

## Renegotiating Long-Term Energy Supply Contracts with Japanese Buyers

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### I. PROBLEM AND BACKGROUND

The greatest challenge in long-term contracts typically arises where the contract price diverges from the market price, forcing the party “out of the money” to seek redress. Sometimes the issue arises in relation not just to one particular contract but to a sector of the market – e.g. where long-term sale and purchase contracts for a particular commodity have been priced on a similar basis. Seldom however does the issue arise as suddenly, and to the extent, as it has with regard to Japan’s LNG imports from Australia.<sup>1</sup>

Japan is the world’s leading LNG importer, taking 37% of global LNG; and LNG supplies around 25% of Japan’s energy, the share having increased over the last decade due to LNG’s lower environmental impact and cost-effectiveness. In 2013 Australia was the largest supplier of LNG to Japan, followed by Qatar and Malaysia, with Japan taking 75% of Australia’s LNG exports.<sup>2</sup>

In the past almost all of Japan’s LNG imports were under long-term contracts. Following the Fukushima disaster,<sup>3</sup> spot and short-term purchases increased to 25% of the total, but that figure is settling.<sup>4</sup> Japan has favored long-term arrangements to ensure

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1 However, a similar but commercially less dramatic issue did arise in the 1970s regarding a long-term fixed-price price for sugar supply from Australia to Japan, which is still sometimes referred to by commentators. See R. LEWI, *Japanese Perspectives on Long-Term Contracts*, in: DHARMANANDA /FIRIOS (eds.), *Long Term Contracts* (Annandale 2013).

2 See e.g. LNG World News, 8 March 2013.

3 S. BUTT/L. NOTTAGE/N. NASU (eds.), *Asia-Pacific Disaster Management: Comparative and Socio-Legal Perspectives* (Berlin/Heidelberg 2014).

4 See e.g. Reserve Bank of Australia Bulletin, September Quarter 2011.

security of supply, while the foreign suppliers have used long-term contracts as the basis for their decision to invest and as security to raise finance.<sup>5</sup>

Traditionally, Japan's LNG purchase contracts have provided for the price to be based upon the Japan Crude Cocktail (JCC), which is a pricing index for Japan's oil imports, because LNG was seen as an alternative energy source, substituting for or competing with oil.

The current problem, for both sellers and buyers as well as their governments, originates from North America. The North American market has always been largely discrete – North America has used its own natural gas and there has been no gas trade between North America and Asia. Recent breakthroughs in technology (“fracking”) are now allowing North America to tap its vast reserves of shale gas, opening the door for developers to export large quantities of LNG. So the markets have merged. Whereas Japan's existing long-term contracts are based in the JCC price, North America has a liquid and competitive market and its gas is priced based on the Henry Hub price, which largely reflects production costs.

There is large difference between the prices – spot prices for LNG in Asia reached 19 \$ pmbtu (per million British Thermal Units) compared to 4.50 \$ for local buyers in the US, which translates to 13 \$ if the LNG is shipped to Asia, giving rise to the classic problem of the long-term sales contract: when the market price drops the buyer wants to either escape from its existing contracts or negotiate the price down.

The commercial difficulty is that the sellers, particularly in the recent Australian projects, have made decisions to develop their projects based on predicted oil prices, expecting cash-flow to cover costs plus the possibility of upside from the JCC price. The project lenders have relied upon similar predictions. LNG projects are particularly expensive to develop (the Ichthys and Gorgon projects are each costing about 50 billion \$), so the seller and its financier need to know the revenue will be forthcoming to justify the development. Many of the long-term sales contracts have been entered recently to support a number of large new projects, which are only now nearing completion.

From the Japanese buyers' viewpoint, however, in the past regional monopolies enjoyed by the power utilities enabled them to pass on in electricity prices whatever their fuel cost may be, resulting in one of the highest electricity prices in the developed world. That has now changed with the introduction of privatisation, shareholder pressure to reduce costs and restore profits, competition and tighter government regulation of prices. In short, if cheaper fuel is available, the utility now needs to explain why it is not taking advantage of it. So Japanese buyers are insisting on changing the prices under their LNG long-term sales contracts.<sup>6</sup>

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5 See generally P. DAVIS, *Structural Changes in Australia's Relationships with its Foreign Resources Customers*, AMPLA Yearbook 10 (2008).

6 See e.g. “LNG Execs Looking for Scapegoat”, *Sydney Morning Herald*, 19 November 2013; “US Ready for LNG Sales War”, *The Australian*, 27 February 2014.

