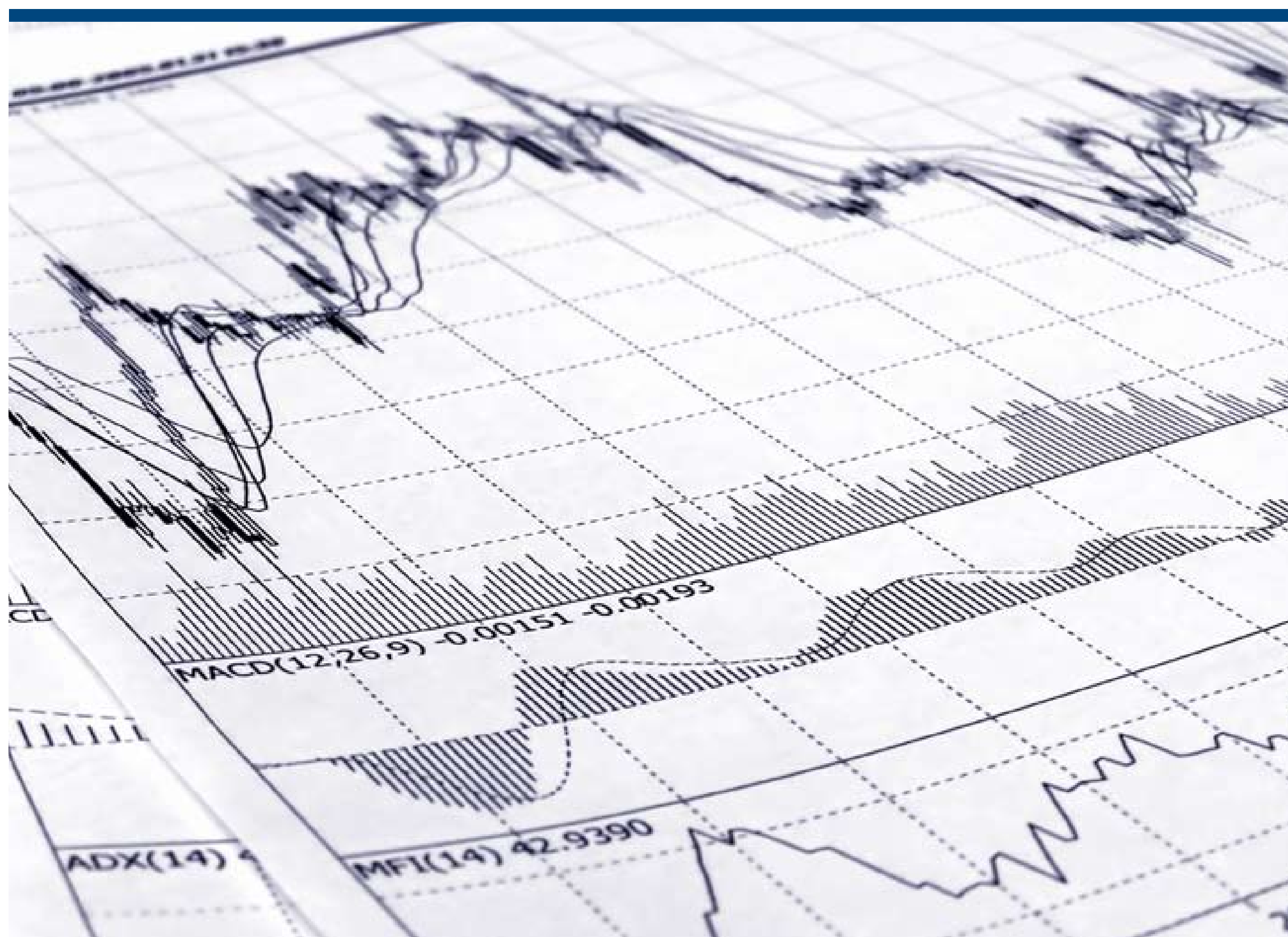
GAS STRATEGIES

Gas Natural v Atlantic LNG: a rare glimpse into price reopener clauses



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Gas Natural v Atlantic LNG: a rare glimpse into price reopener clauses

LNG pricing has become increasingly complex in the Atlantic Basin (a little less so in the Pacific) and already complex price re-opener disputes are both more complex still and more frequent. Many contracts were drafted when the gas markets were closed and few foresaw the changes that have taken place. Indeed, most price re-opener clauses were drafted on the basis of traditional closed markets with no gas to gas competition and no possibility of diversion to other markets. Because the issues were less complex it was unlikely that the disputes would end up in arbitration anyway. This is partly true because price redetermination happens several (often many) years after the deals were done. The question remains: has practice caught up with the changes even in new contracts? Nobody can afford to have really perverse results from arbitration so it will be necessary to sort the problem out.

