

The Paris Energy Series No. 5: Drafting Oil and Gas Dispute Resolution Clauses: (it's always) time to think more creatively

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It may be that as a judge I have a distorted view of some aspects of life, but I cannot imagine a contract particularly one of any size, which does not give rise to some disputes. This is not to the discredit of either party to the contract. It is simply the nature of the beast. What is to their discredit is that they fail to resolve disputes as quickly, economically and sensibly as possible.¹

This article will address the following issues:

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Since the first genuine oil well was drilled by Edwin Drake in 1859, the oil and gas industry has known disputes. In fact, people plan for them. They know that dispute resolution clauses are important and take care when drafting them. In doing so, parties to oil and gas contracts naturally tend to stick to the tried and tested methods of arbitration and litigation. But people are becoming increasingly disenchanted with the cost and time associated with these traditional methods. They are saying: there must be something better.

Many different forms of dispute resolution have been created in recent years, but they are not yet widely used in oil and gas contracts.² The question becomes which of these methods should, and will, find their way in? Where will this search for something better lead? The writers suggest that two methods will find their way to the front of the pack: final offer or "baseball" arbitration and disputes boards. To these, we would add institutional ADR. While non-binding dispute resolution is hardly novel, recent experience suggests that the involvement of an institution may add an extra dimension which makes ADR a more attractive option.

1. Final offer or "baseball" arbitration

One problem with traditional arbitration is that parties tend to inflate their claims. Parties overstate their monetary claims in the hope that claiming a larger amount will ultimately lead to them being granted a larger amount. Such inflation is based on the (sometimes correct) assumption that when arbitrators deliberate, they tend to reach a compromise by granting only part of the amount claimed (often called *splitting the baby*). The problem with such inflation is that it discourages settlement, largely because a realistic commercial settlement might see the claimant accepting only a fraction of its inflated claim.

Final offer arbitration (sometimes called "last-best offer" or "baseball" arbitration) seeks to overcome this problem.³ In final offer arbitration, the arbitrators must choose one of the parties' final positions in the arbitration (hence, final offer). They cannot make a compromise decision between the parties' final positions (i.e. the arbitrators cannot *split the baby*).

This procedural mechanism is designed to discourage parties from exaggerating their claims. Final offer arbitration increases the risk of rejection in submitting an exaggerated monetary claim to arbitration. Consequently, parties narrow their demands since an exaggerated claim would, in all likelihood, lose. Extreme positions and "bargaining" claims are filtered out and settlement becomes less contentious. Final offer arbitration thus, by design, motivates each party to negotiate in good faith and reach their own agreement. "[It] provides a means to compel serious, as opposed to surface,



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bargaining since the increased risk of losing provides a psychological and economic incentive to settle.”⁴

Originally used for baseball salary negotiations, final offer arbitration has become an established part of arbitration practice in the United States. While non-US parties appear reticent to agree to final offer arbitration, recent experience suggests that it is now used – albeit to a limited extent – in continental Europe. And the writers can confirm that final offer arbitration is being used in the energy industry, notably in the area of natural gas and unitization.

Final offer arbitration is best suited to disputes where the outcome is a single numerical figure, or small number of figures. The classic example is pricing disputes, where the decision is ultimately just the price that must be paid. Other examples include interest rates, currency conversions and contractual buyouts.⁵

Some examples of clauses (with names and other details changed) may assist:

An example of a straightforward clause is:

“Each party shall submit to the arbitrator and exchange with each other, in accordance with a procedure to be established by the arbitrator, its best offer. The arbitrator shall be limited to awarding only one or the other of the two positions submitted.”⁶

A more specific example is:

“if the parties fail to agree on a revised price within 60 days after the date the Price Review Notice is delivered, or if the parties agree at an earlier date that their discussions are deadlocked, then either Proponents or Respondents may refer the matter to arbitration under Article 10. The Proponents and Respondents shall each submit to the arbitrators and exchange with each other, in accordance with procedures to be established by the arbitrators, their proposed changes (if any) to elements “A” and/or “B” in the Original Price, together with all such market data and information in support of their proposals as they shall deem relevant. The changes proposed by the Proponents and Respondents need not be identical to the changes originally proposed by them pursuant to paragraphs (c) and (d) above, as applicable. The arbitrators shall be limited to awarding only one or the other of the two proposals submitted. Any revised price determined pursuant to such arbitral award shall be set forth in an amendment to this Contract entered into pursuant to Article 11.”

