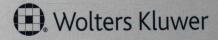


PIETRO FERRARIO



The Adaptation of Long-Term Gas Sale Agreements by Arbitrators

Pietro Ferrario



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About the Author

Pietro Ferrario was born in Milan (Italy) on 7 June 1980. He graduated in law in 2003 at Bocconi University of Milan and passed the bar exam in 2006. In 2008, he received an LLM in International Business Law (with focus on International Commercial Arbitration) from Queen Mary University of London and in 2015, he received a Ph.D. degree (research field in International Arbitration) from Bocconi University of Milan.

Since April 2010, he has been working in the litigation and commercial law department of 'Perani Pozzi Associati' in Milan. Previously, he worked from more than four years for the law firm 'Rucellai&Raffaelli', always based in Milan and, between 2009–2010, he got a six months internship in the international arbitration group at Wilmer Hale LLP in London.

He published the following articles in arbitration:

'The Group of Companies doctrine in International Commercial Arbitration: is there any reason for this doctrine to exist?', Journal of International Arbitration, 2009;

'Challenge to Arbitrators: Where a Counsel and an Arbitrator Share the Same Office - The Italian Perspective' Journal of International Arbitration, 2010;

'The Role of Arbitration in Company Law Disputes - The Italian Perspective' Young Arbitration Review, 2011.

Preface

This book deals with the issue of the adaptation of long-term gas sale agreements by arbitrators upon the occurrence of unforeseen events altering their balance. The power of courts and arbitrators to adjust contracts is, in general, a controversial and discussed matter that assumes a particular importance in relation to long-term gas sale agreements due to their specific features and scope as well as to the recent renegotiation processes and arbitration proceedings regarding the modification of the price formula and of the minimum purchase volume obligations therein provided. With regard to the characteristics, gas sale agreements usually have a long duration and require relevant investments. Moreover, they include a price formula, normally linking the gas price to that of oil products, and the so called 'take or pay clauses', i.e., clauses providing, on the one hand, for the buyer's obligation to take and pay for a minimum quantity of gas every year or just to pay for it (and take it later) and, on the other, for the seller's obligation to supply such quantity. In this way, the seller is granted a stable flux of money necessary to recover the investments made, while the buyer is granted a stable flux of gas in order to cope with the demand in the market in which it operates. It is clear that, in order to reach such purpose, the parties aim to preserve their relationship for the entire duration agreed. However, in this lapse of time, the original market conditions may change and alter the contractual equilibrium originally found by the parties. Therefore, in such case, it is necessary to adapt the agreement in order to rebalance it and, consequently, to keep it alive. For this reason, the parties often, but not always, provide for adjustment clauses – and, in particular, with regard to the price and the minimum purchase volume obligations - establishing the duty to renegotiate the contract's terms upon the occurrence of unforeseen events. Moreover, even in case such provisions are included in the agreement, not always the renegotiation process is successful and, consequently, the parties submit the matter to arbitration (due to their international nature, gas sale contracts usually provide for an arbitration clause). In this situation, therefore, the issue of the power of arbitrators to intervene on the agreement becomes crucial.

This book aims to provide an analysis of such matter under a procedural law and arbitrability perspective by considering both contracts without an adaptation clause and contracts including it, as well as to find out whether it is possible to determine a

principle of law justifying the aforementioned power with regard to both these categories of agreements. In order to carry out such analysis, this book is organised in four chapters.

The first chapter provides for a definition of long-term gas agreements and for an overview of the evolution of some of the main European and extra-European gas markets as well as of the relevant contracts in order to better understand the problem of their adaptation. Moreover, the effects produced on such contracts — and, in particular, on the relevant mechanism for the gas price calculation and on their structure — by the development of spot markets and the occurrence of the 2009 crisis affecting the gas sector will be considered.

The second chapter focuses on the analysis of take or pay clauses by considering their key characteristics and scope as well as the main issues they can give rise to with particular regard to their nature and the consequences that the different qualifications of such provisions can have on the arbitrators' adaptation power.

