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Responding to Litigation and Arbitration over Disputed Gas Supply Agreements

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Agenda

- Identifying key areas of focus in supply contracts when disputes arise
  - Pricing terms and repricing provisions
  - Force Majeure and Hardship Clauses
  - Transportation issues
  - Default versus incremental breach or deficient performance
- Adopting an appropriate remedies portfolio
  - Damages; when and for what?
  - Waivers and limitations of remedies
- Takeaways
Identifying key areas of focus in supply contracts when disputes arise
Pricing terms

- In the US, natural gas has a highly active spot market where brokers and others buy and sell natural gas.
- Often, these locations are segments of individual pipelines or locations where pipelines interconnect with other pipelines or local distribution companies.

Source *Understanding Natural Gas Markets Primer - API*
Pricing terms

- Henry Hub in Louisiana is interconnected with 13 different intra- and interstate pipelines.
- Henry Hub in Louisiana is the benchmark price for North American natural gas.
- Other locations include Alberta, Canada, Chicago Citygate, and Dawn, Ontario, with some of these locations having an even larger number of spot market transactions than Henry Hub.

Source *Understanding Natural Gas Markets Primer - API*
Pricing terms

- In addition to daily spot transactions, monthly spot transactions are often entered during “bid week,” the last five business days of a month.

- During bid week, buyers and sellers arrange for the purchase and sale of physical natural gas to be delivered throughout the coming month, including making delivery arrangements with pipelines.

Source *Understanding Natural Gas Markets Primer – API*
Pricing terms

- Many customers purchase natural gas under longer-term contracts that provide for delivery of gas for a specified period of time.
- The length of time can vary.
- Frequently the prices in longer-term contracts are not fixed, but are instead indexed to prices that are regularly published in the trade press.

Source *Understanding Natural Gas Markets Primer* - API
Pricing terms

- Generally outside the US, natural gas markets lack sufficient information on traded gas prices.
- As a result, parties often look to have an agreed base price along with a referenced to periodic indexation.
Pricing terms

- Gas price formulae often used for a variety of reasons, for example:
  - Maximize Seller’s returns vs. Buyer’s desire to minimize outlays;
  - Desire for certainty while providing flexibility in the contract to deal with changes in market conditions over the long term; and
  - Desire to maintain market share over the long-term

Source: *Predicting the Unpredictable: Gas price re-openers* - Michael Polkinghorne
Pricing terms

- Long-term natural gas sales contracts in continental Europe usually follow this approach of indexing.
- The indexation formula is obviously geared to permit the gas to remain market competitive.

Source: *Predicting the Unpredictable: Gas price re-openers* - Michael Polkinghorne
Pricing terms

 The indexation formula will often refer to a number of items which themselves are capable of determination by reference to international exchanges.

 These elements will be given a weighting, together (often) with a reference to inflation; all in order to try and provide a formulae which remains relevant to the conditions in which the gas will ultimately be marketed.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
The parties have also often attempted to provide some form of protection against “freak” occurrences, by way of insertion of a “ceiling” and a “floor” price.

Others seek to iron out the more extreme variations by way of “S-curve” pricing, whereby the parties agree that (for example) oil-gas pricing clauses would “level-off” the gas price increase where oil prices.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Pricing terms

- There are two basic pricing systems that are commonly used for international trade of natural gas:
  - Oil-indexed pricing and
  - Gas-on-gas based pricing.
- Under gas-on-gas pricing, the price of natural gas is indexed to competitively determined gas market spot prices which change in response to natural gas supply and demand.
- Under oil-indexed pricing, the price of natural gas is determined from oil market spot prices which change in response to oil supply and demand.

Source: Global Natural Gas Markets Overview- EIA - 2014
Pricing terms

- Most international trade in North America uses the gas-on-gas pricing system.
- In Europe, oil indexation is dominant for international trade, but the use of gas-on-gas pricing steadily increased.
- In the Asia-Pacific, oil indexation is dominant, but unlike in Europe, has not shown any steady decline.

Source: Global Natural Gas Markets Overview - EIA - 2014
Pricing Review Clauses

- Long-term natural gas sales contracts often contain a clause providing for a price review because of:
  - The long-term nature of the contract,
  - Volatility of markets, and
  - An absence of clear market-wide price indicators.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Pricing Review Clauses

- A clause providing for a price review may be “regular” (i.e. at agreed dates), or “special” (e.g. occurring at the option of either party).

