

INSIDE ARBITRATION: THE FUTURE OF ENERGY DISPUTES: SHOCKS TO THE SYSTEM

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Legal Briefings

Battered supply chains and turbulent geopolitics mean the energy sector should brace for a surge in disputes

When it comes to disputes, the energy sector is facing as complex a time as it ever has. Some of the challenges, such as climate change, have been on the agenda for a long time. Some are perennial hazards, like state interference. But the industry also finds itself faced with a range of immediate challenges that it would have been hard to anticipate five or ten years ago. These include fallout from a global pandemic and severe supply chain interruptions; an oil and gas supply crunch due to the Ukraine-Russia conflict; and intense national debt and cost-of-living pressures leading to windfall taxes on oil and gas companies being mooted or introduced in many jurisdictions.

In short, there has been a confluence of forces driving soaring oil prices in 2022, only two years after the industry was forced to confront the implications of unusually low prices. The full impact of this volatility on the long-term energy transition is unclear. But in the short-term, we can reasonably forecast a rise in resource nationalism in response to energy security concerns, price reviews as parties seek to rebalance their contracts and turmoil in investment markets.

While high oil prices have historically led to fewer disputes – there being less need to chase every dollar when returns are high – the supply crisis and political instability accompanying this price spike promises to stoke a significant increase in disputes. This article considers a range of areas we expect to be key battlegrounds in energy disputes in the years ahead.

DECARBONISATION AND CLIMATE CHANGE

The largest and most diverse area for disputes remains the energy transition, as the sector grapples with the brutal realities of decarbonisation. Corporate decarbonisation policies are fertile ground for a mismatch between commercial counterparties, with companies' objectives being defined in different terms and on different timetables. Where parties in a joint venture have contrasting approaches to decarbonisation, they may have different attitudes to what is an appropriate operational adjustment to make to reduce the emissions of a project, particularly as corporate commitments often go beyond regulatory requirements. In many cases, there will be a lack of clarity in existing contracts about how to manage this. Warranties, indemnities, force majeure clauses and other contractual provisions are unlikely to be well-suited to allocate risk and responsibility for the consequences of such fundamental changes within supply chains and joint ventures.

The pace of change required by the energy transition will likewise inevitably give rise to further disputes. The growing appetite for renewable energy and decarbonisation of the current energy supply chain will continue to spawn new infrastructure projects, many public-private partnerships, and new collaborations between competitors as well as between traditional energy producers and new technology and renewables counterparts. Disputes will arise as new partnerships are implemented and M&A transactions are completed at speed, generated by mismatches in expectations between partners, technology and designs not fit for purpose, construction projects built on overly-ambitious timetables and transactional warranties (including as to carbon impact) not being met.

Governments may also become key players in climate-change related disputes, whether from a regulatory perspective or as respondents in investment treaty claims as states seek to amend or terminate longer-term hydrocarbon contracts, or in relation to the decommissioning of assets and continuing environmental liabilities.

DISPUTES ARISING FROM THE RUSSIAN CONFLICT

Of course, much of the current oil price volatility, along with a range of supply chain constraints, stems from Russia's invasion of the Ukraine and the global response. Sanctions against Russia are unprecedented and far-reaching, particularly addressing its oil and gas sectors, while a Russian decree requiring European importers to pay in roubles (by way of 'counter-sanctions') has further threatened access to gas.

On one hand, this has exacerbated pressures on existing contracts and supply chains, with parties seeking to rely on force majeure/material adverse change clauses or negotiate exits from affected projects and contracts. Companies may also be considering how to make use of investment treaty protections to recover lost value, against a background of uncertain dispute resolution mechanisms and enforcement options under contracts with Russian entities. On the other, such pressures have stoked Western calls for accelerated clean energy transition and can be expected to drive more frenetic M&A activity in the medium term.

STATE ACTION AND POTENTIAL FOR DISPUTES

Against this turbulent setting, there are many reasons for increased state involvement in the energy sector, with the Ukraine conflict prompting a renewed focus on energy security. At the same time, governments are evaluating the impact of increased public spending to combat Covid-19, together with the current inflationary crisis and ongoing pressure to act on commitments to address climate change.

We are seeing and expect to see increased state involvement in the following four areas:

1. **Windfall profit taxes and retrospective tax liabilities** – increased risk that windfall taxes will be imposed in a high oil price environment, with Spain and the UK among those to have already announced a windfall tax.
2. **Cost audits and cost recovery disputes** – increased government involvement in cost audits and national oil companies (NOCs) challenging investment decisions and expenses incurred by operators.
3. **Indirect government pressure on existing projects** – significant state pressure where revenues under existing projects are due to NOCs or where the oil or gas being produced and supplied is a critical source of energy supply for the state.
4. **Decommissioning and other environmental liabilities** – changing regulatory frameworks for decommissioning, and increased risks around abandonment and allegations of environmental damage.

PRICE REVIEWS

The volatility in gas demand over the past few years has already given rise to price reviews in liquefied natural gas (LNG) share purchase agreements (SPAs) and is continuing to do so. The current high oil price is likely to contribute to that trend, as contract price in many such agreements is linked to oil or oil product prices.

Even before Covid-19, many buyers viewed the LNG market as oversupplied as more projects commenced production in Australia and the US. This consensus contributed to low LNG spot prices even as oil prices stayed comparatively high, prompting some buyers to initiate price reviews under oil-linked SPAs. This was exacerbated during lockdowns when buyers were looking to defer cargoes and considering force majeure claims.

More recently, there has been a significant shift towards energy price increases as economies have reopened, exacerbated by the Ukraine crisis. In this market, we expect many sellers to push for contract price increases under LNG SPAs.

Given these shifting market dynamics, two issues will be a key focus in any price review dispute, including arbitration where such a mechanism is available:

1. **Review period** – whether the review period for the price review ends before the recent price increases. If so, a buyer might try arguing for a decrease on grounds it was an oversupplied market during the relevant period and any recent price increases should be taken into account in a future price review.
2. **Factors to be considered by parties** – whether the price is to be benchmarked against other long-term contracts only, or whether new medium and short-term LNG contracts can also be considered. It may take some time before high oil and gas prices are reflected in long-term contracts. Depending on the wording of the price review clause, sellers may not be able to rely solely on increased short-term LNG prices to push for an increase in prices.

TRANSNATIONAL TORT CLAIMS

Following the UK Supreme Court decisions in *Vedanta and Shell*, we expect to see further growth in attempts by claimants to 'pierce the corporate veil' and pursue transnational parent companies for actions of their overseas subsidiaries. With these cases having opened the door to establishing such parent company liability (at least as a matter of jurisdiction), similar trends are emerging in other common law jurisdictions, particularly in Canada and Australia.

In these cases, the key question was the extent to which the parent company assumed or shared with the subsidiary the management of the relevant operations or activities. This included through management activities, providing defective advice or policies to a subsidiary, promoting and implementing group-wide safety and environmental policies, or holding out that the parent company exercises a particular degree of supervision and control over the subsidiary.

We expect to see future attempts at such claims, scrutinising connections between parent companies and their subsidiaries – particularly via governance procedures and policies, especially in connection with environmental and/or climate change issues. Given current uncertainty as to when parent company liability will arise, there is also the possibility of speculative claims geared towards attempting to extract early settlements.

Hemmed in on all sides, wrestling with intense structural and short-term pressures – it is hard to remember a time when the energy industry has faced risk on so many fronts. Casualties and collateral damage look inevitable.

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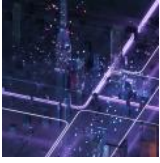
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KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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