

Arbitration and Mediation in the Natural Resources and Energy Sector

**Role of Arbitration and the Change in the Price of Energy:
Adjustment Clause, Indexation, Hardship Clause and Force
Majeure in Energy Contracts**

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Energy prices : characteristics and changes

Contractual clauses raised to challenge energy prices

- A. Indexation/adaptation
- B. Hardship Clause
- C. Force majeure

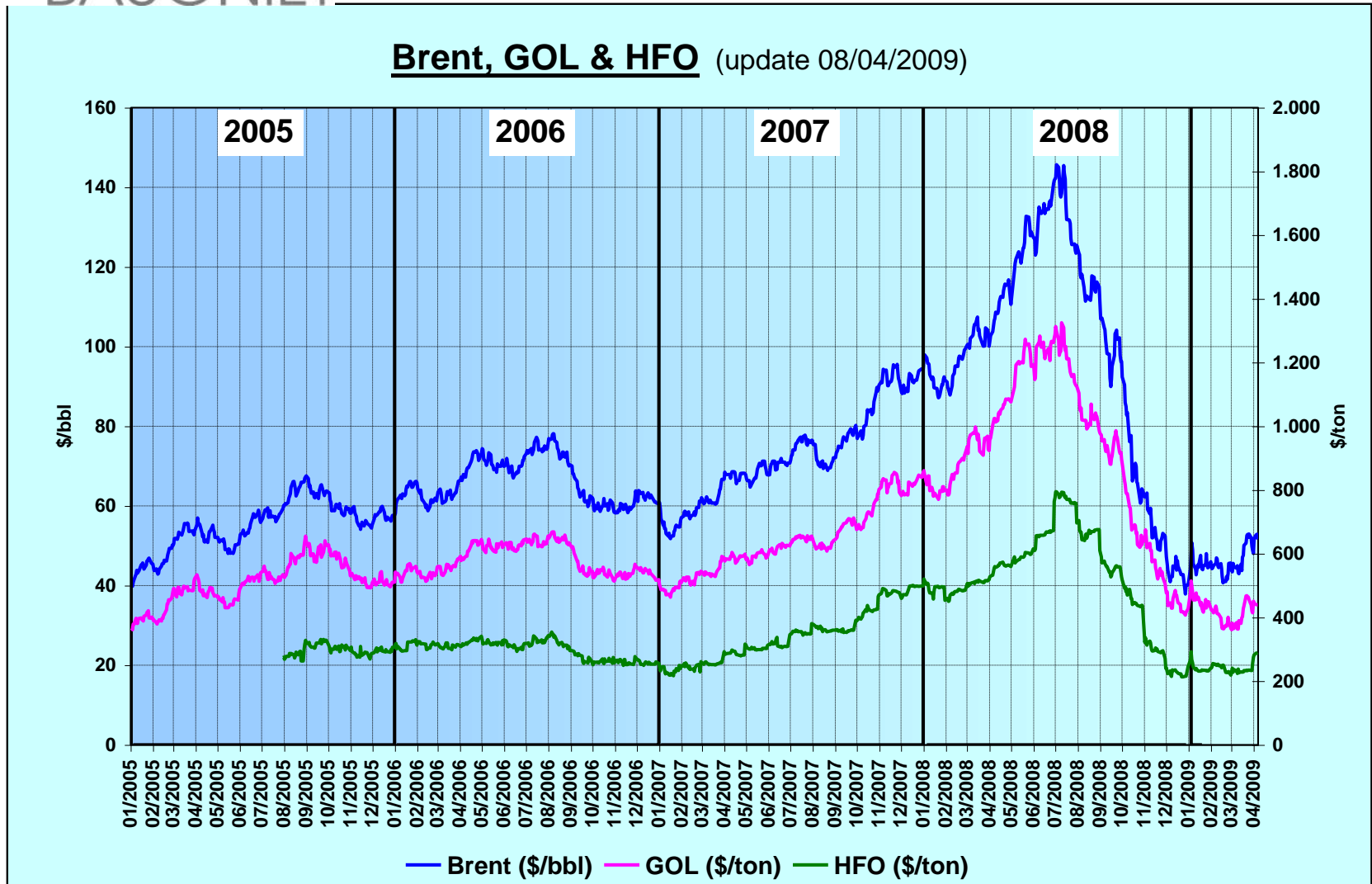
Typology of cases referred to arbitration: role and limits of arbitration

