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The Role of Gas Price Reviews in Addressing Structural Changes

Alexander Marcopoulos

1. Historical Context: the International Model for Pipeline and LNG Sales Contracts

2. The Price Review Mechanism as a Risk Management Tool

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4. The Potential Relevance of Price Reviews to Structural Changes in the Greek Market

1. Historical Context: the International Model for Pipeline and LNG Sales Contracts

- Historically, pipeline gas and LNG sales contracts have included the following key features:
  - A **long term** of performance of 10 years or more (generally driven by the seller's need to monetize discoveries);
  - "**Take-or-Pay**" terms, according to which the buyer is required to pay for a minimum quantity of gas each year, regardless of whether the full quantity is taken (driven by the seller's need for debt securitization); and
  - A **commodity-indexed price** which in the past has generally been indexed to oil products

    ➔ Since European markets have liberalized, there has been a trend towards hub-based pricing

- These features entail two significant risks, which must be balanced in the sales contract:
  - The **volume risk** that arises from the buyer's long-term take-or-pay obligation (which persists regardless of downstream demand); and
  - The **price risk** that the commodity-linked contract price could fall out of line with prices in the buyer's market

1. Historical Context: the International Model for Pipeline and LNG Sales Contracts

Seller agrees to make available to Buyer a minimum quantity of gas per year for the contract's long term

Seller

Buyer

Buyer agrees to take and pay for, or pay for if not taken, a minimum quantity of gas per year for the contract's long term

[allocation of risk]

PRICE RISK

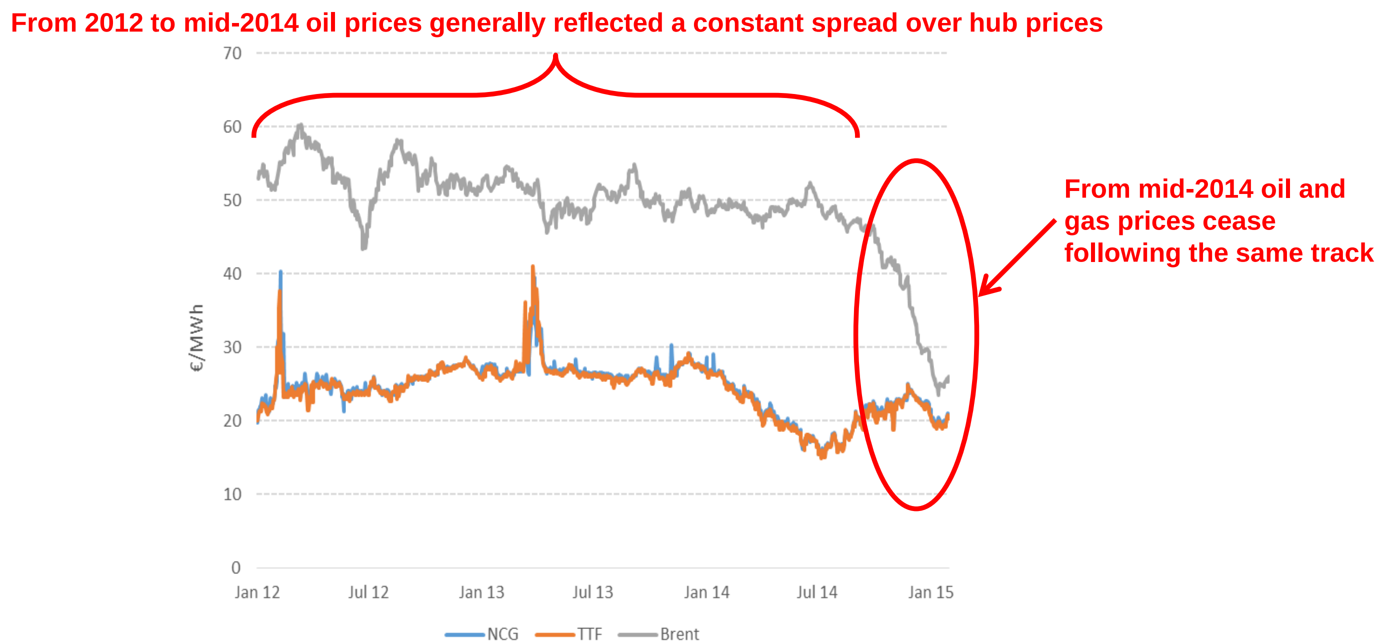
- Buyer needs protection to ensure that its ToP obligation will remain commercially viable
- Seller guarantees that gas purchased will "in any case" remain capable of competitive sale in the Buyer's market

