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Price review clauses in long term energy contracts

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Price adjustment mechanisms are a common feature of long term energy contracts. They ensure that over time, the price for commodities supplied under the contract reflects changes in the market.

A common price adjustment mechanism is a price review clause, under which a party may initiate a process to adjust all or part of the contract price for the commodity.

This article highlights some of the important considerations to be taken into account in drafting price review clauses for long term energy contracts.

Structure of a price review clause

Price review clauses commonly contain the following features:

- a trigger event,
- a procedure for arriving at the adjusted price,
- a description of the factors or guidelines to be taken into account when adjusting the price,
- the consequences if an agreement on price is not reached, and
- a description as to how the adjusted price is to apply under the contract.

Price review clauses can be non-prescriptive (eg a clause based on an agreement to negotiate in good faith an equitable revision to the price if market circumstances have changed) or explicit and prescriptive (eg a clause requiring arbitration with adjustments only to be made with reference to pre-defined criteria). Often a buyer will prefer to make it as hard as possible to revise the price (on an assumption that the price trend is increasing), while a seller will prefer a formal and binding mechanism to permit price increases.

Set out below are some issues that ought to be considered when drafting price review clauses.

Trigger events

A trigger event describes the circumstances in which a party can initiate a price review under the contract.

The trigger event may occur:

- at a specific time (eg every fifth contract year),
- on the occurrence of external events constituting a change in the circumstances which existed between the parties, or
- when one party (reasonably) believes that such an external event has occurred.

Those trigger events which depend on the occurrence of an external development are more likely to give rise to disputes. For example, a price review mechanism triggered by a specified change in a particular public index is unlikely to be open to subjective interpretation, and disputes should not occur. On the other hand, if the trigger is expressed to be an event which causes the cost of production of the commodity to be substantially varied from the cost at the date of the contract, there is ample room for disagreement about whether the condition has been satisfied.

Some clauses seek to avoid disputes by providing a trigger which is not the occurrence of the event itself, but the belief (or reasonable belief) by a party that the event has occurred. This trigger can still give rise to disputes, where there is doubt about whether the belief is honestly (and reasonably) held by the relevant party.

Procedure for arriving at adjusted price

Most price review mechanisms commence with a negotiation process. Failure to agree an outcome can give rise to deadlock breaking mechanisms, including expert determination or arbitration. While often expensive, the value of the sought after price adjustment can dwarf the costs involved in such a determination.

Negotiation

It is well accepted that an appropriately drafted clause requiring parties to negotiate prior to the commencement of any proceedings may be effectively enforced by restraining any such proceedings until the parties have fulfilled their respective obligations to negotiate.[1] Similarly, an obligation to negotiate in good faith is capable of being enforced.[2]

Provided there is a method of resolution of any failure to agree, for example by reference to third party to determine the price in accordance with certain criteria, the clause is likely to be sufficiently certain to be enforced.[3]

Expert determination vs arbitration

There are considerable differences between expert determination and arbitration. Expert determination is generally the relatively 'quick and dirty' of the two options.

An expert determination can be described as:

> *an inquiry that presents a question to be answered on the basis of individual experience, expert knowledge, and personal inquiry and investigation.*[4]

An expert may decide the issue on the basis of their own experience without hearing the parties, unless the agreement provides to the contrary.

An arbitration is quite different:

> *Where it appears from the terms of the agreement by which a matter is submitted to a person's decision, that the intention of the parties was that he should hold an inquiry in the nature of a judicial inquiry, and hear the respective cases of the parties, and decide upon evidence laid before him, then the case is one of an arbitration.*[5]

A significant differentiator which arbitration offers to parties involved in a price review mechanism over expert determination is the access to certain court procedures including, most importantly, the ability to obtain evidence through the issue of subpoenas.[6] Where a price review requires information in the possession of non parties, the price review should be made referable to arbitration and not expert determination. Price reviews which involve some form of analysis of market prices or a limited basket of contract prices will inevitably require information to be obtained from non parties. Of course, this will complicate the process and add expense and delay.

In contrast, a review based on production costs, where the relevant information will be in the possession of the party providing the commodities, or an index based review, where the information is publicly available, could be addressed by expert determination.

Factors to be taken into account when adjusting price

Price review clauses will describe the way in which the price will be adjusted. A number of formulae are commonly used, each with strengths and weaknesses.

The clause may be vaguely cast, such as an 'equitable' or 'appropriate' adjustment to the price or an adjustment which 'restores the economic equilibrium between the parties'. Alternatively, the clause may be detailed and prescriptive and set out the factors (whether an exhaustive or inclusive list) which are to be taken into account when adjusting the price.

Vague guidelines should be avoided by parties seeking a clear, binding outcome. A process of negotiation coupled with an 'equitable' adjustment to the price leaves plenty of wiggle room and is unlikely to result in a prompt adjustment.

On the other hand, a review based on factors such as the state of the market or a basket of contracts will involve evidence of the market or contracts concerned and expert evidence as to the price based on that evidence. This involves its own delay, through an often extensive information gathering exercise including issuing subpoenas on non parties. This exercise is usually the most time consuming in any arbitration, is often contentious and can result in the parties to the arbitration incurring significant costs.

How adjusted price will apply

Price review clauses should clearly set out what price is to prevail while the outcome of a price review process is pending, so that monies can still be paid under the contract.

A process should also be set out which provides an obligation on either:

- the buyer to pay any incremental amounts due as a result of a higher price being agreed or determined, or
- the seller to set-off any overpaid amounts by the buyer if a lower price is agreed or determined.

This article was written by Michelle Cole, Partner, Perth.

Endnotes

1. *Hooper Bailie Associated Ltd v Natcon Group Pty Ltd* (1992) 28 NSWLR 194 at 210-211.
2. *Aiton Australia Pty Ltd v Transfield Pty Ltd* [1999] NSWSC 996; (1999) 153 FLR 236 at [154]-[159]; *Strzelecki Holdings Pty Ltd v Cable Sands Pty Ltd* [2010] WASCA 222; (2010) 41 WAR 318 at [62]-[63].
3. *Coal Cliff Collieries Pty Ltd v Sijehama Pty Ltd* (1991) 24 NSWLR 1 at 26-27.
4. Justice McPherson, '*Arbitration, Valuation and Certainty of Terms'* (1986) 60 Australian Law Journal 8 at 16.
5. *Re Carus-Wilson and Greene* (1886) 18 QBD 7 at 9.
6. See e.g. s 23 *International Arbitration Act 1974* (Cth); s 17 *Commercial Arbitration Act 1985* (WA).

More information

For information regarding possible implications for your business, contact

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