

## Energy & Natural Resources - Switzerland

### Relevance of original bargain in gas price reviews

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#### Introduction

Long-term gas supply agreements operate in what may be a constantly changing market environment. Agreeing on a fixed gas price is therefore impractical and parties draft complex pricing arrangements to try to ensure that the contract price evolves with the value of the product sold as far as possible. Such pricing arrangements consist of a price formula which is used to recalculate the price mechanistically for each billing period in combination with a price review clause which allows a revision of the price formula in certain circumstances.

In case the parties cannot agree on an appropriate price revision, arbitral tribunals usually revise the contract price. It is often said that the task of these tribunals is to re-establish the original bargain of the parties. But what is this original bargain and can an arbitral tribunal modify it in a gas-price review?

#### Original bargain

The original bargain reflects the economic balance of an agreement, defined by the mutual rights and obligations allocated between the parties, including the price agreed. In exchange contracts (eg, sales or supply agreements) the bargain is the relationship between the value of the product sold and the contract price.

Under typical long-term gas supply agreements, the seller is obliged to supply the gas (ie, to sell the gas and manage the contractual deliveries) and depending on the provisions of the relevant gas supply agreement to, for example, ensure firm delivery and provide gas of a specified quality, defining the value of the overall product. The obligations of the buyer usually include, for instance, a take-or-pay obligation (ie, the buyer agrees to off-take or at least pay for a minimum volume of gas), the primary obligation being to pay a defined price for the gas. The balance of both parties' sets of rights and obligations, together with the price at the time of execution of the agreement, determines what is often called the 'original bargain' under a long-term gas supply agreement.

In one-off transactions or sales agreements, these sets of obligations are defined at a certain point and the price is fixed at that time. However, under a long-term gas supply agreement the situation is more complex. Market circumstances may evolve in a way that is not reflected in the price, leading eventually to price revision and a modification of the pricing arrangement. In the context of such gas price revisions, what is the relevance of the original bargain and how is it determined?

#### Pricing and price review arrangements

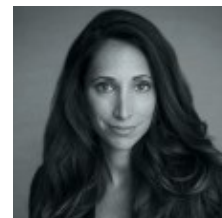
Gas markets are too complex and potentially volatile for a one-off arrangement regarding the contract price if the parties intend to conclude a long-term supply agreement. No parties to a long-term gas supply agreement would reasonably agree on a fixed price for the whole period of the contract. The value of the commodity changes over time, sometimes quite abruptly.

Therefore, parties to long-term gas supply agreements negotiate pricing arrangements which can adapt to such complex market conditions. They contain at least two elements:

- a price formula, instead of a fixed price, which is designed with the intent that the value of the gas continues to be reflected in the gas price, usually by indexing the price to relevant indices; and
- a price review clause to provide a mechanism for re-aligning, if necessary, the price formula with market conditions in case the contract price fails to reflect the relevant developments.

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The purpose of these two provisions is therefore slightly different. The price formula defines the contract price in between price revisions; the applicable contract price will be re-calculated for each billing period on the basis of this price formula. The price review clause, on the other hand, defines the criteria that have to be applied when re-adjustment of the price formula is sought to adapt it to a changed market environment.

A price review clause is thus a contractually agreed mechanism that usually changes only one essential element of the contract – the price – under specific circumstances and according to pre-defined rules and principles. Typical long-term gas supply agreements provide for an obligation of the parties to re-negotiate the price formula once a party has validly (according to the criteria spelt out in the contract (the 'trigger criteria')) asked for a price review (ie, triggered a price review). In case the parties are unable to reach an agreement on the appropriate price revision, typical long-term gas supply agreements provide for the parties to refer the price review to arbitration proceedings.

### **Price review**

In applying this mechanism the parties – or, as the case may be, the arbitral tribunal – modify the initial drafting of the price formula in the contract. Applying a price review clause is therefore not an issue of contractual interpretation or other such mechanisms, which leave the original wording of the contract intact.