VOLUME RISK

- Buyer guarantees that it will purchase a minimum quantity of gas each year regardless of downstream demand
- Subject to annual, seasonal and daily flexibility (standard in long-term ToP contracts)

2. The Price Review Mechanism as a Risk Management Tool

- Even with commodity price indexation, structural changes can frustrate the parties' initial bargain as to price:
  - This was seen, for example, in the wave of liberalization in Western European markets over the last 10 years
  - These structural changes caused a decoupling of oil-indexed contract prices from the price of gas at liquid trading hubs



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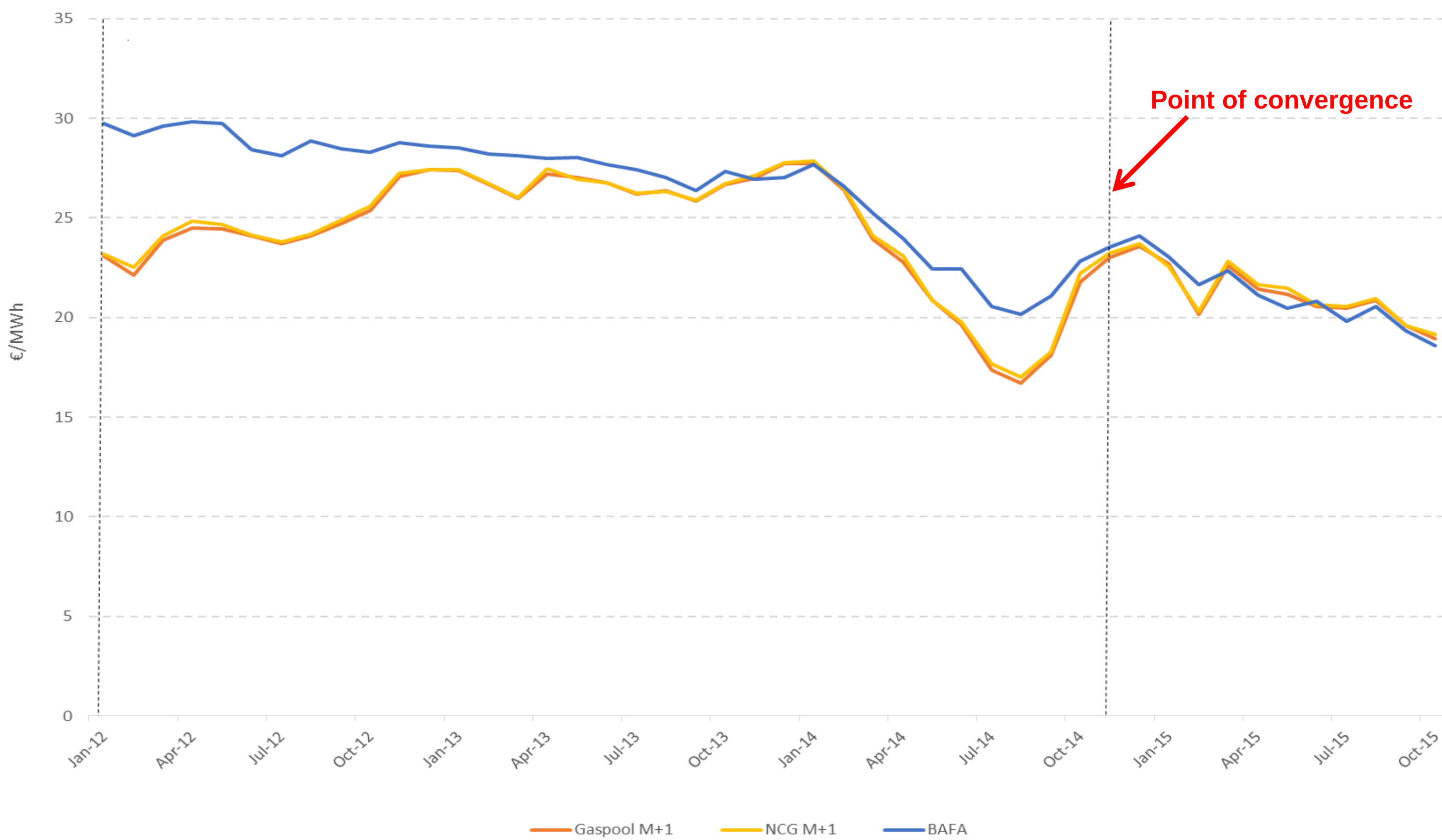
  - These structural changes caused a decoupling of oil-indexed contract prices from the price of gas at liquid trading hubs
  - Depending on the contract, recent oil price changes could be argued as having frustrated the parties' initial bargain
- Therefore, most LTCs include a **price review clause** establishing an agreed procedure for adjusting the price
- The effect of price reviews initiated to address decoupling can be seen in the convergence of European import prices (as reported by BAFA) with hub prices beginning in late 2014