The rapid expansion and evolution of the global LNG market has led to the development of increasingly sophisticated commercial contracts between energy players. Now, more than ever, securing the correct terms in commercial contracts and having experienced commercial staff to manage the agreements is fundamental to the success of any energy project.

Planning the appropriate scope for renegotiations, strategies for such negotiations and risk assessments of potential contractual interpretations within SPAs can prove as crucial to ensuring the long-term profitability of a project as the pricing mechanisms agreed in initial negotiations. This has been particularly evident over the last few years which have witnessed an explosion of price review disputes, triggered by factors such as the liberalisation of key gas markets and the soaring oil prices in 2007 and 2008.

And, as a New York court case last year over a price reopener dispute between Atlantic LNG Train 1 and Gas Natural revealed, companies can no longer rely on traditional contract structures to guarantee a fair outcome when pricing disputes arise. The case – notable as the first arbitration dispute on a price revision clause in an LNG SPA to enter the public domain – raises critical questions as to the role of price review clauses and their operation in the current LNG market.

“One important issue this case highlights is the way arbitration panels are instructed (or otherwise) to adjust a pricing mechanism,” says James Ball President of Gas Strategies. “What we are finding, particularly in LNG price reviews, is that the market has moved on from the world in which the price review and arbitration clauses were drafted and operated.” Particularly in Europe, “the spiritual home of the price review clause, reviews were expected to be a relatively amicable reapportionment of rent which the parties assumed they would conduct and control every few years, ” Ball adds, “But instead they are going to often fractious arbitration outside their control. So instead of arbitrators tweaking the largely agreed outcome in one party’s favour, they are potentially being handed greater commercial responsibility without clearer terms of reference.” Thus understanding the risk and opportunity this can present has never been more important.

As Ben Holland, a partner at law firm CMS Cameron McKenna, who is currently actively involved in three price review disputes, says “The financial outcomes of price re-openers are often significant, because if even small changes to the price formula in the contract are made, you end up with vast financial implications because of the huge volumes of gas or LNG being shifted over, say, a twenty year contract.”

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TRAIN 1 SPA WITH GAS NATURAL AND PRICE REOPENER CLAUSE

Atlantic LNG Train 1 company, which markets its LNG as a single venture, started production at its first 3 mtpa LNG train at Point Fortin, Trinidad in April 1999 and delivered its first cargo to the Everett terminal in Boston on April 30 (see Gas Matters, April 1999).

In July 1995 Spain-based Enagas (the contract now held by now Gas Natural) entered into a 20-year SPA with Atlantic LNG to buy 1.1 mtpa from Atlantic LNG Train 1. LNG deliveries would start in 1999, destined primarily for Enagas' receiving terminals in Spain, but with the option to sell cargoes to Cabot[1] for its Everett terminal located in Boston. Cabot was the other Train 1 off taker, purchasing 60% of the Train 1 production, under a pricing mechanism done on a net-back basis from its market in Boston. The LNG prices under the Enagas SPA were calculated using a base price and a multiplier indexed quarterly based on a mix of European gas oil and fuel oil prices. A provision was structured into the contract clearing stating that regardless of the cargo destination, Enagas would only pay the Spanish pricing formula.

However, in the early 2000s, following the race for market share resulting from rapid liberalisation of the Spanish natural gas market, gas prices in the country dropped. As US gas prices were starting to rise Gas Natural decided to enter into a six-year deal with GDF Suez to sell its full Atlantic LNG off-take into the American market.

In 2005 Atlantic LNG triggered the price reopener clause, initially demanding an estimated $1 billion price increase through the life of the contract.

Under the SPA either party could request a revision of the pricing formula providing it established that:

"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 above-mentioned Contract Price provisions in accordance with the remaining provisions of this Article 8.5."[2]

Atlantic LNG argued that as none of the cargoes were now being delivered into Europe the Spanish formula should be raised to reflect the higher US gas prices. After six months Gas Natural and Atlantic LNG could not agree on a new pricing formula so Atlantic initiated arbitration against Gas Natural in October 2005. Gas Natural counter-claimed, asserting that the price at which gas could be sold to end-users actually required a reduction of around $2 billion through the life of the contract (if the price reopener is not activated again).