The problem is immense. For example, the Ichthys project has entered sales contracts worth over 70b \$. There is no guarantee that past solutions to similar problems will work in the new world. In the 1980s a similar situation arose in the US gas market, but in the end the parties largely reached a commercial settlement. Similarly, in the 1990s, British Gas had entered into a number of contracts for North Sea gas at high prices. When the US market price collapsed, BG asked the British government to intervene but it refused to do so formally. Again, the parties finally reached a commercial settlement.<sup>7</sup>

## II. THE LAW AND THE CONTRACT

LNG long-term sales contracts are inevitably governed by English or New York law, giving rise to possible application of the English legal doctrine of frustration and the U.S. doctrine of impracticability. However, the Japanese doctrine of changed circumstances, based on the principle of good faith, could conceivably apply. So might the 1980 UN Sales Convention (CISG), which both Australia and Japan have now acceded to.<sup>8</sup>

The starting point however is the contract itself which, being comprehensive,<sup>9</sup> displaces or at least modifies many of the legal doctrines that would otherwise apply. Long-term LNG sales contracts usually contain two provisions of relevance.

### 1. *Price Review Clauses*

One is the price review clause, which typically provides for the price to be “reviewed” either at specified intervals (e.g. every five years) or when requested by one of the parties. Often the test includes a materiality threshold, e.g. requiring that the party seeking to reopen the price establish that it is materially worse off.

The initial question is: does the review provision, once triggered, only give rise to an obligation to negotiate? Under New York law a party may be liable for failing to negotiate but damages are limited to the cost in compelling the party to engage in the negotiations. It is unlikely that a New York court would find the parties are actually required to set the price. Under English law the parties probably don’t even need to meet.<sup>10</sup>

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7 B. HOLLAND/P. S. ASHLEY, *Natural Gas Price Reviews: Past, Present and Future*, in: *Journal of Energy & Natural Resources Law* 30, No. 1 (2012) 29.

8 See generally L. NOTTAGE, *Changing Contract Lenses: Unexpected Supervening Events in English, New Zealand, U.S., Japanese and International Sales Law and Practice*, *Indiana Journal of Global Legal Studies* 14, No. 2 (2007) 385–418.

9 LNG long-term sales contracts are often about 150 pages in length.

10 K. S. CULOTTA/M. HWANG, *Uncertain LNG Price Environment Turns Focus on Price Revision Clauses*, in: *LNG Journal* (April 2008) 25.

In terms of the substance of the review, where the buyer is a “foundation buyer”,<sup>11</sup> the review clause will often contain a “most favored customer clause” such as:

The price paid by the buyer shall not be materially higher than that paid by other buyers from the project.

Such a clause is often accompanied by a “most favored supplier clause”:

The price paid by the buyer shall not be materially less than the price paid by the buyer’s other suppliers.

These clauses would not give relief to the Japanese buyer when cheaper North American shale gas becomes available.

Of more relevance is a “market parity” clause, which seeks to ensure that the price will not be out of line with a particular market.

The price shall be based on the pricing of similar sales [into Japan][into the North Asian market]

Sometimes the comparison is made against current imports into Asia/Japan, sometimes against new long-term contracts into Asia/Japan, and sometimes both tests are applied. If the wording provides that the comparator is to be new contracts, the buyer would seem to be able to claim relief, although it will need to establish that imports at that price have reached a level that affects the market as a whole.

## 2. *Hardship Clauses*

Most long-term sales contracts also contain a hardship clause. Hardship clauses differ from review clauses in a number of respects. Rather than being triggered at a specific point in time, as is often the case with price review clauses, hardship clauses can be triggered at any time if a specific test is met, such as:

Upon a substantial change in circumstances resulting in one party suffering substantial hardship.

Some contracts make it clear that the obligation is to discuss only; if no agreement is reached the matter is not subject to arbitration. Other contracts are ambiguous on the point, consciously or unconsciously.

The clause usually provides for a review of all provisions of the contract causing hardship, not just price.<sup>12</sup> Presumably mere divergence of the contract price from the market price itself will not be enough. Will it be enough if the buyer shows it is paying more for its imports than its competitors?<sup>13</sup> Or that the regulator refuses to approve a

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11 A foundation buyer is one whose commitment to buy is used as the basis for the final investment decision (“FID”) on the project. Often the foundation buyer receives preferential treatment on pricing or rights to purchase additional quantities.

12 In fact some contracts provide that the hardship provision will not apply to price.

13 Noting that Japan’s power and gas utilities have limited competition.

retail power price that takes account of the higher fuel costs. Or that the utility is operating at a loss? And if so, over what period of time?

In considering these questions the decision maker, usually an arbitral tribunal, needs to give consideration to a number of legal issues.

