clauses are – and arguably no clause is – "typical" and if crude oil prices remain around the US$80/bbl mark as many predict, a wave of new price review claims from sellers is possible.

Whereas in the past some arbitrators have been driven by a decoupling of oil and gas prices, which buoyed a market move towards hub-based pricing, present oil prices raise the prospect of claims which are, conversely, based upon the influence of hub pricing in a pricing formula being too great. This, some have predicted, will have broader implications on the market and possibly slow the decoupling of oil and gas prices worldwide.

Long term contracts – for a number of years beset by price reviews and renegotiations – can bring a certainty of supply attractive to a net-imported and which allows a seller to take and secure financing for long-term investment decisions. To that extent they appear valued by industry players and will continue to be a feature of the market. However, with uncertainty ahead, parties may be more circumspect about pressing so strongly for pricing formulae which favour hub prices over oil prices, or vice versa, allowing a more measured negation and a "fairer" result. Against that background, some see this as an opportunity for long term contracts to regain some stability and credibility in a market weary of continual legal proceedings. The result will probably see key industry players with a portfolio of long term contracts and spot purchases, with the long term contracts themselves containing a mix of different formulae to try and balance out risk.

Nevertheless, market participants should not be complacent about a new era of co-operation between buyers and sellers and we anticipate that any new disputes referred to arbitration will, especially given the amounts normally in dispute, be hard-fought. Advance preparation – legal and expert – is therefore key, both for those thinking about seeking a better deal for themselves and those who consider they may be vulnerable to such an approach from a customer or supplier. A lack of early preparation can still make a party vulnerable to nasty surprises from better prepared counterparties, changing market dynamics and/or contractually-imposed time limits, with results that can last decades.

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