Nonetheless, in spite of this apparent leeway, the parties to a long-term gas supply agreement usually do not agree to a modification of the bargain which they struck in their initial agreement through a typical price review clause.

On the contrary, the main rationale of price review clauses, in particular those which assess the change in price against the change in the value of gas over a certain period, is to provide the parties with a tool to restore for the future the 'economic balance of the contract' as it was agreed to in the past by a re-adjustment of the price formula. Price review is thus usually about restoring the 'economic balance of the contract' (ie, the bargain, rather than modifying such bargain).

The role of such a price review clause is particularly pertinent where the price is not indexed to a market price for gas but by reference to, for example, competing alternative fuels or other proxies for the value of gas. In these circumstances, a changed market environment may lead to the value of gas becoming out of step with alternative fuels or a benchmark against which the original price was set, such that a review of the price becomes necessary to restore this original relationship or original bargain.

In this regard, a typical price review clause is not, for example, comparable to a hardship clause. In case of hardship, the initial bargain has turned out to be untenable for one party. This initial bargain can in some circumstances be modified through applying a hardship clause (contractual or statutory). Price review, on the other hand, does not *per se* alleviate any hardship of the requesting party. Contrary to hardship clauses (contractual or statutory), typical price review clauses do not provide for a modification of the bargain.

### **Defining 'bargain'**

In price review clauses which assess the change in price against the value of gas over a reference period, the bargain inherent in the existing price formula carries considerable weight. Such price review clauses usually permit revision of the price formula in order to restore the relationship between the contract price and the value of the gas as embodied in the initial price formula (the original bargain).

Defining this bargain therefore becomes key.

The economic balance of a long-term gas supply agreement – its bargain – is defined primarily by the pricing arrangement on the one hand and the value of the gas including the value of the service obligations performed by the seller on the other. The value of the gas in a market where there is no transparent market price for gas must often be derived from a gas-market value analysis. Among other things, the seller's sales obligations (eg, whether it has to provide firm supply), the extent of its daily contract quality and annual contract quality obligations and the extent to which quality deviations are permitted also define the value of the product sold.

During contract negotiations, parties are often focused, mainly if not exclusively, on the original contract price. After all, this is the provision which has an immediate economic affect. The original price formula resulting from the negotiation will thereby inform the arbitral tribunal on aspects of the agreed allocation of risk and value between the parties.

However, the price review clause itself may also play an important role in defining this bargain. The price review clause can often shed light on how the parties to the gas supply agreement intended the bargain to be set and which developments were to be reflected in this bargain, in particular if its wording provides information about:

- the fundamental pricing philosophy – for example, whether the contract price is:
  - based on the costs of the seller;
  - benchmarked to a certain variable; or
  - based on a valuation of gas by reference to competing fuels;

- which factors (and their development) have to be taken into account when determining the new price or which risks have been allocated to one of the parties in the bargain and therefore remain with the respective party; and
- which market (if any) and which market movements the price formula and thus the contract price is supposed to track.

In this regard, a price review clause, like any other contractual provision, must be interpreted first by the parties and then by an arbitral tribunal in cases where the price review is referred to arbitration.

A choice of law clause may have an important effect. Some jurisdictions (eg, Switzerland) have a more open approach to contractual interpretation, whereas others (the usual example cited in this context being England) may be less flexible, in particular concerning the reference to pre-contractual negotiations, which can play a critical role in how the original bargain is determined in a subsequent arbitration. Flexibility in this context can work both ways. How this flexibility (if any) is applied in the particular case may further depend on the arbitrators whom the parties have appointed. An election of a national law often includes by reference the Convention on Contracts for the International Sale of Goods, which contains no general exclusion for gas supply agreements (unlike for electricity sales contracts), which could also play an important role.

Gas price reviews are usually about restoring rather than modifying the original bargain of the parties. Defining this bargain therefore becomes key. Both the price formula and the price review clause must be read together in order to determine what is usually an opaque bargain and should be carefully considered when parties enter into a long-term gas supply agreement, as well as during any subsequent price reviews.

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