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Dispute Resolution in Gas: Experience Matters!

How Asian Disputants Benefit From the European “Battlefields”

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PRICE RENEGOTIATIONS IN EUROPEAN GAS CONTRACTS: WHAT HAS HAPPENED?

Background: rationale for price renegotiations in long-term gas sales agreements

Overall the European gas business has been very successfully dealing with long-term relationships for decades. The characteristics of long-term gas contracts required sophisticated contract design and particularly smart pricing.

As fixed prices would not have been sustainable for long-term contracts, the industry invented "dynamic pricing" systems with prices mainly linked to oil prices and being periodically recalculated according to negotiated price formulae.

Yet the smartest price formula would not necessarily cope with decades of unforeseeable changes in related to markets, changing regulation, technological breakthroughs, etc., which are affecting the value of gas. To manage all these uncertainties and to ensure that the contract prices continue to be in line with the understanding of a bargain when entering into the contracts it is necessary to adapt to changes of energy markets or the value of gas now and then.

Many or even the most of the European long-term gas contracts account for such uncertainties using the tool of price re-opener clauses within the contract, while other contracts contain at least more general hardship clauses.

Independent from the approach to renegotiate a contract, all renegotiations happen within the contractual framework. Initial chances and risks are reflected, as well as new and unexpected market changes.

Buyers' strong desire for transition from oil-indexation to gas hub pricing driver for the recent disputes

It was in late 2000s when the financial crisis turned into the most severe economic crisis since World War 2. Consequently the demand for natural gas fell substantially. The decrease in world gas demand by 2.6% in 2009 compared with 2008 was the strongest decrease ever since the 1960s.

At the same time the US driven shale gas revolution (production of natural gas using horizontal drilling and advanced fracking technology) and additional LNG volumes coming on stream led to increasing gas production and gas availability for world markets.

These developments met increasingly liberalised gas markets in Europe and eroded gas prices. Spot gas prices at traded markets (hubs) fell substantially below oil-indexed formula prices under long-term contracts. Emerged hubs enabled gas trading outside of long-term contracts and thus put pressure on the incumbent players. This established the basis for complex and long lasting price renegotiations and in many cases ended in formal disputes and arbitrations.

Impact of European price renegotiations & disputes

The effect on the European gas business has been enormous: some 100 bcm (3.5 TCF) of annual contract quantities were renegotiated, and billions of dollars have been in dispute. While quite a substantial amount thereof has been awarded for reimbursement payments, another significant number of claims have been rejected.

Consequently the outcome of renegotiations has substantially affected the parties' income statements. Results for buyers (and sellers respectively) have varied significantly. Reasons are manifold. On the one hand each price renegotiation is individual and depends on the specific contract clauses, the contract history and changes in the related energy markets. On the other hand the strategy of the parties and the quality of their claims/positions matters. In order to be compelling, legal briefs and expert reports need to be of highest quality and adjusted to the individual case.

As it takes two to tango the defendant's position, strategy and quality is equally important. In many cases the defendant has to lose what the claimant can win.

Transition from oil-indexation to gas hub pricing in Europe – Asia to follow?

In addition to financial reimbursements price renegotiations and arbitrations have led to a substantial increase of gas hub pricing in Europe over the last decade. According to IGU's *Gas Price Survey* from 2016, the share of oil price indexation has decreased from 78% in 2005 to 30% in 2015. Oil price influence has to a large extend been replaced by gas hub pricing using a variety of approaches.

Europe has undergone a transition from oil-indexation to gas hub pricing and the disputes there seem to have calmed. As Asian markets are gradually changing from oil pricing to gas pricing combined with a period of oversupply and a shift from a sellers' market into a buyers' market we foresee a new dispute cycle is on the verge of floating to Asia.

From the many price renegotiation and arbitration cases our team has been involved in, we have learned that the approach matters. Experience is key for success. Below we will provide some further key learnings and will describe some best practices approaches once a dispute goes formal and becomes an arbitral proceeding.

