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Gas Natural Aprovisionamientos, SDG, S.A. v. Atlantic LNG Company of Trinidad and Tobago *and Price Reopener Clauses in an Uncertain Environment for LNG Pricing*

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Summary

The seller of LNG in the recent case of *Gas Natural Aprovisionamientos, SDG, S.A. v. Atlantic LNG Company of Trinidad and Tobago* in the United States District Court for the Southern District of New York (2008 WL 4344525 (S.D.N.Y.)) objected to the LNG price formula imposed by the arbitration panel in a dispute involving the application of a price reopener clause in a long-term LNG sale and purchase agreement. The Court upheld the LNG price formula imposed by the arbitration panel pursuant to the price reopener clause.

If the buyer and the seller elect to include a price reopener clause in their LNG sale and purchase agreement, the parties should devote as much attention to the negotiation of the price reopener clause as to the negotiation of the LNG price itself. As the price reopener clause is a contractually binding mechanism for a party to initiate a process to review and, in some cases, override and reset the then-applicable LNG price and price formula, the price reopener clause should be structured in such a manner to reconcile the competing interests of the buyer and the seller and facilitate a commercial agreement. The Gas Natural case demonstrates how a price reopener clause may result in an unsatisfactory LNG price for one of the parties.

Gas Natural Aprovisionamientos, SDG, S.A. v. Atlantic LNG Company of Trinidad and Tobago

In July 1995, Gas Natural Aprovisionamientos, SDG, S.A. ("Gas Natural") and Atlantic LNG Company of Trinidad and Tobago ("Atlantic LNG") entered into a 20-year LNG sale and purchase agreement (the "LNG SPA"), with deliveries beginning in 1999. The LNG SPA included a pricing formula that contained a base price and a multiplier indexed quarterly to European prices for certain substitute petroleum products. The LNG SPA contemplated that Gas Natural would transport the LNG to its receiving facilities in Spain or to a receiving terminal in New England.

The LNG SPA also included a price reopener provision that provided:

> 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 . . . and the Contract Price . . . 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 abovementioned Contract Price provisions.

The LNG SPA further provided that, in the event that Gas Natural and Atlantic LNG could not reach agreement on the revised price formula within six months, either party may submit the matter to arbitration for final resolution.

After the parties entered into the LNG SPA, Spain substantially liberalized its natural gas market. As a result, Spanish natural gas prices decreased and prices in the New England market became more attractive to Gas Natural. Gas Natural entered into a long-term agreement to resell all of the LNG purchased under the LNG SPA at the New England receiving facility. Indeed, since at least October 2002, Gas Natural did not transport any LNG purchased under the LNG SPA to its receiving terminals in Spain.

Citing these circumstances, Atlantic LNG notified Gas Natural on April 21, 2005 that it was seeking a revision to the contract price. The parties were unable to agree on a new price and on October 21, 2005, Atlantic LNG submitted the dispute to arbitration and requested an upward revision to the LNG price to reflect the value of natural gas in the New England market.

The arbitration panel first determined that the necessary conditions precedent to the applicability of the price reopener clause had been satisfied. Concluding that, "since New England should be the basis for determining the value of natural gas . . . when LNG is being sold in New England on a sustained basis," the arbitration panel then implemented a two-part pricing scheme:

- First, the arbitration panel preserved the original Spanish pricing formula subject to an adjustment to the base price component.
- Second, the arbitration panel added a "New England Market Adjustment" for quarters in which more than a specified percentage of LNG under the LNG SPA was transported to the receiving terminal in New England.

The arbitration panel made the revised pricing scheme effective from April 21, 2005, the date on which Atlantic LNG notified Gas Natural that it was seeking a revision to the contract price. As a result of the revised pricing scheme, Atlantic LNG owed Gas Natural more than $70 million for the period between April 21, 2005 and December 31, 2007.

Atlantic LNG challenged the arbitration panel's imposition of the two-part pricing scheme. Atlantic LNG argued that the arbitration panel exceeded the scope of its authority by imposing a pricing scheme that skewed the original bargain between the parties and effectively rewrote the LNG SPA. Atlantic LNG contended that the dual-price structure gave Gas Natural the unbargained-for ability to determine which price will apply to all shipments merely by shifting the delivery destination.

The United States District Court for the Southern District of New York held that the arbitration panel did not exceed its authority. Moreover, the Court specifically stated that, in respect of the arbitration panel's imposition of the dual pricing scheme, the LNG SPA did not "set a structural limitation on permissible price revisions." The price reopener clause only required the arbitration panel to reach a "fair and equitable revision" of the contract price.

The arbitration panel's determination and the Court's decision in the Gas Natural case provide a useful study of the issues involved in the negotiation of a price reopener clause in long-term LNG sale and purchase agreements.

The Price Reopener

There are three key components to a price reopener clause –

- The conditions precedent (or triggering events) that a party must satisfy before it may invoke the price reopener clause.
- The procedure for the buyer and the seller to review and determine the revised price.
- The procedure in the event that the buyer and the seller fail to agree on a revised price.