The third and fourth chapters, besides providing for an analysis of adaptation clauses (and, in particular, of price review and hardship provisions), deal with the issue of the arbitrators' power to adjust long-term gas sale agreements by considering both the case in which such contracts do not provide for an adaptation clause and the case in which, instead, they include it. This analysis, aiming to determine whether it is possible to find a justification for the aforementioned authority, is carried out under a procedural law and arbitrability perspective and provides an overview of some of the most relevant European legal system as well as of the US one. Moreover, the approach adopted by arbitration tribunals in relation to the aforementioned issue is examined. In this regard, it has to be noted that, due to the few published awards in the gas field, the analysis will also consider courts decisions issued in setting aside or enforcement proceedings of commercial arbitration awards handed down in energy disputes.

Furthermore, I carried out some interviews with lawyers and arbitrators (and, namely, Professor Ana Stanic, Ms Lisa Beisteiner, Ms Courtney Lotfi, Mr Steven Finizio, Mr Craig Tevendale, Mr Aadne Haga, Dr Johannes Willheim, Marco Lorefice) experts in the field and involved in some of the most recent arbitration proceedings regarding the adaptation of long-term gas sale agreements. In this regard, it has to be underlined that no-confidential information was provided by the persons interviewed.

Finally, I would like to record my sincere thanks to the above-mentioned experts that I interviewed and to Professor Maxi Scherer of Queen Mary University of London for the help and support provided to me.

Table of Contents

About t	he Aı	ithor	VII		
Preface			xiii		
CHAPTER	1				
The Gas	Mar	ket and the Relevant Agreements	1		
§1.01	Introduction				
§1.02	The Gas Market and Sale Agreements				
	[A]	The Evolution of the Dutch Market and Relevant Gas Sale			
		Contracts	4		
	[B] [C]	The Evolution of the UK Market and Relevant Gas Sale Contracts The Evolution of the Norwegian Market and Relevant Gas Sale	8		
	[O]	Contracts	11		
	[D]	The Evolution of the US Market and Relevant Gas Sale Contracts	13		
	[E]	The Evolution of the Russian Market and Relevant Gas Sale			
	[-]	Contracts	17		
	[F]	The Evolution of the Algerian Market and Relevant Gas Sale			
		Contracts	20		
§1.03	The	Development of Gas Spot Markets	21		
§1.04	The 2009 Crisis				
§1.05	Conclusions				
CHAPTER	2				
Take or	Take or Pay Clauses				
§2.01	Introduction				
§2.02	Main Characteristics				
§2.03	The Nature of Take or Pay Clauses				
	[A]	The Common Law Approach	36		

		[1] I	English Law	36		
			[a] The Distinction Between Penalties and Liquidated			
			Damages	36		
		[[b] The Distinction Between Debts and Damages	42		
		[[c] Take or Pay Clauses as Penalties	48		
		[[d] Take or Pay Clauses as Main Obligations	53		
		[2] I	US Law	54		
			[a] Take or Pay Clauses as Main Obligations	54		
		[[b] Take or Pay Clauses as Penalties	59		
		[3]	Australian Law	61		
	[B]	The Ci	vil Law Approach	62		
§2.04	Concl	usions		65		
Снарты	R 3					
			ong-Term Gas Sale Agreements by Arbitrators			
Contra	cts With	nout ar	n Adaptation Clause	71		
§3.01		luction		71		
§3.02			and Hardship Clauses	79		
§3.03			ral Applicable Law Perspective	84		
	[A]		rvative Legal Systems	88		
			Γhe French Legal System	88		
			Γhe Belgian Legal System	94		
			Γhe Swiss Legal System	99		
			The Common Law	102		
			onservative Legal Systems – The Italian Legal System	114		
			onservative Legal Systems	121		
			The German Legal System	121		
			The Dutch Legal System	125		
			The Swedish Legal System	130		
			usions on the Procedural Law Perspective	133		
			ation Rules	137		
§3.04			ional Arbitration Perspective	138		
§3.05			f the Arbitration Agreement and Arbitrability	144		
§3.06	Conci	usions		149		
CHAPTE		f T -	Tarra Cas Cala Assessments has Ashitustara			
			ong-Term Gas Sale Agreements by Arbitrators	167		
§4.01	Introduction ICC Case n. 10351/2001					
§4.02				169 172		
§4.03		Atlantic Case Cases p. 0813 (1000 and p. 13504/2007)				
§4.04			9812/1999 and n. 13504/2007	177		
			ase n. 9812/1999	178		
	[B]	ICC Ca	ase n. 13504/2007	182		