TEAM CONSULT'S BEST PRACTICES FROM RECENT DISPUTE CASES

1 USE COMMERCIAL EXPERTS AND LAWYERS FOR EARLY ASSESSMENT BEFORE THE CASE GOES FORMAL

Take a second opinion as early as possible. This applies if you prepare an own claim but also if you might be threatened by being taken to court.

Early assessment involving outside experts can avoid filing a claim which would turn out unpromising. Both legal and commercial experts will be a valuable test for the robustness of your arguments. Let the experts be the devil's advocate. Have the markets really changed in the direction you would need for your argumentation? What could be counter effects of a certain calculation?

Early preparation is also important in a defendant's position. A strong defence prepared for court filing might not always be needed and then perceived as unneeded spending in hindsight. But the opposite is true. Defence is most successful, when not needed in court.

2 PROCESS EXPERIENCE IS KEY

Thorough preparation, accurate planning, and comprehensive knowledge: Support in arbitral proceedings may seem like any consulting project – but it is not!

Dispute support is not only about providing expertise. It is about expecting the unexpected. It is about performance in front of a tribunal and standing the heat if the opposing party challenges you.

Dispute support is not about as much expertise as possible. It is about controlling the process and deciding which arguments matter.

Dispute support requires a team you can trust and rely on. Other than "normal" consulting projects there is no second chance. Replacing the expert during ongoing arbitral proceedings will put the process at extreme risks for you!

3 STRONG TEAM FROM A TO Z

In most cases relatively small teams of internal and external specialists are involved in renegotiations. Given the large volumes in dispute it is obvious that the choice of specialists – internal and external – is crucial for the success of price renegotiations.

Engage a strong external team and make sure to allocate strong and capable internal resources to the case. Avoid hiring experts which are opportunistic pleasers. Let the experts express their true opinion instead. This requires more discussion and alignment at the beginning but it is the only way to avoid falling into traps by using poor arguments or calculations later on.

It is better to have tough internal feedback and robustness tests than receiving bad surprises when the counterparty answers and rebuts your arguments too easily or if the tribunal renders an award with negative surprises.

4 KNOW YOUR CONTRACT (AND HISTORY)

Many approaches are feasible to “open” a contract for adjustments. For instance openers can be price review clauses, loyalty clauses, frustration of contract, competition law.

And much more approaches are conceivable to determine an appropriate adjustment to a contract price formula or to quantify a reimbursement sum. Even if the contract seems to give clear guidance in your understanding other interpretations can be possible.

Which benchmark is to apply? How is it to apply? Is there an explicit approach defined and agreed?

In our experience almost no approach is distinct and explicitly agreed to. Assume a phrase like “market of the buyer” being part of a review clause. Is such market to be interpreted geographically or vertically in the value chain, or both? Has the interpretation changed over time? Is it the actual or potential market? Is it the potential market of an average supplier or of the marginal supplier? Much more questions will arise just when determining the definition “buyer’s market” etc.

We have seen many parties exaggerating that existing room to manoeuvre and leaving the wording of the contract completely. In our experience this has not turned out successfully while adherence to the contract wording enriched by suitable commercial analyses and assessments has.

5 LESS CAN BE MORE

One of the key strategic questions, both from a claimant's and defendant's view is how extreme the own position should be. Should the claimant go for a claim as high as possible? Should the defendant neglect any adjustment?

We have learnt that tribunals want to take decisions. Two too extreme positions make it difficult for tribunals to render an award (or lead to never-ending proceedings with additional submissions and hearings after the initially planned phase). Allow the tribunal to find a proper decision. Agree to the obvious and increase your overall credibility.

6 DO NOT SAVE AT THE WRONG END

Especially in times of low commodity prices and during cost cutting efforts, companies faced with arbitration procedures are bound to budget restrictions. While this is well understood in general, it is of great danger to save at the wrong end.

In our experience physical meetings are key to the team building between lawyers, experts and the client and also simplify understanding of each other's opinions on the case, even if this takes time.

