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

It is unusual in the secretive world of arbitration for a price reopener dispute to enter the public domain. However, a New York court case last year between Atlantic LNG Train 1 and Gas Natural did just that, sparking debate amongst gas negotiators and legal advisors over the issue of price review clauses and their role in the ever-evolving LNG market.

“The Gas Natural case is the first that I’m aware of where you’ve had a dispute on a price revision clause in an LNG SPA agreement that has become public in the way that it did with Gas Natural,” says Christian Petersen, a partner in Paul Hastings’ Tokyo office. “What the case really raises is the issue of price revision clauses, how they operate and whether the intention of the parties is correctly reflected in the result derived from the exercise of the clause.”

“Of course, it also highlights a closely related issue: the way arbitration panels are instructed (or otherwise) to adjust a pricing mechanism,” says James Ball President of Gas Strategies Consulting. “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.

Especially as over the last few years there has been 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. As prices in almost all European and Asian LNG contracts are linked to oil or oil products, the recent extreme volatility in the oil market has led to worrying instability in SPA pricing mechanisms.

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 reopeners 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.”

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 entered into a 20-year SPA with Atlantic LNG to buy 1.1 mtpa from Atlantic LNG Train 1 (the contract now held by Gas Natural). LNG deliveries would start in 1999, destined primarily for Enagas’ receiving terminals in Spain, but with the option to sell cargoes to Cabot1 for its Everett terminal located in Boston. Cabot was the other Train 1 off

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
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.”

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.

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2 Direct quote from SPA contract as seen in US District Court document. For copy of the court document please email Leigh Elston at Lelston@gas-matters.com
Gas Natural v Atlantic LNG

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 with particular commercial arrangement, conflict resolution and arbitration experience. “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, a move which was not unprecedented. “There are some circumstances under the US and English legal systems when a party can challenge an arbitration award if an arbitral panel has exceeded the scope of its authority,” says Donna Goldsworthy, a senior associate in the International Dispute Resolution and Arbitration practice in Paul Hastings’ London office.
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 and another member of its Commercial Arrangements team (having worked, for instance, on the original drafting of the ALNG contracts). “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.”

Peterson agrees: “If you’re going to submit something to a third party, whether an independent expert or a tribunal, then you need to create a box within which the tribunal, or independent expert, is going to operate. That is not an easy thing to do, particularly as price revision clauses tend to be an after-thought in the negotiation process. But you need to think about creating a box within which the tribunal can base their decision, and if they base the decision on criteria outside the box then a party has the ability to challenge the decision.”

However, 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.

“I think the temptation is for the parties to spend so long agreeing the price formula that the last thing they are inclined to do is look carefully at the price review provisions. But it does seem to me that it would be a very good investment of time to look at carefully, because in a twenty year-plus gas or LNG contract 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 the price review provision is to deal with unexpected events – events that the parties have accepted the price formula cannot deal with,” says Holland.

And here is the dilemma. Those without 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.”

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 long-running tensions between the buyer and seller,” adds Holland.

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 reopeners 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 buyer’s 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.

“The publicity of the case highlights the opportunities open to big LNG buyers, and the need for both buyers and sellers to benefit from trading opportunities for a contract to endure,” says Wenban-Smith. “So it is 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.”

“Price reopeners need to be developed that give reasonable results in this far more complex trading environment,” agrees 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.”

That is the challenge for the LNG world and it will call on all the experience and imagination of the industry. Maybe we will move to an environment of fully traded gas prices and a worldwide LNG price. It would be easier, and reopeners would scarcely be needed, but it does not look close – and it will not be so interesting.”