		Table of Contents
§4.05	The <i>Quintette</i> Case	185
§4.06	The Esso Case	189
§4.07	Conclusions	191
Bibliog	graphy	195
Table	of Cases	205
Index		213

CHAPTER 1

The Gas Market and the Relevant Agreements

§1.01 INTRODUCTION

The expression "long-term gas sale agreements" is used in this book to identify, in general, international commercial contracts concluded among producers, wholesalers and distributors for the sale of gas. The common feature of these agreements is to be characterised by a long duration (usually twenty or more years) and by relevant investments. During such lapse of time, the original market conditions – representing the basis on which the agreement was negotiated and concluded – may change due to the occurrence of unforeseen events affecting the contract's balance. Therefore, it is necessary to review the contractual terms and conditions, especially those regarding the price and the minimum purchase volumes established by take or pay clauses (i.e., clauses providing for the obligation of the buyer to purchase a minimum fixed volume of gas every year and to pay for it even in case the buyer does not actually take it), in order to adapt them to the actual market situation. For this reason, parties often (although not always) include in their contract specific clauses providing for the adaptation/adjustment of the latter terms and conditions. According to such provisions, usually the first step is the parties' renegotiation and, in case of its failure, the second step is the submission of the matter to arbitration or, more rarely, to courts (indeed, due to their international nature, gas sale agreements normally include an arbitration clause). In this situation, arbitrators (and courts) have to carry out the difficult task of the determination of their powers with regard to the adjustment of gas sale contracts. In order to do that, they have to interpret and analyse the contract's provisions (and, in particular, the adaptation, if any, and the arbitration clause) and the applicable procedural law. As seen more in detail below, such double analysis is necessary since, on the one hand, the arbitration tribunal's jurisdiction and authority find their source in the parties' will (i.e., in the contract and, in particular, in the arbitration clause) and, on the other, the issue of the arbitrators' adaptation power has §1.02 Pietro Ferrario

a procedural nature.¹ It is, therefore, clear that the above-mentioned task is more complicated in case the procedural applicable law does not provide arbitrators with the adaptation power and/or the contract does not provide for an adjustment clause. In the latter situation, it will be necessary to determine whether the adaptation process can be carried out on the basis of the general arbitration clause. Furthermore, a problem can arise with regard to the extent of the arbitration tribunal's authority in particular if the contract does not contain any specific definition and indication of the arbitrators' adaptation powers.

The issue of the adjustment of long-term gas sale agreements by arbitration tribunals, on which this work is mainly focused, has assumed even more relevance due to the recent renegotiation and adaptation processes, as well as arbitration proceedings, that involved such agreements, especially in relation to the price and the minimum purchase volume obligations therein provided. The origin of such processes and proceedings can be mostly identified in the crisis that in 2009 affected the gas market and in the emergence and development of spot or traded gas markets, i.e., 'markets in which commodities are bought and sold for immediate or very near-term delivery, usually within a period of thirty days or fewer. The transaction does not imply a continuing arrangement between the buyer and the seller. A spot market is more likely to develop at a location with numerous pipeline interconnections, thus allowing for a large number of buyers and sellers'. As to the price, it has to be underlined that such issue is particularly relevant for gas sale contracts since it has given rise to a debate in relation to which mechanism has to be applied for its determination. In this regard, it is possible to identify two main different methods for the price calculation: the oil price indexation, consisting in determining the gas price by linking it to that applied to oil products (this is the most common method in continental Europe) or the spot/traded markets price indexation, consisting in applying to the sale of gas at the price determined in spot markets (this is the method mainly used in the United States (US) and United Kingdom (UK)).

In order to better address the problem of the adaptation of long-term gas sale agreements, as above identified, it is important to analyse first their key characteristics and the context in which they developed. For this purpose, this chapter will provide a brief analysis and overview of the evolution of some of the main European and extra-European gas markets as well as of the relevant contracts.

§1.02 THE GAS MARKET AND SALE AGREEMENTS

In the international scenario, Europe represents a key area for the gas trade, especially for that of natural gas. As said before, an issue particularly hot and relevant in this market is the method of determination of the gas price. In Europe, it was developed (and it is still the most used in continental European countries) the mechanism of the so called "oil indexation" by which the gas price is determined by referring it to that

^{1.} See Ch. 3.

