SINGAPORE: Are Asia's LNG players heading for a contractual train wreck?

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In a recent study of challenges to pricing in Asia's liquefied natural gas markets, **Howard Rogers** and **Jonathan Stern** of the Oxford Institute of Energy Studies suggest that every market where prices have been liberalised and hubs created has seen "contractual train wrecks", and that for Asian markets to avert such a scenario is "by no means guaranteed". **Darina Maláčová** of De Brauw and **Yuri Yashiro** of Bredin Prat report on a recent event in Singapore that considered this ominous prediction.

Jonathan Stern (far right) addresses panel

The event was organised by the "Best Friends", a group of international law firms that includes BonelliErede, Bredin Prat, De Brauw Blackstone Westbroek, Hengeler Mueller, Slaughter and May and Uría Menéndez, together with McKinsey & Company and the Singapore International Arbitration Centre (SIAC).

Edward van Geuns, partner at De Brauw, opened by quoting Rogers and Stern's prediction in "Challenges to JCC Pricing in Asian LNG Markets", published in February 2014. The day would focus on the challenges that face Asia's markets, with market experts sharing their experience of resolving gas pricing disputes caused by the dramatic changes that afflicted the European gas business in the past decade, he said.
They would also consider whether the Asian markets are likely to suffer a high level of stress in the near future and, if so, how market players should prepare themselves.

The event was attended by over 100 participants, mostly representatives of major energy companies active in Asia.

One of the authors of the “challenges” report had accepted an invitation to give the keynote address. Stern, chairman and senior research fellow of the Oxford Institute of Energy Studies gas programme, spoke about the collapse in oil prices since the report was written and whether that alleviates the pressure for change in LNG contracts emanating from the Asia Pacific.

Stern appeared to think not, explaining that the need for a change in the pricing structure of such contracts stems from the fact that the current one does not reflect supply-demand dynamics in the region.

It is uncertain, though, what the replacement structures should look like, he said. The uncertainty could even lead to a transition period in the coming years in which a number of different pricing structures develop in different Asian countries.

Stern predicted a significant LNG surplus in the Asian market, which, combined with the fall of oil prices expected in 2017, will create further need for Asian buyers to adjust the pricing of long-term contracts. However, without a clear price review clause, this will not be easy. The Asian gas market, until now entirely lacking any tradition of gas price litigation or arbitration, may be pushed in the direction of arbitration, he said.

"It would be nice to think that Asian gas players will find consensus. I hope they do, but I actually think the more likely outcome in the next few years is that we will see a move towards litigation despite the lack of precedents and the relationship culture that we've always traditionally had in Asia."

He did not backtrack on his prediction of a “trainwreck scenario”, saying that the expected decrease of LNG spot prices would create stress in the market and that any potential rise of prices could be calamitous.

Otto Waterlander, lead partner at McKinsey & Company's Global Gas Service Line, opened a session moderated by van Geuns on how the predicted developments would affect individual market players.
He shared his experience as expert witness in numerous gas price disputes and gave the audience a number of valuable lessons in how to deal with contract stress.

Arbitration can be used to create leverage and to stimulate commercial negotiations, ultimately leading to an amicable settlement of the dispute, he said.

A lively discussion led by Stern, the head of LNG at Vitol Group **David Thomas**, and **Louis Christophe Delanoy** of Bredin Prat exposed the complexity of the market situation and the difficulty the energy companies have in responding it.
As Stern put it: "This is a very disturbing period after a period where things may have been difficult but were a little more predictable than they're going to be in the next few years".

Delanoy suggested that players under stress in changing market conditions should seek the advice of external experts and counsel at an early stage to better assess what they can claim in any negotiation. This might prevent them from later incurring high expert and lawyers' fees if the matter goes to arbitration.

Stern and van Geuns exchanged views on what the perfect price review clause looks like and whether it even exists. The panel then discussed whether market players should consider substituting longterm gas and LNG contracts with short term ones, until such time as a clear price formulation mechanism emerges and price review clauses become sufficiently clear to enable contractual parties to move to a different mechanism.

This represents a big dilemma for the market players who have to find the right balance between reducing their price risk on the one hand and weakening their security of supply on the other.

The last panel included **Nikolas Hübschen**, head of gas purchase law at E.ON Global Commodities; **Paolo Daino**, partner at BonelliErede; **Marnix Leijten**, partner at De Brauw; and **Lim Seok Hui**, CEO of SIAC. It took a closer look at arbitration as a means to address pricing disputes.
As moderator, **Henning Baelz**, partner at Hengeler Mueller, asked what parties should ask for in price reviews. All the panellists agreed that the extent of the amendments sought depends primarily on the price review clause itself and on the market circumstances triggering the price review process.

Daino and Leijten observed that usually a generic price revision clause would allow parties to request an “appropriate” adjustment in the pricing formula, including changes in the indexation mechanism.

While negotiations offer flexibility to ask for changes not provided for in the price review clause, Baelz acknowledged that arbitration may limit the scope of what parties can ask. By

requesting a tribunal to determine a contract price formula, they are putting their business in the control of third parties and need to be prepared to go all the way.

He and Leijten said an arbitration can also become an “organised negotiation” supported by the arbitral tribunal.

Although it may take time to receive guidance from the tribunal, the written phase of proceedings allows parties, with the help of competent counsel and experts, to test and refine their arguments and ripen their positions in negotiations.

SIAC’s recently unveiled arbitration-mediation-arbitration protocol may be one solution to save time and costs by giving the parties a chance to reach an agreement faster than through arbitration, said **Lim Seok Hui**. The only challenge is to find a mediator with the necessary skills and business sensitivity to help the parties achieve results.
If arbitration isn’t perfect, is there a way to improve it? Baseball arbitration is one option that allows parties to keep control over the outcome, limiting the tribunal’s decision to one of of their proposed solutions, panellists said.

In pricing disputes, baseball arbitration works well for small adjustments but may be less effective when what is sought is significant structural change in the pricing formula.

Finally, the panel considered whether there is a dispute resolution mechanism that is better than arbitration. If so, it hasn't been found was the reply.

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