The arbitration panel handed down an award on January 17, 2008 that sought to maintain a reasonable profitability for Gas Natural under the changed market conditions. It introduced a two-part pricing scheme into the SPA, ruling that if LNG is sold into New England on a sustained basis, New England should be the basis for determining the value of the gas. Under the New England market price adjustment clause, for the quarters when the majority of cargoes were shipped to the Everett terminal, the price of LNG for all contracted volumes, even those destined for Spain, would be based on the Boston City Gate price. If the majority of cargoes were shipped to Spain, all LNG for those quarters would be priced according to the slightly adjusted Spanish pricing formula.

The new pricing structure was made effective from April 21, 2005 when Atlantic LNG had first triggered the reopener clause.

[1] The names of these companies have changed many times since then; Cabot is now GDF Suez and the trading functions of Enagas (now the Spanish grid company) were passed to Gas Natural

[2] Direct quote from SPA contract as seen in US District Court document. For copy of the court document please email Leigh Elston at l.elston@gasstrategies.com

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THE CONSEQUENCES

The arbitration panel's decision is believed by various commentators to have cost Atlantic LNG between $500 million and $1 billion – although the details are not in the public domain – including $70 million owed immediately to Gas Natural for payments from April 2005 to December 2007 and multiple millions of dollars it is estimated to have lost since as the gap between US and European prices under the dual pricing structure widened. The New England price has allowed Gas Natural to extend its six-year contract with GDF Suez to sell cargoes into the Everett terminal by 18 months.

"This case was very unusual," says Gay Wenban-Smith, a member of Gas Strategies' team of consultants. "Because after the various submissions by the parties, the tribunal decided to take the matter into its own hands and decide – on the basis of its own opinion – that the price review mechanism had indeed been triggered (which it turned out the parties had been a bit ambivalent about), and that the solution was a dual pricing formula, which neither of the parties had requested

"What is more, the tribunal imposed its verdict without consulting the parties or considering their views. This is in stark contrast to many arbitrations that Gas Strategies has been involved with, where the tribunal has attended carefully to each party's opinion and attempted as far as possible to resolve issues in a mutually acceptable way, sometimes soliciting the experts' help."

Atlantic LNG petitioned the US District Court for the Southern District in New York to vacate the award, claiming the arbitration panel had exceeded its authority by imposing the dual pricing structure. However on September 16, 2008, the court upheld the panel's decision on the grounds that the original SPA did not set a limit on how the price revision should be structured; the reopener clause only required that a "fair and equitable" revision of the price be set, and it would have exceeded its powers only if it exercised a power it did not have.

CONCLUSIONS

"There are obvious conclusions to draw from this case," says Rob Shepherd, a Senior Associate with Gas Strategies. "Don't go to arbitration on a price reopener if you can possibly avoid it. This case is clearly extreme, but a significant proportion of arbitrations on LNG price (and there did not used to be that many) end up with uncomfortable results which are well out of line with normal industry practice. This is almost inevitable as the arbitrators, although formidably learned, cannot be expected to become expert on the gas industry over the course of the hearing.

"And, secondly, make sure that the price reopener clause sets out a clear trigger for a price reopener and gives clear guidelines for the type of revision to be made, which prevents the arbitrators from setting off into uncharted territory."

But as Holland says: "We see a lot of gas and LNG contracts at both the drafting and the dispute stage and I think very few have price review provisions with any sophisticated guidance in them directing the arbitrators how they should be changing the price formula." There is, therefore, an increasing need for commercial expertise throughout the full life-cycle of LNG and gas contracts, not only to support the dispute resolution process but in the structuring of price review provision, in the preparation and pre-emption of cases for negotiation and the provision of ongoing market monitoring.

Holland continues: "It seems to me that it would be a very good investment of time to look at price review provisions carefully, because in twenty year-plus gas or LNG sales contracts, price review provisions are, if they can be triggered easily, arguably of equal importance to the initial price."

But it is, of course, difficult to execute in advance as neither buyers or sellers can predict how energy markets and prices will shift, and therefore what limitations they want to set on a future tribunal. "The whole point of a price review provision is to deal with unexpected circumstances – events that the accepted price formula cannot deal with," says Holland.

And here is the dilemma. Those without price review clauses are "mightily unhappy waving goodbye to fixed price LNG when they know it will be sold into a market at four times the value" Ball comments. "But we have to operate the clauses or contracts we have. This requires both more forward looking drafting of today's terms and operating the price reviews we have with greater care."

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When looking to the future, often parties want to give arbitrators as much flexibility as will be needed to restore equilibrium to the contract; the advantage of keeping price reopener provisions open-ended is that it gives arbitrators the freedom and independence to reason to a fair outcome. “If you try to overly limit the ability of the tribunal to allow the contract to keep pace with the market then you could end up with the long-running tensions between the buyer and seller,” adds Holland.