^{2.} American Petroleum Institute, Understanding Natural Gas Markets, www.api.org, 32 (2014).

applied to oil products. This mechanism, that was also exported to Asia, is the opposite to that developed in the US where the price of gas provided in sale agreements is that determined in spot markets. However, it has to be noted that also in Europe the latter method of price calculation has begun to spread and to be used in contractual relationships (in particular, in the UK).

The importance of the European scene was recently underlined by Professor Melling who stated that:

Today, Europe is witnessing an unprecedented collision between these two pricing mechanisms and gas industry cultures. According to the International Energy Agency, one of the most essential questions related to global energy supplies and security is whether the traditional link between oil and gas prices will survive. While Europe is currently the battleground, the implications stretch beyond Europe's borders because once-isolated regional markets are now interconnected through the rising trade in liquefied natural gas. If the spot market model gains the upper hand in Europe, Asia will be the last remaining stronghold of oil-indexed pricing, possibly making it unsustainable. Alternatively, if oil indexation re-exerts its predominance, there is the prospect that spot prices in North America will be influenced by this model.³

It is commonly recognised that the growth of natural gas market in Europe began in the 1960s, in particular, as a consequence of the discovery of natural gas fields in the Netherlands (and, in particular, of the Groningen field) and in the North Sea. Indeed, due to such discoveries, the Netherlands and Norway could begin to export their gas to other European countries and the UK gas market could develop. Moreover, the importations of Russian and Algerian gas also contributed to the growth of the gas trade in Europe.⁴

It is possible to identify seven European main gas markets developed during the period between 1960 and 1990: the Netherlands, UK, Norway, France, Germany, Italy and Belgium. In particular, the first three countries played a key role in the creation and growth of the gas trade in Europe. For other European countries, that lacked local resources and that were far from the major suppliers, it was, instead, difficult to develop a specific gas market especially because of the high costs linked to the pipelines transportation of gas.⁵

As already mentioned, it is important to note that the main feature of the developing gas market was the use of long-term gas sale contracts providing for oil-indexed price. The price of natural gas was, therefore, linked to prices of other competing fuels and, first of all, to that of oil products. Within the described context, it is interesting to provide a brief overview and analysis of the evolution of the three most important European gas markets (the Dutch, UK and Norwegian markets), as well as of other relevant international experiences connected to the European scenario (the US,

^{3.} A.J. Melling, *Natural Gas Pricing and Its Future*, http://carnegieendowment.org, 7–8 (2010). For a general overview of the gas markets, *see* DNV KEMA Energy & Sustainability in collaboration with COWI Belgium, *Study on LT-ST Markets in Gas*, www.ec.europa.eu (2013).

^{4.} Melling, id., at 9 et seq.; J.P. Stern, European Gas Markets, 2 et seq. (The Royal Institute of International Affairs 1990).

^{5.} Stern, id.

§1.02[A] Pietro Ferrario

Russian and Algerian markets), with particular attention to the development and main characteristic of the relevant sale contracts.

[A] The Evolution of the Dutch Market and Relevant Gas Sale Contracts

As said above, the discovery of the Slochteren Groningen field in 1959 was crucial for the development of the European gas trade. Indeed, this discovery made possible for the Netherlands not only to cope with its domestic market demand but also to export the gas towards other European countries and, in particular, to Germany, France and Belgium (exportations were also facilitated by the proximity of the Groningen field to the main urban areas of these countries). For several years, the Groningen field was the exclusive source for the production of Dutch gas. Only after the oil crisis of 1973–1974, other marginal fields were exploited in order to preserve the reserves of the Groningen field.

