Pricing Complexity and Predictable Disputes – A Primer on Modern Long-term Gas Supply Contracts

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On Monday, June 16, 2014, Gazprom announced that it commenced arbitration proceedings against Naftogaz under the SCC Rules (seated in Stockholm, Sweden) alleging that Naftogaz has failed to pay US$4.5 billion for gas that Gazprom has already delivered to Naftogaz. Naftogaz also announced that it had commenced a claim under the SCC Rules, seeking the establishment of a fair price for gas and alleging that it has overpaid for the gas already supplied. Some reports suggest that another claim – valued at over US$18 billion – is just around the corner.

When disputes of this value arise, it is important to understand the issues underlying the dispute and how these disputes can be avoided or mitigated. We set out below some thoughts on the structure of pricing provisions in modern long-term gas supply agreements generally.

Complex pricing provisions are a common feature of long-term commodity contracts. In long-term gas sales agreements, a fixed price for the term of the agreement is usually unrealistic due to shifts in the competitiveness of the price over time. There is no single pricing term or indices that parties can universally reference. For this reason, parties typically agree on a bespoke price formula that includes a number of variables. The variables in the formula are agreed between the parties during the negotiation of the contract. Variables can represent substitute energy sources, hub prices, coefficients to counteract the impact of inflation or mitigate currency exchange risks or any other factor that the parties consider might impact the value of gas sold under the agreement.

It is difficult for parties to agree on a price formula that will be in effect for the entire term of the contract because energy markets change over time. Price review provisions provide a means for buyers and sellers to review and revise the price formula during the term of the agreement. When seeking to review the price, parties typically first attempt to reach an agreement through negotiations. Where the buyer and seller cannot agree on appropriate revisions to the price formula (or, possibly, whether revisions are even required), the issues are submitted to an arbitral tribunal and resolved through international arbitration.

There is no “standard” price review clause, and the scope and effect of provisions can vary significantly from contract to contract. The reasons for the variations are numerous, ranging from the backgrounds of the parties involved to the circumstances of the relevant gas market(s). But despite the non-existence of boiler plate pricing provisions, there are some general trends. Parties are usually only permitted to initiate a price review at certain periods in time and/or a certain number of times during the life of the contract. For example, many long-term gas supply contracts specify that either party may only commence a price review once every three years. Some agreements will also include a limited number of additional price reviews that parties can initiate at any time over the entire term of the agreement (sometimes referred to as “jokers”). This creates flexibility and allows parties to accommodate dramatic market events.

In addition to limiting when a party can initiate a price review, price review provisions often require parties to demonstrate reasons why a price review is needed. This is sometimes referred to as a “trigger”. A party may be required to prove that a “significant change” has occurred, that the relevant market for energy has changed in a meaningful way or that the price produced by the formula is “out of market”.

Even if a party has shown that a price review is necessary, the terms of the contract may require the party to demonstrate the ways in which the formula needs to be revised. Price review provisions sometimes provide guidance on this point and set out an objective test or standard to be met. For instance, some agreements require a party to prove that a price formula no longer produces a “marketable price” and show how a proposed revised price formula would better meet this metric.

Frequently, price review provisions also include wording that seeks to limit the scope of the pricing dispute. For example, because the value of gas varies from market to market, there is sometimes confusion about which market data should be considered. In some contracts, the price review provision directs parties to only consider changes in a specific energy market (whether regional or national). Parties sometimes also include terms that identify an intention or purpose for the price formula and explicitly state why certain variables were chosen; for example, the terms of the contract may specify that indexation to coal prices is intended to represent a competing energy source in the power market or that indexation to fuel oil is intended to represent a competing energy source in the industrial market. Notably, as liberalization of the European gas markets has progressed and produced gas-to-gas competition, it is has become increasingly common for price formulae and price review provisions to explicitly refer to hub-prices and the impact of liberalization.

The challenge for parties to long-term gas supply contracts is to agree on price review terms that are general enough to accommodate unforeseen changes to the market, but specific enough to provide adequate guidance to the parties or an arbitral tribunal. There are an array of options available and the drafting choices made by the parties can have an impact on the magnitude and complexity of future pricing disputes. Proper consideration of price review provisions is key and can help limit the uncertainty in price review arbitrations.

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