- These clauses – often called “price re-openers” – usually contain several elements:
  - A limited number of times (or periods) when a review may be requested;
  - A “road map” or indication of what information may be taken into account in any review; and
  - Consequences if the parties are unable to agree.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Example of a Pricing Review Clause

- If the circumstances beyond the control of the Parties change significantly compared to the underlying assumptions in the prevailing price provisions, each Party is entitled to an adjustment of the price provisions reflecting such changes. The price provisions shall in any case allow the gas to be economically marketed based on sound marketing operation.

- Either Party shall be entitled to request a review of the price provisions for the first time with effect of dd/mm/yyyy and thereafter every three years.

- Each Party shall provide the necessary information to substantiate its claim.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Example of a Pricing Review Clause, continued

- Following a request for a price review the Parties shall meet to examine whether an adjustment of the price provisions is justified. Failing an agreement within 120 days either Party may refer the matter to arbitration in line with the provisions on arbitration of the Contract.

- As long as no agreement has been reached or no arbitration award has been rendered all rights and obligations under the agreement – including the price provisions – shall remain applicable unchanged. Unless otherwise agreed or decided by the arbitral award, differences to the newly established price shall be retroactively compensated inclusive of interest on the difference calculated at a rate reflecting the conditions on the international financing market.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Example of a Pricing Review Clause – brief form 1

If... economic circumstances in the buyer’s market... have substantially changed as compared to that expected when entering into the contract for reasons beyond the parties’ control... and the contract price... does not reflect the value of natural gas in the buyer’s market.

Source: *Predicting the Unpredictable: Gas price re-openers* - Michael Polkinghorne
Example of a Pricing Review Clause – brief form 2

“Either party may request a review of the method of determining the Contract Sales Price set forth in clause X if it has a good faith basis for believing that, for reasons outside its control, there has been a material change in the value of imports into Y and/or re-gasified LNG in the Y gas market which is anticipated to have lasting effect.”

Source: *Predicting the Unpredictable: Gas price re-openers* - Michael Polkinghorne
Example of a Pricing Review Clause – brief form 3

[T]he price payable hereunder shall at all times enable the buyer to resell the gas competitively in its end-user market.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Pricing Review Clause, Criteria

Example 1:

Parties shall take the following into account: (1) an assessment of the weighted average price of long term LNC contracts under which deliveries into [•] are taking place at the time of the price review; and (2) an assessment of the weighted average price of new binding, unconditional long-term LNG contracts concluded since the commencement date, or the previous price review, as applicable, under which deliveries into [•] are to take place within the period until the next price review or if there is no further price review then until the end of the term.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Pricing Review Clause, Criteria

Example 2:

For this purpose, contract prices for liquefied natural gas to be delivered into [•] on FOB or CIF terms will be adjusted to allow for comparison on a DES basis. Parties shall also have regard to: (1) the terms recorded in the Agreement and other comparable binding unconditional long-term liquefied natural gas contracts for delivery into [•]; (2) the reliability and security of LNG supply from Sellers; and (3) trends in world prices of substitutable energy.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Force Majeure Clauses

- Most contracts with performance obligations almost always contain some type of force majeure clause with a normal list of exclusions.
- Typical force majeure clause grants extension of time to the extent performance delayed by a force majeure event.
- Often contain a notice requirement and require the party claiming force majeure to provide evidence to support claim of force majeure.
- Party able to substantiate claim of force majeure gets time extension but each Party generally bears their own cost during the force majeure event (i.e. no additional compensation).
Force Majeure Clauses

- In addition, courts in the U.S. and the U.K. have traditionally been reluctant to accept claims of change of market conditions as a valid legal claim as grounds for a force majeure.

- Generally, a force majeure is not the best tool for dealing with changed market circumstances or any change circumstance where a party wants the possibility to receive additional time for performance and compensation to cover the cost of such performance.
Hardship Clauses

- Generally, a Hardship clause grants a party the ability to initiate a renegotiation of the agreement where the party claiming hardship can demonstrate that– because of changed circumstances – the party is suffering hardship under the current terms of the agreement.