### 3. *Resulting Mix of Legal Issues*

#### *Are these contracts relational or operational?*

In the past the parties did not expect long-term sales contracts to be literally performed. However, there is greater pressure today on companies to enforce their rights – the directors, even in Japan, have now to be ready to answer the question as to why they didn't – so adjustments must take place under mechanisms that are built into the contract, rather than outside it. Further, when the parties go into extra-contractual negotiations, they inevitably do so after having confirmed, and adjusted their positions based on, their legal (contractual) rights.

#### *Different functions of a sale contract.*

The seller will no doubt strongly argue that mere divergence of the agreed contract price from the market should not warrant a change in the pricing mechanism – that is a mere consequence of the bargain that the parties have struck. Put in the extreme: the bargain was a 20-year speculation on the relationship between the market prices of LNG and that of oil. English law would tend to favor that view, more so than NY law (impracticability) and Japanese law (changed circumstances doctrine).<sup>14</sup> A major question for an arbitral tribunal will be: is it restricted to applying only the approach that reflects the governing law of the contract?

#### *Expectations:*

In deciding whether, and if so how, the price should be changed, to what extent must account be taken of the expectations that were shared by the parties? In the Australia-Japan cases, should account be taken of the function of the contract in securing sufficient revenue to cover the seller's development costs, particularly if the buyer is a foundation buyer?<sup>15</sup> Should account also be taken of expected profit, and the fact that while the oil price may present the seller with opportunistic profits, it may in the future also sink below the contract price?

#### *Awareness:*

How unexpected was the new fracking technology? Should the arbitral tribunal be considering what the parties were aware of or should have been aware of at the time of the contract, and the extent to which they took that into account or decided not to?

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14 See generally NOTTAGE, *supra* note 8.

15 See *supra* note 11.

*Did the parties intend this is to be decided by an arbitrator?*

Long-term sales contracts inevitably provide for disputes to be subject to arbitration. But the initial challenge for the tribunal is to determine whether under the clause itself it has jurisdiction to review the price and set a new price or mechanism – does failure to agree constitute a “dispute”, permitting arbitration, or merely that there will be no change?

Some contracts provide expressly that the matter will be decided by arbitration. Some make it clear that if no agreement is reached there will be no change. Often, however, the review clause is such a sensitive matter in negotiations that the parties, consciously or unconsciously, leave the question open. In this case the wording of the dispute clause becomes key. For example does it cover disputes only, or also failures to agree where the contract is quite capable of continuing operation without (new) agreement?

*Arbitrators scope – Blank sheet? Criteria:*

When the issue is, as here, not a one-off matter (such as breach), but what should be the ongoing pricing mechanism, a major question facing the tribunal is how far it should be able to come up with its own solution? In the arbitration each party typically puts forward its own extreme position, leaving a tribunal which believes a middle course to be appropriate little choice but to formulate its own solution. There have been some disturbing cases. In the *Gas Natural* case the tribunal came up with a two-part pricing scheme which neither party requested. The U.S. District Court upheld the award.<sup>16</sup> In *RWE v Gazprom*, apparently the ICC tribunal decided to change the price linkage from an oil link to a gas link.<sup>17</sup>

To avoid the tribunal being put in this difficult position, it may request the parties to agree to “baseball arbitration”<sup>18</sup>, or make a partial or draft award for input from the parties before making the final award.

Where the hardship clause requires the tribunal to alleviate the hardship, it has perhaps greater scope to impose its own solution than in the case of a price review.

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16 D. MILDON, *Gas Pricing Disputes*, available at <http://www.essexcourt.net/publications/7103/gas-pricing-disputes>. Provided that all parties were on notice and able to present arguments on the appropriate new price, a different scheme would generally be upheld under the UNCITRAL Model Law. See e.g. *TCL Air Conditioner (Zhongshan) Co Ltd v The Judges of the Federal Court of Australia [2013] HCA 5*, available at <http://www.austlii.edu.au/au/cases/cth/FCAFC/2014/83.html>. Even if price adjustment relief is not provided under the law governing the underlying contract, arbitration regimes do not generally provide an appeal for error of law, let alone error of fact.

17 MCNAIR CHAMBERS, *LNG Price Review Disputes*, 10 December 2013, available at [www.mcnairchambers.com](http://www.mcnairchambers.com).

18 In baseball arbitration each party makes its submission as to what the determination should be. The arbitral tribunal must choose between them. In “night baseball” the submissions are kept from the tribunal until it makes its own determination and it then must choose the submission which is closest to its determination.

### III. FORWARD-LOOKING SOLUTIONS

There is already a move towards hybrid pricing, based partly on the JCC and partly on Henry Hub pricing.