Before its discovery, the Dutch gas market was characterised by the government's monopoly of the wholesale of natural gas. In particular, according to the law in force at that time, the company established for the exploration and development of the hydrocarbons discovered in the Netherlands – Nederlandse Aardolie Maatschappij BV (NAM) whose shareholders were Shell and Exxon - had the obligation to sell for a twenty-year period any gas surplus to the State Gas Board (SGB), a state-owned entity, which, in return, was required to pay for any quantity of gas offered by NAM. Upon the discovery of the Groningen field, the Dutch government decided to change strategy and to end the monopoly of the gas supply held by SGB without, however, completely losing the control of such resource. Therefore, it was decided to involve in the exploitation and marketing process another state-owned entity, Dutch State Mines (DSM), that was the main producer and distributor of solid fuels and coke-oven gas in the Netherlands. Thanks to this decision, it was also possible for DSM not to be negatively affected by the discovery and supply of the Groningen gas since the latter was in competition with the products sold by DSM. Moreover, it was established the direct involvement of Shell and Exxon also in the gas marketing phase (which, until that moment, was an exclusive prerogative of the State) in addition to the role already played in the production process. Furthermore, other two entities were set up: the Maatschap, by which the State controlled the production's costs and profits, and the N.V. Nederlandse Gasunie (Gasunie) – that in 2005 was split into GasTerra (a gas trading company) and Gasunie (a gas transportation company) - involved in the transportation and marketing of gas and whose shareholders were for 50% Shell and Exxon (with 25% of shares each one) and for the remaining 50% DSM and the State. It was also decided that NAM, through a specific separate division (NAM-Gas Export),

^{6.} See, in general, Melling, supra n. 3, at 16–19; A.F. Correljé & P.R. Odell, Four Decades of Groningen Production and Pricing Policies and a View to the Future, 28 Energy Policy 19 (2000); Stern, supra n. 4, at 42 et seq.; M.V.H. Peebles, Evolution of the Gas Industry, 113 et seq. (Macmillan Press Ltd. 1980).

^{7.} M. van der Hoeven, M. Kraven & B. van de Leemput, *The Netherlands: The Energy Hub of Europe*, Oil & Gas Financial Journal, 1 (2010).

would have been in charge of the gas exportations for Gasunie (after 1975 Gasunie started to directly export the Groningen gas).

As explained by Professors Correljé and Odell, in 1963 the structure of the Dutch gas sector was the following:

i) The holder of the Groningen concession, the *Nederlandse Aardolie Maatschappij BV* (NAM), a 50/50 joint venture of Shell and Exxon, was exclusively to undertake the production activities. ii) The state, via the Staatsmijnen (later Dutch State Mines or DSM), was to participate in the costs of exploiting gas from the Groningen field and in the flow of revenues through a financing partnership, known as the *Maatschap* (40% DSM, 60% NAM). iii) Gasunie was established as a joint venture owned by the Dutch State Mines (DSM) (40%), the Dutch State directly (10%) and Exxon (25%) and Shell (25%). Gasunie was given the exclusive responsibility to co-ordinate the commercialization of the Dutch natural gas resources on behalf of the Sate and the concession-holder, NAM. NAM Gas Export was to be responsible for the sales of gas abroad.⁸

It is clear that, through the above-mentioned structure of the gas market, the Dutch government, although not directly involved in the production and exploitation process of the gas, had a key role and relevant control in all the decisions regarding the Groningen field (from the prices to the production and trade volumes). Thus, what was created and implemented was a de facto monopoly. More specifically, the Dutch government had the following powers:

the right of approval of the transfer price between the 'Maatschap' and Gasunie; the right of approval of the gas sales plan; the right of approval of conditions and tariffs for the delivery of gas by Gasunie to public distribution companies in the Netherlands, as well as the right to approve the price level for other customer categories; the right of approval for the construction of transmission lines and other equipment for the transportation and storage of gas; the right of approval of the Dutch border prices for export sales; and the right to have limited quantity of gas supplied by and for the account of Gasunie at prices and conditions as stipulated by him after consultation with Gasunie to customers to be designated by him, if he should consider the desirable to promote industrial development in certain parts of the country. 9

Moreover, with regard to the demand of gas, 'the conditions for market developments were equally propitious. Groningen was located close to the centre of one of the world's most energy intensive using regions, within which the two most important suppliers of hydrocarbons were the two companies, viz. Shell and Exxon, which had discovered the fields. Under these conditions, the creation of a set of national or regional monopolistic transporters and another set of monopsonistic distributors and marketers of the potential gas supply from Groningen was axiomatic. Monopoly plus monopsony was thus imposed and implemented on the emerging European natural gas industry'. ¹⁰

^{8.} Correljé & Odell, supra n. 6, at 20.

