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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Pricing Provisions And The Gazprom-Naftogaz Dispute

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Jeremy Wilson

On June 16, 2014, Gazprom announced that it had commenced arbitration proceedings against Naftogaz under the Stockholm Chamber of Commerce rules alleging that Naftogaz has failed to pay $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 $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 they 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 and consider the provisions at issue in the current proceedings.

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 typically 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 nonexistence of boilerplate 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 can 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.

The current arbitration arises under Contract No. KP dated Jan. 19, 2009, a 10-year, long-term gas sales agreement between Gazprom and Naftogaz for volumes ranging from 40 to 52 billion cubic meters of gas per year. On the basis of the statements released by the parties, it appears that Gazprom will be alleging a debt claim. Naftogaz appears likely to invoke the price review provisions and seek a decrease in price.

To resolve the dispute, the tribunal will likely need to consider the price review provisions in the contract. Pricing terms and price review provisions are confidential and rarely disclosed. However, Ukrainskaya Pravda — a Ukranian news outlet — purported to publish the terms of the contract when it was agreed. Assuming that the contract published by Ukrainskaya Pravda contains the price review provisions that are relevant to the current arbitration between Naftogaz and Gazprom, the tribunal will be required to interpret some unusual terms.

For instance, the contract published by Ukrainskaya Pravda does not appear to provide a set period of time during which the parties may initiate price reviews. The parties appear to be allowed to initiate a price review at any time during the contract's term. There do not appear to be any limits on the number of times that the parties can commence price reviews. While providing flexibility, this type of price review clause also creates the possibility that the parties are frequently reviewing the price, which would be very disruptive. For example, if either party is unhappy with the result of the arbitration, then it can immediately seek to commence a new price review. The tribunal will be aware of this possibility and it may color the decision it reaches.

The price review provisions in the contract published by Ukrainskaya Pravda require the tribunal to determine whether there has been a material change in the market for fuel and energy products. But the contract does not appear to define “market” explicitly. The tribunal will need to determine what market data they should evaluate in order to determine whether there has been a material change.

The definition of “market” may be contentious. While Gazprom supplies almost the entirety of the country's imported gas, Ukraine has begun to diversify its energy supply. Some European energy companies have recently begun providing “reverse flow” gas to Ukraine through Poland and Hungary. Data from markets outside Ukraine may be relevant. The tribunal will need to determine whether it is allowed to consider this data from markets outside Ukraine under the terms of the price review provision.

The terms of the contract published by Ukrainskaya Pravda also require the tribunal to determine whether or not the price produced by the price formula reflects the “market price.” The contract does not specify any approach for determining the market price. Moreover, while the price formula is indexed to gasoil and mazut (a low quality fuel oil), and each is weighted equally, there is no explicit wording about why these variables were chosen and whether or not their weighting relates to any specific market segmentation.

In short, the price review provisions of the contract published by Ukrainskaya Pravda provide the tribunal with little guidance and a tremendous degree of discretion. This makes the proceedings more complex and can increase the uncertainty about the result.

As demonstrated by the contract at the center of the arbitration between Naftogaz and Gazprom, there are many ways of drafting price formulae and price review provisions. There are an array of options available to parties as they negotiate pricing terms. 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.

—By Jeremy Wilson and William Lowery, Covington & Burling LLP

Jeremy Wilson is a partner and William Lowery is an associate in Covington & Burling's international arbitration group in London.

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