The major advantage of final offer arbitration is its high settlement rate. Although little empirical evidence exists outside of Major League Baseball, its application to those disputes has been impressive. Studies report settlement rates as high as 90%. It also seems to have other advantages. For example, final

offer arbitration may inflict less harm on long-term business relationships and is less antagonistic compared to litigation and conventional arbitration.

Final offer arbitration is also considered to provide relatively speedy resolution of disputes, especially if combined with a rigid or “fast-track” timeframe.

Final offer arbitration also has perceived disadvantages. It may, for example, actively encourage the onset of arbitration. Where final offer arbitration is available, parties may commence arbitration proceedings more often than those whose only option is conventional arbitration although, admittedly, most cases settle before an award is handed down. Final offer arbitration has also been said to promote a game rather than a resolution.

Final offer has also been criticized as not providing the most “just” or legally exact solution.

And, of course, final offer arbitration is not suitable for all disputes. It does not, for instance, provide a sensible mechanism for resolving “trigger” issues (i.e. when can a party invoke a price review; many disputes start here). It also requires special attention where a dispute covers price and other elements (i.e. the need to modify the elements making up the price).

Final offer arbitration clauses also have to be drafted carefully. Particular care needs to be paid to the relationship between the clause and the arbitral rules, especially if they are institutional. To illustrate, any ICC clause would need to take into account the time limits set out in the rules and the ICC’s requirement for a reasoned award.

In any event, final offer arbitration warrants serious thought.

2. Dispute boards

One classic problem with long term contracts is that a series of small disputes arise and then fester because they remain unresolved. Over time, the partners’ relationship breaks down, with the previously minor disputes snowballing into a larger, more serious dispute. To deal with this, long-term construction contracts regularly address disputes via a real-time adjudication process, typically called “dispute boards”.

Contracting parties appoint their “dispute board” – usually three independent members – at the project’s outset, before any disputes have arisen. The board is then actively involved throughout the project and serves to provide a forum to discuss and resolve litigious matters.

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Dispute boards are not purely concerned with *resolving* disputes. Rather, their primary aim is to *avoid* disputes. Dispute boards should, in theory, deal with “issues” and tensions as they arise, to avoid them escalating into disputes. However, dispute boards are increasingly empowered to make binding decisions. Whether or not a board’s decisions are binding will depend on its contractual mandate. In general, the decisions of a “dispute adjudication board” are final if the parties do not challenge the board’s decision. If decisions are challenged, they typically have interim effect until they are reviewed by a court or tribunal.

Experience shows that dispute boards are astoundingly successful, studies suggesting they dispose of all but 3% of claims put before them.⁷ Apart from their effectiveness in promoting the early resolution of disputes and maintaining working relationships, dispute boards also avoid needless hostility.

Cyril Chern describes dispute boards’ successful application to construction disputes:

“The ‘nature of the beast’ is changing, however, thanks in great measure to the use of dispute boards. As an example, the Ertan Hydroelectric Dam in China valued at US\$2 billion⁸ had 40 disputes referred to its dispute review board for decision and no decision of this dispute board went on to arbitration or litigation of any kind. The Hong Kong International Airport valued at US\$15 billion had six disputes referred to its dispute board and of those only one went on to arbitration, at which time the decision of the dispute review board was upheld, and the Katsse Dam in South Africa valued at US\$2.5 billion had 12 disputes referred to its dispute board and of these only one went on to arbitration where, again, the decision of the dispute review board was upheld. In each instance, the dispute board did resolve those disputes as quickly, economically and sensibly as possible.