- IV. Conclusion: how to avoid more frustration?
 - A. pay more attention when drafting energy price clauses
 - B. what do you expect from arbitration?
 - C. be coherent with your (future) arbitration proceedings

I. Energy prices : characteristics and changes

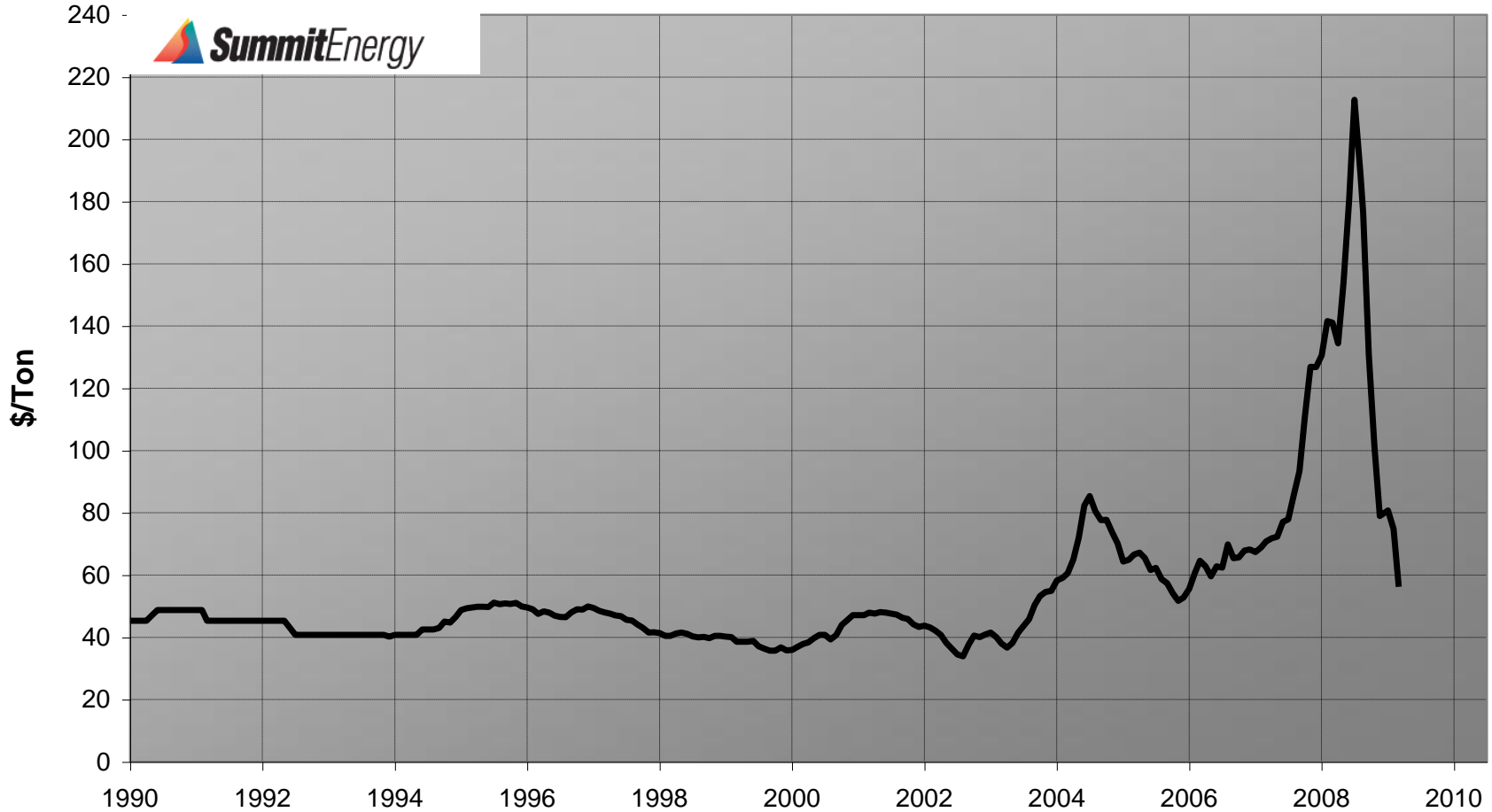
1. Today's market: volatility vs stability (see SUMMIT ENERGY)

