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Falling oil prices: is it possible to revise the contract price?

The recent fall in oil prices and the possible effects on long-term energy contracts

Some prices of long-term energy contracts (ie, gas, electricity, steam, etc) are connected to the oil market. One of the main features of the oil market during the 1990s was the relative stability of the long-term oil price.[1] However, oil prices have fallen sharply since the middle of 2014. The fall has materially affected a wide range of energy companies, with many players forced to rethink investments, cost structures and even business models. In addition, this drop may have a significant impact on the price agreed in long-term energy contracts linked to the oil market.

Therefore, parties to long-term energy contracts connected to the oil market will need to determine whether the recent fluctuations of oil prices have led to a material change that ought to be reflected in the contractually agreed price. In these circumstances, some parties under long-term energy agreements spanning ten years or more may believe that the price in their contract does not reflect the extent of the change in oil price or that the price is overcompensating for the change. As a result, either party to the contract may seek to change the agreed price formula to reflect the alleged changes in circumstances.[2] The parties usually submit their disputes to arbitration instead of litigation.

The submission of price revision to arbitration for confidentiality reasons

In the oil and gas industry, arbitration is a popular alternative dispute resolution method given that it offers certain advantages, such as:

- neutrality of the process;[3]
- neutrality of the *forum*;[4]
- degree of autonomy for the parties;[5]
- the speed of the award;[6] and
- the enforceability of the award.

Nevertheless, the main virtue in this industry of submitting the dispute to arbitration is that the proceedings are confidential. Usually the parties agree to keep the arbitration proceedings confidential, including all documents, evidence, orders and awards.[7] For this reason, arbitration is seen as advantageous compared to litigation, which is usually open to the public, save for a few exceptional circumstances.[8] In relation to the revision of the contract price, this confidentiality is critical, given that it prevents sensitive information being disclosed to competitors.

Different price revision scenarios and the possible change in the trend of the *rebus sic stantibus* doctrine application

There are two scenarios where a revision of the formula price of a long-term energy contract can be requested by a party as a consequence of a change in circumstances:

- when the parties have provided a price revision clause in the contract; or
- when the contract is silent.

When the parties have provided a price revision clause

Parties who are aware that economic circumstances that serve as the basis for fixing the contract price may change can agree on a clause in their contract, providing that the contract term or the price formula will be changed, renegotiated or, ultimately, if such circumstances arise and no agreement can be reached, submitted to arbitration (or jurisdiction). This clause can be incorporated by reference to hardship model clauses or the parties may decide to draft an ad hoc clause.

Hardship model clauses are based on provisions provided by international law such as Article 6.2 of the UNIDROIT Principles or Article 6.111 of the Principles of European Contract Law. Hardship clauses typically recognise that parties must perform their contractual obligations even if events have rendered performance more onerous than would reasonably have been anticipated at the time of the signing of the contract. However, where continued performance has become excessively burdensome due to an event beyond a party's reasonable control, which the party could not reasonably have been expected to have taken into account, the hardship clause allows the parties to negotiate alternative contractual terms.[9]

There is also the possibility for the parties to agree on an ad hoc clause (different to the hardship model clause) in which the price revision only applies when the requirements set out in the agreed clause are fulfilled. Hence the parties are free to expressly exclude specific requirements typically included in hardship clauses.

In both cases, regardless of whether the parties have agreed on a hardship clause or an ad hoc clause according to the general principle of the literal interpretation of contracts,[10] if the parties have agreed on a price revision clause, and are willing to revise the price, a strict interpretation (remaining faithful to the literal terms agreed by the parties) should be made in order to determine whether the changes of circumstances justify a revision of the price.

When the parties have not agreed on a price revision clause

When the parties have not agreed on a price revision clause, the majority of national systems have a rule that allows a change in circumstances to modify the binding terms of the contract. This possibility is also known under the maxim *rebus sic stantibus*, which means that the contract remains binding 'provided that things remain as they are'. The principle of *rebus sic stantibus* is a principle of international law that generally applies if no revision clause has been provided by the parties in contracts. The *rebus sic stantibus* is said to be a principle of *lex mercatoria*.[11]

In a nutshell, in order to apply the *rebus sic stantibus* doctrine, the change must be unforeseen, substantial and fundamental.[12] In addition, the change must alter the equilibrium of the contract (an exorbitant disproportion between the parties' obligations). Consequently, ICC awards[13] have been rather strict when applying *rebus sic stantibus*.

However, the recent developments in the economic area and oil market may change this tendency in the next few months. An example could be found in Spain. Spanish case law has always been extremely restrictive in applying the *rebus sic stantibus* doctrine, ensuring first and foremost the *pacta sunt servanda* principle, which in simple words does not allow an interpretation beyond the terms agreed by the parties.

In the past, Spanish courts only applied *rebus sic stantibus* doctrine when there was an extraordinary and unforeseen alteration of the economic circumstances in which the contract was based and an exorbitant disproportion between the parties' obligations.