The pricing tension between buyer and seller may also be eased if there is more vertical integration. This can be both downwards and upwards. Japanese buyers have traditionally taken only minor strategic interests in the project from which they are buying. Recently however INPEX has taken in excess of 65% of the Ichthys Project.<sup>19</sup> The integration can also go downwards: often LNG long-term sales contracts allow the seller to share in the upside of onsales by the buyer and in one dispute in the US in the 1980s, the solution was to allow the seller to share two thirds of the buyer's revenue.<sup>20</sup> It is not unusual recently for contracts to have this "right to share" built in.<sup>21</sup>

### SUMMARY

*There is a considerable body of literature concerning Japanese contract law and the practices and expectations of Japanese parties engaged in negotiating, drafting, performing and contesting contractual obligations, especially under long-term sales contracts.<sup>22</sup>*

*Such perspectives can play a useful role, especially for example for policy-makers interested in reforming contract law generally, as presently in Japan.<sup>23</sup>*

*But a fuller understanding of the issues arising under such contracts requires analysis in the context of the particular industry and its customs and practices. Each industry has developed its own distinctive form of long-term contract for the commodities dealt with in that industry, with a different range of generally accepted negotiation parameters, and the contracts are subject to the pressures arising from time to time from the market circumstances in the industry concerned.<sup>24</sup>*

*This article examines the issues arising under contract law and practice involving Japanese parties in a very significant part of the international energy market, namely*

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19 INPEX 2014 Annual Report, 37.

20 HOLLAND/ASHLEY, *supra* note 7, 32.

21 LNG long-term sales contracts have traditionally been either DES (meaning the seller contracts to deliver to a fixed unloading facility) or FOB (Free on Board) but where the destination is restricted. Occasionally a buyer is allowed to divert shipments to another market but in such cases the destination is often limited, so as not to compete with the seller's other markets, or the buyer is required to share any upside with the seller.

22 See e.g. LEWI, *supra* note 1.

23 See e.g. L. NOTTAGE/S. KOZUKA, Policy and Politics in Contract Law Reform in Japan, Sydney Law School Research Paper No. 13/86 (2013), available at [SSRN.com/abstract=2360343](http://SSRN.com/abstract=2360343).

24 DAVIS, *supra* note 5, comparing e.g. the contracts for coal and those for iron ore.

for Liquefied Natural Gas (LNG), where recent developments in North America are creating major upheavals.

The major focus is long-term contracts between Australian suppliers and Japanese customers, with Australia now constituting the world's largest exporter of LNG and Japan the largest importer. Those trade (and investment) relationships are now underpinned by a newly-signed bilateral FTA.<sup>25</sup>

#### ZUSAMMENFASSUNG

*Japanisches Vertragsrecht und die Praktiken und Erwartungen der japanischen Parteien bei der Verhandlung und dem Entwerfen von Verträgen sind in der Literatur bereits gut dokumentiert. Gleiches gilt bezüglich der Erfüllung und Bestreitung von vertraglichen Pflichten, insbesondere bei langfristigen Kaufverträgen. Diese allgemeinen Darstellungen können nützlich sein, insbesondere für politische Entscheidungsträger, die an einer grundsätzlichen Reform des Vertragsrechts interessiert sind, wie derzeit in Japan.*

*Allerdings bedarf es für ein tiefergehendes Verständnis der aus diesen Verträgen erwachsenden Probleme einer Analyse des Kontextes der jeweiligen Industrie und ihrer Bräuche. Jeder Industriezweig hat seine eigene charakteristische Form langfristiger Verträge für die jeweils hergestellten oder vertriebenen Güter entwickelt, zu der eine unterschiedliche Auswahl an allgemein akzeptierten Verhandlungsparametern gehört. Zudem sind die Verträge dem Druck ausgesetzt, der sich für den betreffenden Industriezweig aus den Marktumständen ergibt.*

*Der Beitrag untersucht Recht und Praxis der Verträge, die mit japanischen Parteien in dem Markt für Flüssig-Erdgas (LNG) geschlossen worden, der einen wichtigen Teil des internationalen Energiemarkts bildet und in dem die neueren Entwicklungen in Nordamerika für gewaltige Umbrüche gesorgt haben.*

*Der hauptsächliche Fokus liegt auf langfristigen Verträgen zwischen australischen Anbietern und japanischen Kunden, da Australien der weltweit größte Exporteur von LNG und Japan der größte Importeur ist. Diese Handels- (und Investment-) Beziehungen werden nun von einem gerade unterzeichneten zweiseitigen FTA (Freihandelsabkommen) unterstützt.*

*(Die Redaktion)*

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25 <https://www.dfat.gov.au/fta/jaepa/>.