Brent / GOL / HFO



Source : Summit Energy

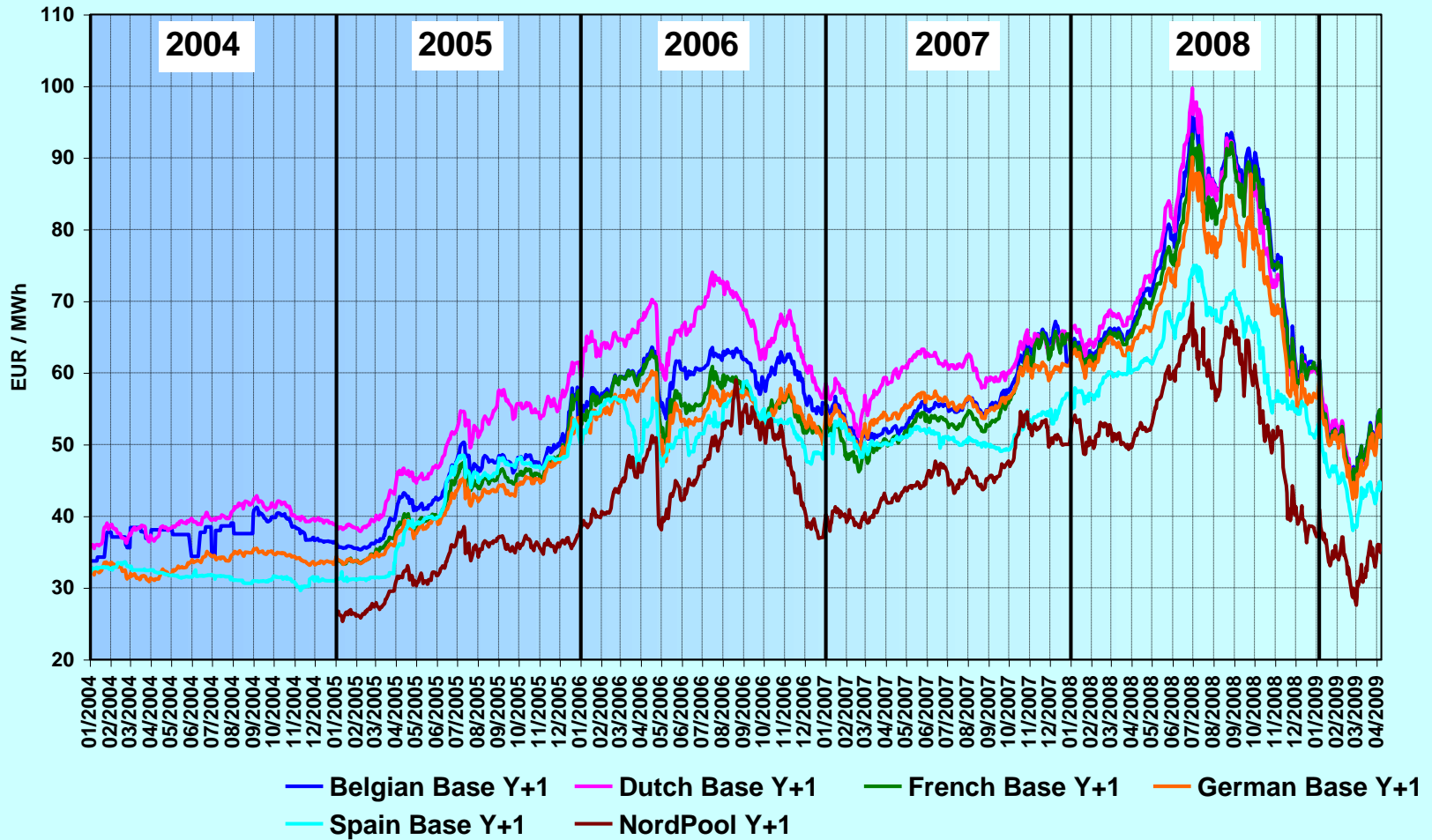
API2 Month Ahead Coal : Price Evolution



Source : Summit Energy

European Electricity

European electricity : Year +1 (update 08/04/2009)



Source : Summit Energy

Sophisticated prices clauses
Stability and previsibility
Share of risks

Typically :

1. Presence of indice (algorithm) and/or link with other energies or commodities (*):
i.e. $P_{\text{gas}} = 1,6 + (0,10 \cdot \text{Brent}) + (0,020 \cdot \text{GOL}) + (0,025 \times \text{HFO}) \text{ €/Mwh}$

$$P_{\text{gas}} = P_x + 0,079 (\text{FOL}_{m(101)} - \text{FOL}_0) \text{ €/Mwh}$$

index reference of : Power exchange (EEX Endex, APX) : other energy (gas (NBP, TTF, Hub Zeebrugge), oil (Brent, GOL, IPE Gasoil, HFO, extra-Heavy fuel oil – FOB Barges Rotterdam), coal, CO2) general consumer Endex, commodities (aluminum, steel, ammoniac, etc.)

Definition of indexes

2. Currency reference : USD, €, ¥, £

(*) The link between gas prices and oil prices, John Huggins, Business Economist, 37, 2006.

Price linked with quantity/period of time Power

Minimum quantity (Mwh, Therm)

Minimum power (MW)

Peak hour /off peak hour

Irrevocable « click »

Top stop – bottom stop

Take or pay (TOP) / Take and pay (TAP)

+/- x %

Carry forward (x year)

Carry backward (x year)

Resale option at cost price

i.e. « *Minimal supply Quantity (TOP): x Mwh* »

« *During the supply period, the Seller shall make available and deliver to the Buyer, and the Buyer shall take and purchase from the Seller, the annual minimum quantity of Natural Gas* ».

Or very sophisticated formulae

II. Contractual clauses raised in arbitration proceedings to change/adapt/challenge energy prices

3 types:

II.A. Indexation and adaptation clauses