Conditions Precedent

The buyer and seller should carefully consider the scope and nature of the conditions precedent that must exist before a party may exercise its rights under a price reopener provision. The conditions precedent typically reflect one of the following approaches:

- A price reopener triggered by the occurrence of a scheduled event, typically the passage of a defined period of time – for example, a review of the price once every five years. A frequency clause offers the parties certainty that the price will be reviewed upon the expiration of the defined period. However, the regularity of the price reopener gives rise to uncertainty as the price may vary during the term of the LNG sale and purchase agreement.
- A price reopener triggered by the occurrence of one or more subjective events – for example, the occurrence of a "substantial change in economic conditions which causes a substantial economic hardship" or as provided in the Gas Natural LNG SPA. A subjective price opener clause offers the parties considerable flexibility as the parties will not typically define the meaning of "substantial change" or "substantial economic hardship". Such flexibility, however, brings risks as a party can challenge whether the subjective conditions precedent are satisfied.
- A price reopener triggered by the occurrence of one or more objective events – for example, if the rate of return of one party is less than a contractually agreed minimum rate of return. An objective price opener clause offers the parties greater clarity and certainty. However, the objective standards must be realistic – otherwise, the objective price review may limit the ability of a party to take advantage of the price reopener mechanism.

The scope and nature of the conditions precedent are important – as satisfaction of the conditions precedent is a gate that the party exercising its rights under the price reopener clause must pass through before it has a contractual right to reopen the LNG price – and the satisfaction of the conditions precedent can provide fertile ground for disputes between the buyer and the seller.

Reaching Agreement on the Revised Price

The price reopener clause commonly sets forth a methodology by which the buyer and the seller will meet to negotiate and agree upon the terms of the revised price. The methodology may be more or less specific – setting forth the frequency of meetings, mandating a certain negotiating standard for the buyer and the seller (negotiating "in good faith" or "on a reasonable basis") and identifying the participants in the price revision negotiations (project managers, senior executives or chief executive officers).

Failure to Reach Agreement on the Revised Price

In the end, as the buyer and the seller have divergent interests, it is very possible that the

parties will be unable to reach an agreement on the revised price. In such case, the price reopener clause may refer the matter to an independent third party for determination. This independent third party can be an expert or arbitrator with knowledge of the LNG industry.

In either case, the buyer and the seller will have elected to delegate settlement of the LNG price to a third party. The *Gas Natural* case demonstrates the real risks and uncertainties involved when the buyer and the seller delegate the determination of the LNG price to an independent third party (whether an arbitrator or an expert).

The LNG price and price formula is the most commercially sensitive element of the LNG sale and purchase agreement. The fundamental commercial equilibrium between the buyer and the seller is undermined if the buyer and the seller do not agree on the revised price. Thus, any mechanism to independently determine the LNG price should seek to achieve a result that most closely reflects the views of the buyer and the seller.

There is not a "one size fits all" mechanism to ensure that an independent third party reaches a price that restores the economic equilibrium of the parties in the LNG sale and purchase agreement. Even a straightforward mechanism – for example, having the buyer and the seller provide the independent third party with a "good faith" or "best guess" price proposal and having the third party select between the two proposals – does not necessarily result in a price or formula that reflects the views of the buyer and the seller or restore the commercial equilibrium of the LNG sale and purchase agreement. This is especially the case in the LNG market – where there are considerable differences and variations in pricing formulas and criteria in the U.S., European and Asian markets.

As the buyer and the seller will clearly identify the terms and conditions of the original LNG price formula – it is recommended that they also expressly proscribe the acceptable parameters and standards to be adhered to by the independent third party. The parties could, for instance, agree to a range of acceptable adjustments to be evaluated by the independent third party – for example, a range of permissible adjustments to the slope or the constant if the LNG sale and purchase agreement has an S-curve, a set of alternative competitive fuels or a list of acceptable alternative reference points.

The parties may want to contractually pre-agree when an acceptable adjustment will take effect – retroactively to the date of the occurrence of the triggering event or the date a party requests to reopen the price negotiations or the date the revised price is finally determined. Otherwise, the independent third party may have considerable discretion to make this decision – a decision that could result in millions of dollars in unexpected costs.

It is also important to expressly limit the authority of the independent third party to base its decision on criteria outside of the list of acceptable parameters. An express limitation of this type will focus the attention of the independent third party to the range of acceptable parameters and, more importantly, will function as a baseline to test whether the independent third party exceeded its authority under the LNG sale and purchase agreement (the central legal question in the *Gas Natural* case).

While it may be time-consuming and difficult for the parties to pre-agree to a range of adjustments for worst-case scenarios – such pre-agreed range of adjustments will likely result in a more acceptable price revision as the buyer and seller will have identified what type or range of adjustments might be acceptable.

The *Gas Natural* case provides a concrete (and public) example of how a price reopener provision may be applied in a manner that neither party intended. The case serves as an important reminder that, particularly during the current period of economic dislocation and market volatility in oil and natural gas prices,

price reopener provisions serve to override the carefully negotiated LNG price and price formulas set forth in the LNG sale and purchase agreement and that the buyer and the seller should devote as much attention to the price reopener clause as they do to the original LNG price and price formula terms.

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If you have any questions concerning these developing issues, please do not hesitate to contact the author:

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