

Energy & Natural Resources - Switzerland

Arbitration and price review negotiations: previous arguments no longer relevant?

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Introduction

Price review steps

Arbitration phase

Price review negotiations versus settlement negotiations

New arguments in arbitration proceedings?

Comment

Introduction

Pricing arrangements in long-term energy supply agreements (eg, those used in the natural gas industry) usually combine a contract price formula – according to which the contract price will be recalculated periodically – with a price review clause. Based on this price review clause, the entire pricing arrangement can be adjusted to changing market conditions. The price review process regularly follows contractually pre-defined steps, from informal negotiations to formal dispute resolution – the latter usually by way of arbitration.

As these steps build on each other and gradually escalate discussions, parties may try to adapt their position and arguments in the course of the price review process. But, from both a practical and a legal perspective, to what extent are parties free to do so? As many long-term energy supply agreements are subject to Swiss law, this update explores the issue from a Swiss law perspective.

Price review steps

There is no universal price review clause. Nevertheless, price review usually follows a three-step process.

Step 1

Price review, in industry terms, must be triggered. The price review clause contains an option right for both parties to unilaterally initiate the price review process, thereby activating the other party's duty to renegotiate the contract price. In order to validly trigger a price review, the party requesting it must fulfil certain procedural or substantive requirements or both.

Step 2

Once the price review process has been triggered, the parties enter the negotiation phase. Thereby, the parties are obliged not only to negotiate, but also to achieve a result, since, in the contract, the parties have stipulated that they will agree to a new contract price if the price review criteria are met. In essence, the initial contract contains an agreement to enter into a contract at a later date (ie, at the end of the price review process) – known as 'Vorvertrag' or 'convention future' according to Article 22 of the Swiss Code of Obligations.

However, the only consequence of not achieving a result is usually the possibility for the other party to initiate arbitration proceedings.

Step 3

Arbitration may be commenced only once the condition precedent of having triggered and conducted price review negotiations has been fulfilled, which usually requires that a certain period has elapsed during which the parties were unable to agree on a new contract price. The arbitral tribunal is then asked to determine the new contract price (ie, the tribunal must determine the content of the parties' agreement to enter into an agreement on a later date).

The arrangements described (Steps 1 to 3) are valid and binding under Swiss law, which provides parties with the flexibility to tailor such clauses to their specific needs.

Arbitration phase

Should arbitration proceedings commence, the following questions, among others, arise:

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- Do any arguments exchanged during the previous phases remain relevant?
- Are the parties bound by them?
- Can any inferences be drawn from the fact that a party modifies its arguments?

A party may wish to modify or amend its arguments throughout the price review process for various reasons, some of which may be justifiable. Better arguments may emerge only at a later stage – for example if a party has avoided incurring substantial costs at the outset of the process by beginning negotiations with less complicated analyses (and only at a later stage involves outside experts and counsel that provide further and possibly more sophisticated input).

In theory, parties are free to enter into express confidentiality, without prejudice or non-disclosure agreements for the price review negotiations phase, providing that, for example, arguments during price review negotiations are without prejudice to the parties' pleadings in arbitration. While such agreements would be valid under Swiss law, they seem to be uncommon in practice and are not considered for the purpose of this update.

Price review negotiations versus settlement negotiations

Price review negotiations must be distinguished from settlement negotiations. Any views, data and analyses exchanged during price review negotiations might therefore have to be treated differently from those exchanged during settlement negotiations.

Under the price review mechanism of most energy supply agreements, the parties are obliged to attend price review negotiations in order to discuss a prospective adjustment of the pricing arrangement, which will enter into force from the effective date of the price revision (which is typically the date on which the price review process was triggered or a date close to that time, rather than the date on which the parties finally reach an agreement). However, the parties are also obliged to reach a certain outcome (ie, an appropriate revision of the contract price).

Settlement negotiations, on the other hand, more commonly aim at retrospectively solving a dispute concerning terminated events. Parties are not obliged to attend settlement negotiations, subject possibly to a multi-tier dispute resolution clause. Even in the context of such multi-tier clauses, there is usually no prior agreement to enter into an agreement at a later date, let alone on certain terms.

During settlement negotiations, parties usually have their rights and obligations in mind and reserve them for later contentious proceedings, but they do not necessarily negotiate in legal terms. In the context of such later contentious proceedings, in order not to distract from these rights, some legal systems therefore shield judges or arbitrators from information regarding settlement negotiations (eg, by way of a without prejudice privilege). Under Swiss law, parties usually remain free to adduce evidence on issues discussed in settlement negotiations, but judges and arbitrators will take into account the context in which these documents were exchanged and that they do not necessarily reflect the parties' legal positions.

However, in the price review context, parties have already agreed in principle that they would enter into an agreement on a new price if the price review conditions are met. The purpose of price review negotiations is mainly to determine details of this new arrangement. As a matter of principle, what was said and exchanged during price review negotiations therefore often provides an indicator of what the agreement could have been and what the parties considered relevant.

New arguments in arbitration proceedings?

But does that mean that a party is estopped from changing its arguments during the arbitration? There is no such principle in Swiss law, and arbitral tribunals might also consider, depending on the particular circumstances, being receptive to improved arguments due to practical considerations, within the confines of the specific price review request.

First, a party may want to adapt its position on the basis of corrected or updated data, which had not been available when the price review was triggered and the price review request negotiated (eg, due to a time lag in publishing or collecting data). Such a scenario should pose no problem and new data should be admissible (insofar as the data falls within the period relevant for assessing the respective price review, known as the 'reference period'), since it could be assumed that the parties had agreed based on correct(ed) data. While taking into account the likely content of the parties' agreement (had one been reached), the arbitral tribunal may want to refer to this data in order to determine the new contract price.

Second, a party may wish to change its methodological approach for assessing the appropriate revision of the contract price – for example, by using a different data set or publication or by relying on a different price review model (although theoretically this would have been available during the price review negotiations, albeit possibly not to the respective party). Assuming the price review mechanism allows for using such data and models, this scenario might raise other concerns – namely, that the obligation to negotiate an appropriate outcome was not met. Credibility concerns may also arise, even though the other party is technically not at a disadvantage if the same requested and negotiated outcome is merely backed by an alternative assessment.

Nevertheless, depending on context, arbitral tribunals may also choose to be lenient in this scenario. Economic valuation exercises are not always black and white and different methods, equally valid and reliable, may be used to support an assessment of the price review outcome. Therefore, if allowed

under the price review clause, it may be appropriate for such new methodological approaches to be accepted in the arbitration. This is particularly true where artificial limits on new arguments may be counterproductive from a business perspective – for example, by requiring parties to front load the price review process (by engaging external experts and counsel early, at a time when it is uncertain whether such expertise will be needed).

Comment

Price review negotiations are different from settlement negotiations. Therefore, absent a specific agreement to the contrary, arguments exchanged during price review negotiations may not be confidential, without prejudice or binding in the subsequent arbitration as they could be in settlement negotiations. From a legal viewpoint, the limit on adducing new data will be the normal procedural safeguard of arbitration proceedings (ie, the other party's right to be heard and to present its case).

From a practical viewpoint, arguments during price review negotiations are indicators of what the parties consider relevant. However, parties may be given leeway to adapt their arguments to evolving knowledge and circumstances (insofar as they are relevant, taking into account the respective reference period and the price revision request negotiated by the parties). When dealing with credibility concerns, the specific context of price review negotiations must be taken into account, as well as the business rationale of incurring costs at the appropriate time.

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