2. The Price Review Mechanism as a Risk Management Tool

European import prices (BAFA) vs German hub prices 2012-2015



3. Typical Features of a Price Review Mechanism | Overview

Although price review clauses can differ significantly from contract to contract, they typically contain the following features:

- a **trigger** for a price review, either at regular intervals (every 3 to 5 years) or upon showing that certain changes have occurred;
- **procedural steps** for reviewing the contract price (usually negotiation followed by arbitration);
- **review criteria** (e.g. benchmarks) against which the contract price should be assessed;
- an **"in any case" clause** requiring that the gas be capable of competitive resale in the buyer's market;
- **adjustment criteria** for determining a new contract price if the other requirements are met

(a) 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.

(b) In reviewing the Contract Price in accordance with a request pursuant to sub-Article 8.5(a) above the Parties shall take into account levels and trends in price of supplies of LNG and Natural Gas [redacted] such supplies being sold under commercial contracts currently in force on arm's length terms, and having due regard to all characteristics of such supplies (including, but not limited to quality, quantity, interruptability, flexibility of deliveries and term of supply).

(c) The Contract Price as revised in accordance with this Article, shall in any event, allow the Buyer to market the LNG supplied hereunder in competition with all competing sources or forms of energy [...] in the market of the Buyer at the point of consumption, taking into account, *inter alia*, all appropriate operations, services and risks which are usual in the Natural Gas industry from the points of import for handling and marketing the Natural Gas in all market segments when due regard is given to all characteristics of the LNG supplied under this agreement [...] and on the basis that sound marketing practices and efficient operations on the part of the Buyer are assumed and such Contract Price Shall allow the Buyer to achieve a reasonable rate of return on the LNG delivered hereunder.

[Price Review Clause from the contract between Atlantic LNG Co. of Trinidad and Tobago and Gas Natural Aprovisionamientos, SDG, SA]

3. Typical Features of a Price Review Mechanism | The Trigger

The “trigger” describes the circumstance(s) in which a review / revision of the contract price is permitted

- In some contracts, the trigger can be mechanical, thereby limiting debate over whether or when a price review is allowed:
  - an automatic trigger at **regular intervals** (usually every 3 years or every 5 years); or
  - a mechanical trigger based on **precise, pre-defined criteria**, e.g. a specific spread between the contract price and the benchmark

- More commonly, the trigger is defined in a more open-ended manner, usually with reference to qualitative “changes” that:
  - are “**significant**” or “**substantial**”;
  - were **unforeseen** as of the date the existing contract price was set; and
  - were outside of the requesting party’s **control**

3. Typical Features of a Price Review Mechanism | Review Criteria

Price review clauses can define review criteria identifying the '**where**', '**when**' and '**how**' of the price review