Nevertheless, two rulings recently rendered by the Spanish Supreme Court in 2014[14] changed this trend. The rulings granted two requests for a price revision based on the argument that the economic crisis constitutes extraordinary and unforeseen circumstances, which may cause a lack of equilibrium between the parties' obligations. In these rulings the Spanish Supreme Court reduced the strictness of requirements to apply this doctrine and accepted that the economic crisis was unforeseeable and hence could allow a revision of the price contract, insofar as it disproportionately affected the equilibrium between the parties' obligations.

Conclusion

Two questions are still up in the air:

- Will these cases be applied to the fall in oil prices?
- Will arbitrators follow this case law?

In the current circumstances, parties contemplating a potential price review should consider these recent trends whilst remaining mindful of the original expectations of their price review clause. While it is easy to evaluate what has already occurred, it can be difficult to foresee if these changes will continue to affect oil prices and/or gas markets in the future. In a wider sense, when dealing with long-term contractual arrangements, it is important to have clear adjustment standards that take into account the effects of inflation, currency fluctuations and changes to the law. For parties considering a price review, they will need to consider each of the possible economic explanations and determine whether they are significant, lasting changes. The answer may be worth hundreds of millions of euros.

Notes

1 B Fattouh and P Scaramozzino, 'Uncertainty, expectations, and fundamentals: whatever happened to long-term oil prices?' (2011) 27(1) *Oxford Review of Economic Policy*, 186.

2 J Wilson and W Lowery, '"Trigger Happy": Considering the requirements of your price review clause', *Inside Energy & Environment*, 15 February 2015.

3 Oil and gas contracts frequently involve parties from different national jurisdictions.

4 M L Moses, *The Principles and Practices of International Commercial Arbitration* (2nd ed, Cambridge University Press, 2012), 3.
5 H R Dundas, 'Dispute Resolution in the Oil and Gas Industry: an Oilman's Perspective', (2004) 2(3) *Oil, Gas & Energy Law Intelligence* (*OGEL*), 3.
6 Arbitration takes a relatively shorter time than litigation, mainly due to the fact that the award is non-appealable except in exceptional circumstances.
7 V Rajora, 'Confidentiality in Arbitration', *Social Science Research Network*, 16 March 2010.
8 See A Robb, 'Confidentiality and Arbitration', 39 Essex Street, 5 May 2004.
9 F R Fucci, 'Hardship and Changed Circumstances as Grounds for Adjustment or Non-Performance of Contracts', American Bar Association, Section of International Law, Spring Meeting, April 2006.
10 Ie, ICC Case No 9812 (1999).
11 M Mustill, 'The new Lex Mercatoria: The First Twenty-Five years', [1988] *Arbitration International*, 86.
12 Decision of the International Court of Justice, *Fisheries Jurisdiction Case*, 2 February 1973.
13 Ie, ICC Award No 1512 (1971), ICC Award No 6281 (1989), ICC Award No 8486 (1996).
14 Decisions No 591/2014, 15 October 2014 and No 333/2014, 30 June 2014 of the Spanish Supreme Court, regarding publicity and hotel management contracts.

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Brazil – the oil industry, sustainable development and legal certainty

It is interesting how global awareness regarding environmental protection has progressed over the past decades. Since the United Nations Conference on Sustainable Development in 2012, the concept of sustainable development, forged by the Brundtland Report in 1987, has solidified in such a way that it is no longer possible to think ahead without ensuring that future generations are also able to benefit from natural resources. Today, the environment is recognised for its intrinsic value and new ways of measuring the wealth of nations are being discussed, taking into account nature and the environmental surroundings that guarantee satisfactory conditions to human life in our planet.

In this scenario, the energy sector should less and less be seen as dissociated from the environment. The feasibility of any energy project must undergo a detailed assessment of its environmental impact. In the oil industry there are several instances where environmental challenges have become legal issues and environmental law ends up being seen as an obstacle. Environmental law in the oil industry must be seen through the lense of sustainable development, considered by the Brazilian Supreme Court as the 'factor for reaching a fair balance between economy and ecology'. This is the only possible way to solve some of the legal dilemmas faced by players in the oil industry nowadays.

One of the most challenging matters is civil liability for environmental pollution, not only for the oil and energy industries, but for every activity involving environmental risks and a high level of natural resource utilisation. The extent of civil liability for environmental pollution was outlined in a classic judgement by Minister Herman Benjamin, of the Brazilian Superior Court of Justice, which states that:

> 'for the purpose of verifying the chain of causality regarding a given environmental damage, polluter is everyone who does it, who does not prevent it when was supposed to, who allows it to be done, who does not care that other people do, who pays for another person to do it, and who benefits from it when others do it'.

The comprehensiveness that our high courts have been granting to the concept of polluter and to the configuration of the chain of causality to impose civil liability (eg, the obligation to clean up or compensate environmental pollution) results in severe legal uncertainty, not only for those who conduct high-risk activities, but also for all those who are part of the supply chain, including their financiers. Would it be possible to apply this theory to impose civil liability on those who finance such an activity?

On the same theme, it is important to note that the Brazilian environmental liability framework is based on the Federal