Similarly some data sources are costly. Some clients were hesitant to invest in data with unknown outcome. Don't be hesitant, even if there is no guarantee to find supportive data. Compared with the value at risk these investments are negligible.

7 CLEAR MILESTONE PLANNING AND ADHERENCE TO INTERNAL DEADLINES

Short-term changes regarding the time schedule will always happen. Sometimes last-minute changes regarding the scope of an expert report or legal brief are also unavoidable.

And yet, precisely because of these short-term last minute changes it is even more important to have clear milestone planning for the preparation of a legal submission and associated expert reports.

Deadlines for the legal submissions are mandatory anyway. But internal deadlines during the creation of draft versions of expert reports, feedback thereto etc. must be adhered to.

If any, last-minute interventions are only feasible in a well-planned environment.

8 DON'T UNDERESTIMATE THE BULK OF WORK CLOSE TO FILING THE SUB-MISSION

In a similar regard, the bulk of work adding up and due in the final days of a submission are often underestimated.

In order to prove the expert opinion many exhibits and attachments have to be filed together with the expert reports and legal briefs. Quality checks, which, at least to some extent, can only be made at the end of the case, add up. And the physical production of the reports and shipment is also time-consuming (always reserve buffer time!).

9 DO NOT CLOSE COMMUNICATION (NEGOTIATION) LINES TO COUNTERPARTY

Disputes often are played hardball. Don't let the rough language of submissions disturb your partnership with the counterparty. Distinguish between the submissions and the long-term relationship parties have and which will hopefully still be honoured.

Never close communication lines for commercial negotiations (unless temporarily for strategic reasons).

10 ALIGN PARALLEL NEGOTIATIONS WITH THE ONGOING ARBITRATION PROCESS

When you receive the counterparty's briefs and associated expert reports, be prepared to read a convincing argumentation line, sometimes completely opposing to your perception of the case and plausible at first sight. Don't expect anything else or even agreement with your position. You might even feel shocked by the perceived plausibility (or boldness) of the story.

This is clearly not the time to enter commercial negotiations! Wait until you have reached level playing field again. Wait until having digested their arguments. Wait until legal counsel and experts have evaluated the submission.

SUMMARY

The European gas industry has seen a cycle of renegotiations of long-term gas contracts to some extend ending in arbitration. Lessons have been learned from this process. The Asian gas market may see a similar development. In addition to in-depth knowledge substantial experience to manage such processes is essential.

AUTHORS

Madjid Kübler

Madjid Kübler is the managing director and owner of Team Consult. He heads Team Consult's dispute resolution practice. Prior to the acquisition of Team Consult, he has worked in senior positions at Accenture and Arthur D. Little. He is an experienced expert, witness and commercial arbitrator in gas price and further energy disputes.

Georg Haas

Georg Haas has been working as a business consultant in the energy sector since 2008. For Team Consult he is mainly focused on gas trading and price revisions. He has managed projects for preparation and support of price renegotiations and arbitration proceedings and been nominated expert witness.

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TEAM CONSULT G.P.E. GmbH, which is headquartered in Berlin, is an internationally active and networked consultancy firm for the energy sector. Strategic business consultancy focusing on the power and natural gas/LNG sectors, market studies and dispute resolution management are at the heart of our service portfolio.

TEAM CONSULT acts as an experienced partner in commercial negotiations and arbitral proceedings. Our team is made up of highly qualified experts who have profound knowledge of the energy sector from many years of experience.

In the recent years we have been assigned as experts in disputes relating to natural gas, power and renewables, from energy production via transport, storage and selling / purchasing. Our clients in these regards have been international energy companies, regional and local utilities as well as leading law firms. Our customers entrusted us to support them in the renegotiation of billions of Dollars in dispute.

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Gas.Power.Experience.

Robert-Koch-Platz 4
10115 Berlin

Tel: 030.400 556 0
Fax: 030.400 556 99
E-Mail: info@teamconsult.net
Internet: www.teamconsult.net