As set out from ICC award (N° 3344, 1981, Rec 1974-1985, p. 442): The main difference between adaptation clause and hardship clause lies in the « *automaticity of the modification* » of the price; the parameters of indexation/adaptation set out in the contract must be objective and lead to an *unique solution*.

Examples:

« *The price is fixed and not reviewable for the duration of the Contract and will be increased automatically with the amount of taxes, duties, royalties, charges, allowances, certificates or contributions of any nature, issued by Public Authority that would be directly or indirectly charged to the Supplier, in the framework of the sale of Electrical Energy* ».

« Price – Substitutional and Adjustment of Indices

If at any time either Party can show that in respect of any of the indices at any time or from time to time required to be used in the calculation of the Contract Price

- i) such Index is no longer published and is unlikely to be published again in the foreseeable future, or*
- ii) such index is changed in the basis of calculation or such Index no longer reflects the actual prices of the commodity/capacity that it refers to at the place and time that it refers to or the quality or type the commodity/capacity that such Index refers to has changed materially and not only temporarily, or*
- iii) the relevant figures representing such Index have been computed or published in error, or*
- iv) such index has become controlled unduly influenced by the government of the country where such Index is published,*

then that Party may notify the other Party of such circumstances and the Parties will forthwith meet and endeavor to agree upon an appropriate amendment to or replacement of such Index which will as nearly as possible achieve the objectives of the original Index.