^{9.} Peebles, supra n. 6, at 128–129.

^{10.} Correljé & Odell, supra n. 6, at 21.

§1.02[A] Pietro Ferrario

As to the sale contracts employed for exportations of the Dutch gas, it is important to underline the method for calculating the relevant price. This method was based on the so called "market-value" or "netback-value" principle, that was established by the Dutch Minister of the Economic Affairs at that time (Jan Willem de Pous) in the Nota inzake het aardgas of 1961-1962. It should be distinguished from the so called "cost-plus" principle, that was the prevailing method used until that time for the calculation of the town gas price (i.e., a kind of manufactured gas deriving from the distillation of coal, that was the most common type of gas used before the discovery and development of natural gas). In particular, the netback price is calculated by identifying the market value of natural gas in a specific market sector. This process requires, first, to take into account the other competing fuels sold in the same sector (the gas price is, therefore, linked to other fuels' price and, in particular, to that of gasoil, for small customers, and of heavy fuel oil, for large customers) and, then, to deduct from such value the relevant costs (such as, transportation and storage costs), general expenses, taxes and profits. Through this method, it is possible to determine the value of the gas at the moment of the sale. A clear explanation of such principle is provided by the International Energy Agency, according to which:

the price paid by the gas company to the foreign or domestic gas producer at the border or the beach is negotiated on the basis of the weighted average value of the gas in competition with other fuels adjusted to allow for transportation and storage costs from the beach or the border and any taxes on gas. There are in principle three different average netback market values. These correspond to existing gas users, new gas users (such as Greenfield industrial plants) and to existing oil users with no dual firing capability (the market value of the latter being the lowest because of the high capital cost of fuel switching). The beach/border base price that is ultimately negotiated will correspond to a level between the highest and the lowest of the three values, weighted across the different end-user customer categories. The base price is usually indexed to oil product prices (usually heating oil and/or heavy fuel oil) or simply to crude oil (on the implicit assumption that the ratio of crude to product prices will remain broadly constant). This is to ensure that effective prices over the life of the contract remain broadly in line with market values.

11

On the contrary, according to the cost-plus method, the sale price is calculated as the sum of production and transportation costs, general expenses and profits. It is, therefore, clear that the price based on the netback-value principle is more competitive and attractive for customers that are incentivised to buy natural gas instead of other fuels. Thus, such price was the one used for the exportation of the Groningen gas in order to enter into new markets and, in particular, into the German one where the prevailing type of gas consumed until that moment was the town gas. It follows that it was necessary to practise prices appealing for the customers in comparison to other fuels. Provided that, the application of the market-value principle, in any case, permitted to the Dutch government and producers to earn high revenues since, on the one hand, the Groningen gas price was linked to that of alternative fuels which at that time were high-priced (there was no cheapest gas available in the market) and, on the

^{11.} International Energy Agency (IEA), Natural Gas Pricing in Competitive Markets, 32 (IEA 1998).

other, the production and transportation costs were low. On the contrary, consumers would have been more advantageous (and, consequently, less convenient for the State and the producers) if the gas sale price had been referred to the production costs of the Groningen gas that, as said, were low. In this regard, it was noted that:

At the time of gas' extensive introduction to the markets, Europe consisted of a set of relatively high-priced energy markets arising from the combination of highly protected indigenous coal and a less than fully competitive supply of oil products. Thus, the netback value of the Groningen gas marketed could be a multiple of the very low long-run supply price of the commodity; leading to consequential super-normal profits for the producers and generous revenues for the state. Energy consumers were, of course, the losers; but this was largely unrecognized by them in the context of the ordered system imposed. They were, in any case, ... very used to high-energy prices, so that gas could, in effect, be offered on a take-it or leave-it basis as a so-called premium fuel at so-called 'competitive' prices, in a market in which no gas at lower prices was available. Monopoly power was effectively exercised. ¹²

The same price mechanism was applied by Dutch exporters to Belgian and French buyers. Due to the fact that the netback price was different from country to country, since the market value of the gas and the transportation costs varied on the basis of the place of destination, the Dutch gas sale contracts included the so called "destination clauses" in order to match a specific price with a specific destination. Another characteristic of the above-mentioned contracts (i.e., common to gas sale agreements in general) was the long duration (usually around 20–25 years). For this reason and the possible variation of the netback value of the gas (and, therefore, of the sale price) over such a long period of time, such contracts also provided for the possibility to review the price by means of the so called "price review" or "price re-opener" clauses allowing the parties to periodically adjust the price on the basis of unforeseeable changes incurred in the relevant market that affected the gas price.