- Hardship provisions also exist in law of a number of civil law countries.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Hardship Clauses

UNIDROIT PRINCIPLES 2010

Article 6.2.1 (Contract to be observed)
Where the performance of a contract becomes more onerous for one of the parties, that party is nevertheless bound to perform its obligations subject to the following provisions on hardship.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Hardship Clauses

UNIDROIT PRINCIPLES 2010
Article 6.2.2 (Definition of hardship)
There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party’s performance has increased or because the value of the performance a party receives has diminished, and
(a) the events occur or become known to the disadvantaged party after the conclusion of the contract;
(b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;
(c) the events are beyond the control of the disadvantaged party; and
(d) the risk of the events was not assumed by the disadvantaged party.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Hardship Clauses

UNIDROIT PRINCIPLES 2010
Article 6.2.3 (Effects of Hardship)
(1) In case of hardship the disadvantaged party is entitled to request renegotiations. The request shall be made without undue delay and shall indicate the grounds on which it is based.
(2) The request for renegotiation does not in itself entitle the disadvantaged party to withhold performance.
(3) Upon failure to reach agreement within a reasonable time either party may resort to the court.
(4) If the court finds hardship it may, if reasonable.
(a) terminate the contract at a date on terms to be fixed, or
(b) adapt the contract with a view to restoring its equilibrium.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Hardship Clauses

Brief Hardship clause:
If a substantial change that was not predicted at the time of execution takes place in the circumstances on which the Agreement was based so that a party suffers or is foreseen to suffer substantial hardship, which is likely to continue, arising from that change, then the parties shall immediately consult and make mutually acceptable revision of the terms and conditions appropriate to ‘alleviate or eliminate the hardship, in a spirit of mutual understanding and cooperation.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Dealing with changes in the agreed index

Should the [index] be abolished or abandoned, no longer published, or its basis for calculation changed in a material respect, then the parties agree to meet in good faith to agree upon a similar index as a substitute and, failing agreement, the matter shall be referred to dispute resolution.

Source: *Predicting the Unpredictable: Gas price re-openers* - Michael Polkinghorne
Dealing with third party offers

Negotiation initiated by the Seller
Seller shall have the right to request a renegotiation of the price for LNG if Seller has received a bona fide firm written offer from a third party to purchase a comparable quantity to the quantity of LNG that Buyer is committed to purchase hereunder, with similar terms and conditions, for a price that is at least X% higher than the then current price of LNG thereunder.

Source: Predicting the Unpredictable: Gas price re-openers - Michael Polkinghorne
Dealing with third party offers

**Negotiation initiated by the Buyer**

Buyer shall have the right to request a renegotiation of the price for LNG if Buyer has received and presented to Seller a bona fide firm written offer from a third party offering to sell comparable quantities.

Source: *Predicting the Unpredictable: Gas price re-openers* - Michael Polkinghorne
Transportation issues - Natural Gas Composition

- **Hydrocarbons**
  - Methane \( CH_4 \)
  - Ethane \( C_2H_6 \)
  - Propane \( C_3H_8 \)
  - Butane \( C_4H_{10} \)
  - Pentane \( C_5H_{12} \)

- **Non-Hydrocarbons**
  - Water vapor \( H_2O \)
  - Carbon dioxide \( CO_2 \)
  - Nitrogen \( N \)
  - Helium \( He \)
  - Hydrogen Sulfide \( H_2S \)
Transportation issues
Transportation issues

• The HNS Convention (Hazardous and Noxious Substances by Sea Convention) – the *International Convention on Liability and Compensation for Damage in Connection with the Carriage of Hazardous and Noxious Substances by Sea, 1996* – provides for compensation for damages caused by spillage of hazardous and noxious substances including LNG during maritime transportation.

• HNS convention is not yet in force and is pending the required ratification.

• Creates an international liability regime that would make LNG ship owners and LNG receivers or cargo owners strictly liable for accidents unless the relevant sale and purchase agreement provides otherwise in a legally enforceable manner.