“Price re-openers need to be developed which give reasonable results in this far more complex trading environment,” says Shepherd. “It is not easy, particularly in times of high price volatility. Indeed it is difficult to devise satisfactory pricing formula in the contracts that cover the major options open to buyers and sellers in the short run.”

Susan Farmer, a partner at Fulbright and Jaworski International, who advised one of the ALNG shareholders in the negotiation of the original SPA agreements with Enagas and Cabot and who has advised clients negotiating long term LNG SPAs at different points in the LNG market cycle in a variety of regional markets, says: “Because of the complex nature and many factors that may affect the international gas and LNG markets over a 20 to 25 year time frame, it may not be possible to precisely define all of the variables which might be taken into account by an arbitral panel but the parties should at least be able to reach agreement on some of these points – for example specifying which elements of the pricing mechanism the arbitrators are authorised to determine (e.g. only base price or only escalator basket) or stipulating that ‘baseball arbitration” (where the arbitrators must choose between the submissions of the two parties rather than coming up with one of their own) be used. This would at least mean the arbitrators do not have complete free will – as in the ALNG case – to impose a pricing mechanism that neither party bargained for and thus at least limit the risk of turning the SPA pricing provisions over to an arbitrator.”

Price re-openers are generally agreed to be a necessity in an LNG contract where prices are linked to oil prices, as in traditional Asian and European contracts. As conditions in the gas market change over time and the original indexation no longer mirrors the market, then reopeners – in theory – help realign the indexation to the market. In the old LNG world where gas markets were controlled by large monopolistic utilities and LNG was supplied on fixed links by dedicated chains the system worked well and relied less on the precise phrasing of the reopener. But when LNG can be diverted to higher value markets to take advantage of arbitrage opportunities, it gets more difficult; should the seller share the benefit of the arbitrage? Or, when the market liberalises, gas to gas competition develops and end user prices fall; should the sellers cut prices to support the buyers margin and cushion the effects of competition? Both these effects were at work in the Atlantic case and it is not surprising that a price reopener written before either of these changes had really had any impact, did not produce the desired effect when arbitrated.

GAS STRATEGIES’ CONTRACT RENEGOTIATION AND DISPUTE RESOLUTION SUPPORT

The publicity of the Atlantic LNG case highlights the opportunities and risks open to big LNG buyers, and the need for both buyers and sellers to benefit from trading opportunities for a contract to endure. It is therefore not only the drafting of the price revision clause that needs careful consideration; the whole commercial arrangement needs to be carefully negotiated and thoroughly understood so that both parties have an interest in its continuation.

MANAGING CONTRACTS PROACTIVELY FOR OPTIMUM VALUE

Planning for and pre-empting renegotiations can offer significant additional value in such processes and as such we at Gas Strategies, further support the management of contracts on a proactive basis. Discussions on strategic approaches to renegotiations and collecting, verifying and assessing the relevant data through market monitoring (involving the periodic round up and analysis of key factors shaping target market regions) all play a role in this approach. Our general market awareness – together with specific monitoring of events that could act as potential triggers for price reviews and renegotiations enhances the preparations and positioning of our clients for future renegotiations.

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EXCEPTIONAL KNOWLEDGE AND EXPERIENCE OF CONTRACTS' FULL LIFECYCLES AT YOUR DISPOSAL

Gas Strategies' expert witness and dispute resolution support draws on our hundreds of collective years of engagement in the gas market and the individual expertise of our team of international consultants and their variety of specialist knowledge. We act as industry experts providing independent opinions in negotiations, mediations and as lead witnesses before arbitration panels.

Our understanding of the full life-cycle of contracts – from initial negotiation through renegotiation to closure – and the breadth of our experiences provides you with an excellent insight into the drivers and views of all sides in a renegotiation or arbitration / conflict resolution.

Arbitration often requires "reconstructing", and bringing to life for a Tribunal, the market conditions at the time of the original contract or previous review point. Gas Strategies has the depth of knowledge and experience to contextualise the market conditions and contracting practices in relevant periods and can add an extra dimension of realism to this part of evidence as a result.

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Gas Strategies is a specialist professional services organisation providing commercial gas advisory services globally.

We operate in all sectors of the value chain: upstream, midstream and markets, and cover the full LNG value chain.

We offer a strong business model, in which our integrated service lines synergise to bring powerful solutions to our clients, meeting their specific needs through Consulting, Training, and Information Services.

WE PROVIDE ADVISORY SERVICES IN:

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- Gas market supply, demand and pricing analysis
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If you would like to find out more about Gas Strategies' work in this area or have any other questions, please contact:

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