Other features of Dutch gas sale contracts were, on the one hand, the flexibility with regard to the daily and annual volume of gas that the buyers were obliged to take according to take or pay clauses and, on the other, the application of an additional charge (so called "capacity charge") to be paid independent of the gas consumed in order to compensate the aforementioned flexibility. As shown below, the exportation gas contracts employed by other countries were not characterised by the same degree of flexibility as Dutch contracts. This was mainly due to the following factors. First, the long distance existing between suppliers and buyers that implied high transportation costs through pipeline systems (often dedicated to a single buyer), involving, as a consequence, relevant investments by the seller. The latter, therefore, required the buyer to pay for an agreed minimum annual quantity, usually ranging from 80% to 90% of the so called "Annual Contract Quantity (ACQ)" of the gas to be supplied pursuant to the sale agreement. Such payment obligation was due even in case the gas was not actually taken by the buyer (this is a peculiarity of take or pay clauses). In this way, the seller was sure to recover the capital costs borne for the gas transportation.

^{12.} Correljé & Odell, supra n. 6, at 21.

§1.02[B] Pietro Ferrario

The second reason was represented by the particularly low production costs in the Groningen field that, consequently, made Dutch gas sale contracts more competitive (in terms of flexibility) than the others.

The above-mentioned characteristics can also be found in the ongoing gas sale agreements. However, it has to be noted that, due to the liberalisation, the development of spot markets and the crisis, some of the most recent contracts for the exportation of Dutch gas have a duration of one or two years and the relevant price is determined on the basis of spot markets.

[B] The Evolution of the UK Market and Relevant Gas Sale Contracts

The other most important European gas market considered in our analysis is the one developed in the UK. 13 Even in this case the trigger event was the discovery of new gas fields and, in particular, of those located in the North Sea during the years 1965–1966. Before such discoveries, the most common type of gas used in the UK was the town gas¹⁴ and the market players were small private companies and county councils. In 1948, with the enactment of the Gas Bill, the UK gas industry was nationalised and twelve autonomous Area Boards were established with the task to organise their supplies and the relevant financial aspects. In particular, 'they were permitted to fix their own prices, insofar as this was compatible with the general direction that "every Area Board shall reduce, so far as practicable, the price of gas and coke, and avoid undue preference in the supply of gas and coke". At the same time, the Area Boards were required "to secure that the revenues of the Board are not less than sufficient to meet their outgoings properly chargeable to revenue account, taking one year with another"'. 15 In order to better coordinate these activities among the Boards, it was decided to set up a central body, the Gas Council, gathering the twelve Area Boards chairmen and dealing with some matters of general interests. In particular, this central organisation had the following tasks: '(a) to advise the Minister in questions affecting the gas industry and matters relating thereto; and (b) to promote and assist the efficient exercise ad performance by Area Boards of their functions'. 16

Moreover, from October 1964, the UK started to import liquefied natural gas (LNG) from Algeria pursuant to a fifteen-year contract, concluded by the Gas Council on behalf of eight Area Boards, at a fixed price. Almost in the same period of time (and, precisely, from September 1964), the British government, according to the Continental Shelf Act of 1964, authorised the oil main companies to explore the UK area of the

^{13.} See, in general, Melling, supra n. 3, at 22–23, 97–100; C. Webber, The Evolution of the Gas Industry in the UK, International Gas Union Magazine 198 (2010); A. Juris, Market Development in the United Kingdom's Natural Gas Industry, 3 et seq. (The World Bank, Private Sector Development Department, Private Participation in Infrastructure Division 1998); Stern, supra n. 4, at 2 et seq.; T.I. Williams, A History of the British Gas Industry (Oxford University Press 1981); M.V.H. Peebles, supra n. 6, at 21 et seq.

^{14.} As defined in the previous paragraph.

^{15.} Williams, supra n. 13, at 116.

^{16.} Gas Act, s. 22 (1948).