- <u>Where</u> do the "changes" defined in the trigger clause have to have occurred?
  - The market of the buyer?
  - A wider energy market (e.g. "the energy market of Western Europe")?
- <u>When</u> is the relevant period falling for review?
  - Price reviews are typically subject to a circumscribed "review period" extending from the effective date of the last revision to the notification date of the present price review
  - For purposes of assessing the <u>trigger</u>, the "changes" must have occurred within the review period
  - Arbitrators sometimes have to look beyond the review period to assess whether the "changes" were transient or lasting
- <u>How</u> is the contract price to be reviewed?
  - Some clauses require an assessment focusing only on the <u>end of the review period</u>
  - Some clauses require a "<u>delta change</u>" analysis, comparing the situation at the start and end of the review period

3. Typical Features of a Price Review Mechanism | The “In Any Case” Clause

Consistent with the standard allocation of price risk to the seller, many price review clauses require that, “in any case”, the contract price shall allow for the gas to be economically marketed in the buyer’s market

- The nature and function of these clauses has been subject to much debate
  - Do they only function as a defense for the buyer in case the seller seeks an upward price revision?
  - Can they be relied upon by the buyer as a separate trigger for a downward price revision?
  - Can they be relied upon by the seller as a separate trigger?
- There is likewise much debate over the meaning of the phrase “economically market” or similar language
  - Does the “in any case” clause guarantee the buyer a positive margin?
  - What are the competing fuels against which the marketability or competitiveness of the contract gas should be assessed?
  - In what period should the marketability or competitiveness of the contract gas be assessed?
- Typically, “in any case” clauses provide that sound marketing practices and efficient operations by the buyer are assumed; this is to prevent a buyer from relying on its own failures to invoke the clause

3. Typical Features of a Price Review Mechanism | Adjustment Criteria

Price review clauses provide varying degrees of guidance with respect to the calculation of a price revision

- Some clauses provide specific, prescriptive guidance—for example:
  - by indicating the specific elements of the price formula that can/should be revised (e.g. the base price ‘P0’ or indices); or
  - by specifying a methodology for the price revision (e.g. “delta-change” analysis)
- Other clauses are less prescriptive and more open-ended, providing, for example, that the revised price must be “fair and equitable” to the parties
- Clearly-defined adjustment criteria are desirable so as to avoid disputes over the scope of the tribunal’s mandate in revising the contract price
- In any event, it is important for the adjustment criteria to address the change relied upon to trigger a price review; otherwise, grounds for a further trigger would remain even after the price had been reviewed / revised

4. The Potential Relevance of Price Reviews to Structural Changes in the Greek Market

- While the Greek market has taken significant steps towards liberalization since 1998 (in accordance with the relevant EU Directives), it has not yet experienced the full suite of structural changes seen in Western Europe
  - The market is still dominated by DEPA, who remains the principal importer of natural gas to Greece
  - Private companies are now able to import natural gas, but they do not yet have a meaningful presence in the market for pipeline imports pursuant to long-term contracts
  - Unlike most of Western Europe, Greece still does not have access to a liquid gas trading hub
  - Plans are in the works for new natural gas production in Greece, new LNG storage and regasification facilities, new access to pipeline imports (e.g. from Russia through Turkey) and potentially the establishment of a gas hub
- To the extent significant changes occur, these could (in theory) trigger a price review under existing contracts
- As the Greek market opens to new players and new contracts are signed, it will be necessary to consider the changed market environment when drafting new price review clauses (and reviewing existing clauses)
  - The triggers defined in the price review clause should be appropriate to new market realities
  - Appropriate price review benchmarks should be defined (e.g. it may not make sense to peg the contract price to hub prices that Greek buyers are unable to access)
  - The “in any case” clause should take into account the nature and extent of competition in the end user market

Please feel free to contact me with any questions…

Alexander Marcopoulos
Counsel, International Arbitration

T +33 (0)1 53 89 48 09
M +33 (0)6 23 15 26 02

amarcopoulos@shearman.com