If within (2) months from the date of the said notice no such agreement has been reached, then (at the request of either Party) the matter shall be referred to an arbitrator/expert for determination in accordance with the provision (x) » (...)

« *In any determination to be made by an arbitrator/expert hereof, such determination shall comply with the intention of the Parties that this Agreement shall not be terminated because of any of the events mentioned in Article (..) hereof, but that it is intended that such adjustments to the existing indices to made or that such substitute Indices be used as are necessary so that the adjusted Indices or the substitute indices will in effect be as nearly comparable to the effects sought from the original Indices as any reliable data then available will allow* » [Role of Arbitrator/Expert].

EFET (European Federation of Energy Traders) – General Agreement concerning the delivery and acceptance of Electricity (version 2.1.a; 2007)

Art §15: « Fallback mechanism » in case of the failure of any relevant Price Source to announce or publish information necessary for determining the Commodity Reference Price, the temporary or permanent objective unavailability of any relevant Commodity Reference Price, a temporary or permanent closing of the Price Source of any relevant Commodity Reference Price (etc.), the *Alternative Settlement Price* will be determine as follows:

- (a) Fallback Reference Price (first alternate commodity reference price ...);
- (b) then, negotiated fallback;
- (c) and finally, dealer fallback (§15.3).

II.B. Hardship clauses

(also called « Changes in circumstances », « unforeseen events », « termination clause », « exoneration clause », ...)

Hardship clauses apply when unforeseen events (political, economical, legal environment/regulation, technical) affect fundamentally the equilibrium or the economy of the contractual relations and render its execution much more/abnormally burdensome or difficult (see, art. 6.2 UNIDROIT PRINCIPLES).

The parties must state with precision:

The circumstances triggering the clause (external, beyond the control of the parties)

The consequences:

- a) renegotiation : - role of the arbitrator/expert?
 - on which basis?
 - which equilibrium to reset? Etc.
- b) « termination » of the contract if no agreement is reached.

Examples:

Changes in circumstances

« In the event of unforeseeable events or events which were excluded from the Parties' forecasts, including any substantial changes to taxes and duties, which could have the effect of undermining the economic basis of the existing market or prejudice one or other or the Parties, the Parties shall come to an agreement, in the spirit in which the present agreement was concluded, to make the necessary adjustments so as to replace one or the other provisions of the present contract under the conditions of balance comparable to those which existed at the time of entering into the present contract. In the absence of an agreement, the Parties may refer their dispute to arbitration (as set in article ..)»;

Price Adaptation

« It is agreed between the parties that in case significant changes in primary energy costs, and in particular gas prices would occur and make the electrical power purchased by the Buyer not competitive towards electrical energy based on such primary energy, the partners shall find a mutual agreement to adapt the prices of delivery accordingly such agreement cannot be reached within 2 months, the parties are entitled to refer the matter to arbitration ».

Exoneration clause

« If, due to circumstances of an economic, unforeseen, exceptional or particularly serious nature, occurring after the conclusion of the Contract and outside control or will of the Parties, the economy of the contractual relations would become disturbed in such way that the execution of its obligations would be detrimental towards one of the Parties, the Parties will in good faith to obtain the most suitable solution in order to continue their contractual relationship.

If the Parties have not found a mutual agreement within a period of three (3) months as from the moment of the unforeseen, serious change of the economic contractual relations, each Party will have the possibility to terminate the Contract ».

Contract of Evolution (Evolution du contrat)

« Si, après conclusion du contrat de fourniture d'électricité, l'évolution du contexte technique ou économique était telle que le contrat entraîne pour l'une ou l'autre partie des conséquences néfastes inattendues et que, en toute équité, celles-ci ne peuvent être supportées par la partie concernée, les deux parties essaieront de se mettre d'accord sur une adaptation en toute bonne foi du contrat à cette évolution. Cette éventualité ne confère aucun droit à se désengager du contrat et les autres droits et obligations découlant du contrat ne seront en aucune manière affectés ».

