SQUIRE PATTON BOGGS

To Arbitrate, or Not to Arbitrate, That Is the Question

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Expectation and anticipation. These are two words that, for some time, best described the next wave of gas and LNG price review disputes in Asia.

As time passed, anticipation turned to speculation, as only a handful of cases started, and they subsequently settled in quick succession. Many commentators thus began to doubt the possibility of this new upsurge of cases becoming a reality. While rumour and uncertainty adhered to the prospect of disputes commencing, there was no ambiguity that buyers in Japan, China and South Korea were leading the way as the principal importers of LNG, acquiring vast volumes of LNG under numerous long-term contracts within their wider portfolios.

Yet, during this same period, the markets within which these contracts operated – or would soon operate – changed dramatically: (i) supply and demand dynamics were transformed by an increase in LNG supply from the US, Russia, Qatar and Australia; (ii) long-term LNG prices fell into decline; (iii) significant energy transition occurred with legislation enhancing renewable uptake; and (iv) LNG spot market trading matured and scaled up considerably. Together, these factors affected and influenced the commercial bargains struck in these newly signed long-term contracts. As a result, supposition and speculation surrounding a future wave of disputes started again. This time, however, the predicted shift finally arrived.

Buyers in the region who signed contracts in the 2010–2015 era had agreed to contract prices that were becoming fundamentally misaligned to current market realities. This was (and remains) especially true in Japan. In the last decade, a series of impactful and largely unforeseen market developments impacted Japanese power utilities' and gas companies' market competitiveness and the economics of their long-term contracts. As in Europe before, Asian buyers began consulting their contracts for relief in an effort to secure more competitive contract prices, which better reflect prevailing LNG market prices. What followed was a surge in new price review negotiations. The impact of the various market changes, together with an inability for buyers to pass through price increases to their customers, served as the catalyst for meaningful change in the region and price review negotiations became more essential than ever for Asian buyers trying to ensure that changing market conditions were reflected in the contract price of their contracts.

Of course, a spike in negotiations does not necessarily equate to an increase in arbitrations. For some time, the litmus test focused on the question of whether Asian buyers would actually escalate matters to arbitration if negotiations failed. Some commentators argued that Asian buyers resisted arbitration in favour of the traditional cultural preference to simply "meet and discuss" these issues. In any event, these negotiations, without resort to arbitration, often led to very small price reductions. Certain buyers observed the front-runners in this exercise and quickly followed suit, agreeing to similarly small price reductions. Equally, protracted price review negotiations (in some cases lasting two to three years) produced results that often did not do enough to improve contractual economics in the aggressively evolving Asia Pacific markets, placing increased pressure on sale and purchase terms. This reality has triggered a further change in behaviour and the emergence of the following question: to arbitrate, or not to arbitrate?

As this author noted in another recent article,[1] the contractual unknown can be a daunting prospect with which to consciously engage, especially when, in doing so, a buyer is departing from a historical negotiation practice that the seller counterparty has come to expect. Some have suggested that Asian buyers have traditionally harboured concerns regarding the potential damage to the counterparty relationship if arbitration ensues. To the extent correct, this concern can often (i) manifest itself in a buyer's overall strategic approach to negotiations, thereby underutilising the role of legal leverage; (ii) create an appetite to reach a prompt agreement on less favourable pricing or broader commercial terms; and (iii) provide a valuable negotiation tool to a seller counterparty, who may filibuster or adopt a non-transparent approach to talks, safe in the knowledge that the buyer will not take steps to escalate matters for fear of damaging the relationship. The connection between the parties' commercial relationship and arbitration can be, and often is, misunderstood – and can be exploited by sellers as the party typically with more experience of price review arbitration in Asia, introducing rhetoric playing on this uncertainty.

1 "Strategic Considerations for Price Review Success", Squire Patton Boggs Insight, September 2021.

While safeguarding the commercial relationship is an important feature in the development of a price negotiation strategy, it bears emphasis that, rather than damaging a relationship, arbitration can actually help support and nurture that relationship, as per the following examples:

1. The relationship may possibly be under considerable strain caused by protracted and challenging negotiations, where the prospect of a deal is becoming increasingly unlikely. It is customary in the LNG industry that if parties cannot agree on a revised price during a price review negotiation, they can ask an independent arbitral tribunal to consider and ultimately decide the matter. Entrusting the dispute into the hands of experienced arbitration lawyers and decision-makers allows the long-term counterparties to resume their focus on the day-to-day operation of the long-term SPA, without the tension of regular price review meetings impacting relations.
2. Certain sellers maintain the previously referenced historical perception that Asian, and particularly Japanese, buyers will categorically not commence arbitration if negotiations fail. Dispelling this myth can be a valuable tool in talks and may, in fact, radically shift the approach of the counterparty if they feel they are dealing with a party who may advance the case to arbitration if necessary. This can also prompt early settlements.
3. In circumstances where a counterparty deploys an uncooperative approach, with minimal transparency and explanations of its underlying assumptions or methodologies, commencing arbitration will help introduce a positive change, whereby that party will be obliged to disclose the full extent of its position by reference to objective evidence. In other words, it will compel a party to adopt a more transparent approach, which can help encourage early settlements.
4. It is relatively common in long-term LNG SPAs for the dispute resolution clause to require a further mandatory period of negotiations beyond the period of the price review discussions. Issuing a notice of dispute, or actually commencing arbitration, can assist in demonstrating a party's willingness to engage in that process, which may help break any deadlock in talks.
5. In the context of a long-term contract that provides for multiple price reviews over the full contractual term, taking assertive steps in an earlier price review can help set the tone for the next price review, with the parties understanding the value and strategic impact of arbitration. This creates new incentives for the parties, helping to promote constructive and productive dialogue, knowing that a restrictive, non-transparent approach may result in a dispute.

Thus, contrary to the widely held perception, arbitration may foster, rather than stifle, the parties' relationship over the long life of the contract. Appreciating this issue, and taking full advantage of it, may actually help negotiations from becoming protracted, continuing over several years and, ironically, placing more strain on the commercial relationship. It follows that negotiating parties can use the prospect of, or willingness to embark into, arbitration to introduce impactful legal leverage in an effort to secure much improved terms if negotiations do not yield successful outcomes. Showing a willingness to arbitrate can help change the dynamic of a negotiation that has reached an impasse, especially in instances where sellers in the Asia Pacific markets do not expect an Asian buyer to take steps to escalate matters.

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Max Rockall
Partner
T +44 207 655 1354
E max.rockall@squirepb.com