See [http://www.hnsconvention.org/Pages/Home.aspx](http://www.hnsconvention.org/Pages/Home.aspx)
Transportation issues

- Seaworthiness
- Damage by third parties (e.g. collisions, piracy)
- Regulatory requirements and inspections including vessel security requirements (e.g. IMO and SOLAS standards addressing port facility and ship security issues)
Transportation issues
North American Pipeline Grid
Pipeline Transportation issues

- Health, Safety, Environment & Sustainable Development
  - Natural gas pipelines no treated as transport of a hazardous substance under US Federal Law, need to consider applicable jurisdiction requirements
  - Risk of fire
  - Explosion
  - Emissions
- Maintenance and Reliability
- Off-Specification Natural Gas
- Damage by third parties
- Regulatory requirements and inspections
Logistics & Value Chain

• Wellhead - Quality – “pipeline specifications”/”commercial grade”
  – Methane
  – Btu Value
  – Water Vapor
  – Corrosives(H2S)
  – Nitrogen
  – CO2
  – Need processing?
  – Treatment?
Logistics & Value Chain

• Processing Plants - Basic Operations
  – “Purify” gas stream
    • Remove H$_2$O, H$_2$S (hydrogen sulfide), CO$_2$, N
      – Nitrogen rejection (not widely done – expensive)
      – Glycol absorption (dehydration)
      – Amine treatment – sulphur extraction
Default versus incremental breach or deficient performance

• Long-term gas sales contracts generally provide ability to remedy defaults in most cases

• Special sensitivity to anti-bribery and anti-corruption (“ABC”) laws
Early Termination

- Extended periods of force majeure
- Buyer fails for any reason to take at least [_____] percent (___%) of the Adjusted Annual Contract Quantity or Adjusted ACQ for [_____ (___)] consecutive Contract Years.
- Buyer fails for any reason to cure any late payment within ____ Days after the due date.

Source: AIPN Model GAS Sales Agreement
Early Termination

• For [_____ (___)] Days after the occurrence of any of the following events Buyer may give to Seller a notice of early termination of this Agreement:
  – Seller fails for any reason to fulfill its obligation to construct Seller’s Facilities to the extent and by the date specified in Article 6.1.1; or
  – The aggregate Shortfall Quantity over a period of over a period of [_____ (___)] consecutive Months is greater than [_____] percent (___%) of the aggregate of the Properly Nominated Quantities for such Months; or
  – Seller fails for any reason to make available at least [_____] percent (___%) of the aggregate PNQ for [_____ (___)] consecutive Contract Years.

Source AIPN Model GAS Sales Agreement
Adopting an appropriate remedies portfolio
Damages; when and for what?

- Each of Seller and Buyer respectively, as an Indemnifying Party, shall indemnify, defend, and hold harmless the other Party, as an Indemnified Party, from and against all losses or damages relating to Third Party Claims arising from:
  - The breach of any representation, warranty, covenant or obligation of the Indemnifying Party under this Agreement; and
  - From any other act, omission or event for which the Indemnifying Party is liable pursuant to this Agreement.

Source: AIPN Model GAS Sales Agreement
Damages; when and for what?

- Each of Seller and Buyer respectively, as an Indemnifying Party, shall indemnify, defend, and hold harmless the other Party, as an Indemnified Party, from and against all losses or damages relating to Third Party Claims arising from:
  - The breach of any representation, warranty, covenant or obligation of the Indemnifying Party under this Agreement; and
  - From any other act, omission or event for which the Indemnifying Party is liable pursuant to this Agreement.

Source AIPN Model GAS Sales Agreement
Damages; when and for what?

- Personal Injury?
- Damage to Property?
- Pollution?
- Consequential Losses?
- Administrative Penalties?
- Criminal Acts?
Waivers and Limitations of Remedies

- **Limitation of Liability**
- Except as expressly provided in this Agreement, a Party shall not be liable to the other Party for Consequential Losses arising from any act or omission relating to this Agreement.

- Source *AIPN Model GAS Sales Agreement*
Waivers and Limitations of Remedies

- **Limitation of Remedy**

  Seller’s sole remedy for Buyer’s failure to take the quantities of Gas required for fulfillment of its obligations under Article 12 shall be to enforce Buyer’s obligation to pay to Seller Buyer’s Deficiency Payment, and if applicable, to terminate this Agreement.

Source: AIPN Model GAS Sales Agreement
Takeaways

• Identifying key areas of focus in supply contracts is important to prevent disputes from arising
• Understanding the scope of risks and remedies available to the parties is critical to risk mitigation