Hardship Clause (Clause de bouleversement)

« Dans le cas où des modifications importantes et imprévues sur les plans économique et technique affecteraient le marché de l'énergie et/ou de [...], lesquelles revêtiraient un caractère exceptionnel et divergeraient fortement de situations historiques, entravant de façon substantielle le respect des engagements pris aux termes du présent Contrat, compte tenu du motif pour lesquels ils ont été pris, le Consommateur et le Fournisseur s'engagent à se concerter en vue de trouver au problème une solution qui respecte leurs intérêts respectifs.

Si le Consommateur invoque la présente clause en alléguant que ces modifications rendent la poursuite de la production d'[...] économiquement impossible à supporter pour le Consommateur, la concertation tendra notamment vers la limitation de l'obligation de prélèvement du consommateur et de l'obligation de fourniture correspondante pour le Fournisseur, laquelle limitation ne peut dépasser [...] ».

Adaptation

« In case of substantial change (eine grundlegende Änderung) of circumstances existing at the time of the conclusion of the contract and having an influence on the equilibrium of the economical and reciprocal interests (wirtschaftlichen Interessen) of the Parties, these one will adapt it accordingly (die Vertragsbestimmungen den geänderten Verhältnissen entsprechend angepaßt werden) ».

→ link with the English doctrine of “frustration”:

The presence of a price escalation clause in a contract may make a court more reluctant to conclude that a sudden increase in prices has frustrated the contract [Wates V. GLC (1983) 25 Build L.R.1]

→ Conflict between escalation/indexation price clause and hardship clause

- Do hardship clauses supersede/apply to price clauses?
- What were the intentions of the Parties? What was the initial economic situation/equilibrium of the Contract?
- What is stated about the arbitrator role?

II.c. Force majeure clause

By definition, a force majeure event renders the execution of the agreement quasi « impossible », which differentiates it from the hardship clause (more onerous/difficult).

In case of Force majeure, the execution of the contract is suspended and the parties are exempted from any contractual breach.

Examples:

« 'Force majeure' means any unforeseen event or circumstance, the occurrence of which is beyond the reasonable control of the affected Party, and which could not be avoided or prevented with due care and at reasonable expenses which have the effect of making impossible or unlawful for the affected Party to perform all or any of its obligations hereunder. Force Majeure events shall include but shall not be limited to the following: (...) ».

« For the purposes of this contract, force majeure shall be taken to mean any event outside the control of the Party concerned, which could not reasonably be foreseen or, if foreseen, that could not be reasonably avoided and the consequences of which could not be overcome by the means which should be open to the Parties as prudent and reasonable operators, and which prevents the Party concerned from performing all or part of its obligations under this Contract. Cases of force majeure, when they fulfill the conditions set out above, shall include but not be limited to : (...) ».

« Consequences of Force Majeure

All Natural Gas, the delivery or taking of which has been prevented by Force Majeure, shall, unless otherwise agreed, be deducted from the amounts required to be made available and taken under this Agreement ».

Prices increases or decreases are, under well established arbitration award not generally recognized as force majeure events.

See, ICC Award N° 2216, 1974

Refusal of a Norway Company to take crude oil because of oil price escalation and because of currency variation.

Award : no force majeure event

See, ICC Award n° 2478, 1974

Illegal refusal of a Romanian Company to deliver gasoline because of increase of oil price and of currency variation.

See ICC, Award n° 2508, 1976

Refusal to deliver energy because of increase of oil price

Award: condemnation of the seller

III. Typology of cases referred to arbitration: role and limits of arbitration

4 types of disputes:

III.A. Disputes related to refusal of adaptation of energy prices – new price formulae

- Parties must give to arbitrator and in advance in the contract all the details/factual elements necessary to reach a new price.
Recent case over the adaptation price of uranium where arbitrator were not able to establish/compute new price.
- Parties' behavior (see ICC, Award, n° 3344, 1981)
 - Implicit acceptance consequent to specific silence (see also ICC, Award n° 2520, 1975; n° 3243, 1981)
 - Ambiguity of a party taking the acceptance of oil but continuing to pay the « old » price notwithstanding the request of the counterparty to index it.

III.B. Disputes related to indices – reference – quotation – changes or disappearances

- Again Parties must be clear in their contract. See, i.e. EFET, clause §15 which describe with precision fallback position
- What will be the consequences of index change? Replacement by a new one and from when? Termination of the Contract? Role of the arbitrator?

Example:

« In any determination to be made by an arbitrator/expert under Article (...) such determination shall comply with the intention of the Parties that this Agreement shall not terminate because of any of the events mentioned in Article (...), but that it is intended that such adjustments to the existing Indices be made or that such substitute Indices be used as are necessary so that the adjusted indices or the substitute Indices will in effect be as nearly comparable to the effects sought from the original Indices as any reliable data then available will allow ».

III.C. Hardship clause and potential conflict with indexation price clause

Is there an Hardship clause or not? Does price variation expressly or implicitly fall within this clause? What were the original economic situations of the Parties?

The Arbitrator can only apply such clauses if they are able to reconstitute the « original » equilibrium of Parties' situation.

Example in case of gas delivery to supply a producer of electricity:

Price

« *The gas price will be indexed. The only relevant index will be coal index (...)* ».

Economic change

« In case fundamental change in economy of the Contract which render its execution uneconomical or much more burdensome that originally expected, the Parties will enter into negotiation to replace them in the same situation as it was at the time of conclusion of the Contract ».

The gas price jumped but coal index, at that time, stayed stable. The electricity price jumped also. The gas supply asked for renegotiation of the Contract.

What was the economy of the Contract?

III.D. Disputes arising from TOP Clauses

Description

Basic idea: the buyer is obliged to pay the contract quantity of gas/electricity/LNG (...) even if he fails to take delivery, in order to guarantee a cash flow for the seller.

- Typical energy clause, specially in long term gas contract
- now in short term contract of electricity, gas, oil, LNG

Share of risks between producer and buyer: - « price risk » (market risk »)
- « volume risk »

Initially gas producers wanted to secure payment independently of taken volume; now used to cover reservations, slots on networks, etc. on LNG terminal.

- carry forward (untaken quantities reported to coming years);
- carry backward (overtaken quantity taken in the past years, taken into account on the actual minimum yearly quantity)

- right to resell (at cost price)

Carry forward or backward/right to resell reduce the penalty/the price, etc.

- TAP (obligation to take delivery and pay)

Disputes:

- over legality of such clause (no punitive damages)
- over the exact computation of the penalty
- renegotiation

IV. Conclusion : how to avoid (more) frustration?

3 golden rules:

Pay more attention when drafting energy price clauses (specially for long term contracts)

- do you want an adaptation/indexation or not?
- what are the elements triggering the change in price? When does the change begin?
- do you have a fallback position in case of disappearance of a price component (index, quotation, ...)?
- do you want a hardship clause in case of frustration/loss of economic equilibrium of party's situation? When? Under which circumstances? You must state the details of the original situation or equilibrium of the parties
- hardship clause supersedes adaptation clause or not?

What do you expect from arbitration? Do you give to the arbitrator all factual and legal elements to render a workable award?

- give clear intention of the parties as to price adjustment;
- give all « tools » to the Arbitrator to compute/adapt the price: otherwise the arbitrator will render an award stating that they cannot adapt;
- give the arbitrator the way to find/compute the new index/value/reference;
- give to the arbitrator the original equilibrium of the parties' situation (economic situation) (in the whereas ...)

Be coherent with your (future) arbitration proceedings

- do not adopt a position in contradiction with strategy i.e. :
- « old » price maintained or not
- TOP applicable or not

The arbitrator may draw consequences of Parties' behavior: estoppel, admission, implicit waiver, ...).



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