Dispute boards work and sometimes their mere presence and the ability of the dispute board members to give informal opinions before any dispute even arises can be of immense assistance. A good example of this in the United Kingdom is the Docklands Light Railway valued at US\$500 million, where no disputes ever fully arose or were submitted to the dispute board, or the Saltend Private Gas Turbine Power Plant in the north of England valued at US\$200 million, where both the number of disputes referred to the dispute board and the number that went to arbitration were zero. Needless to say such statistics were unheard of in the construction industry before the advent of the dispute board.”⁹

Of course, nothing is perfect, and dispute boards’ drawbacks relate to cost and enforceability. They are doubtless one of the most complex and thus expensive methods of ADR.¹⁰ Further, their decisions are only enforceable as a matter of contract. It can

thus be costly and time consuming to enforce a panel’s decision.

But do dispute boards have a future for oil and gas disputes? The writers think so. The benefits that can be derived from a dispute board – for the right contract – remain enormous. Such benefits would mainly apply to long term contracts, such as gas SPAs, and exploration and development licence agreements. However, to work, they need to be tailored to the project, and all participants have to be committed to their successful use.

With gas SPAs, a dispute board may be able to cover all aspects of the overall project; ranging from the EPC for construction of any of the facilities (new trains, degas or regas facilities), transport arrangements and/or the SPA itself. They can avoid the ever-present shortcomings of arbitration in that it is easier to have the different players “buy in” to the process, which means one can have all concerned players participate in the one overall discussion, whether all players are privy to all relevant agreements (an unlikely occurrence) or not.

Exploration and production agreements share these attributes, notably their long-time and capital intensive nature.

3. Institutional ADR: time to embrace the beast

In the writers’ experience, ADR is a poorly understood beast. Many reject it as a means for all (obviously) bad faith opponents to string things out. Others say they don’t need a third party to tell them how to settle a case. They are often right; but they are equally often wrong.

Oil and gas contracts frequently provide for some type of non-binding dispute resolution, typically negotiation, as a pre-cursor to arbitration or litigation. The perceived problem with such dispute resolution methods is that they require a significant degree of cooperation between the parties even to move the process forward. If the parties are already involved in an acrimonious dispute, they may not be able to muster enough cooperation to get to the table. One way of breaking at least partially this vicious cycle is to use institutional (as opposed to “*ad hoc*”) ADR. The use of an institution can provide a framework (the appointment of neutrals, etc) which increases the likelihood that the dispute process will at least get off the ground.

The most prominent international example is the 2001 ICC ADR Rules. Uniquely, ICC ADR does not mandate a single mode of ADR like its various alternatives. Instead, parties apply whatever settlement technique suits their specific needs,¹¹ although absent any specific agreement, mediation is the default method applied

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(in 2009 mediation was used in 90% of cases). While ICC ADR's numbers are modest, it has been gaining in popularity. In 2003, only eight ADR cases were registered, however, by 2009, that figure had increased to 24 (compared to 1,305 cases under the ICC Rules of Arbitration).

The advantages of ADR *per se* are evident. While arbitration and litigation focus the parties' attention on the *dispute*, mediation and other forms of non-binding ADR focus the parties' attention on the search for a *solution* and these solutions can, at times, be largely unrelated. An example commonly used in practice is the "oranges" anecdote. Imagine an ownership dispute over a crate of oranges. Ordinarily this would be a legal issue. An arbitrator's process would seek to establish legal ownership of the (perishable) goods. A mediator, however, would seek a commercial solution. A mediator might enquire about the parties' intended use. If the first party replied orange juice and the second replied marmalade, the dispute would disappear. The first could take the juice, while the second used the rind.

Statistics demonstrate that ICC ADR is both effective and fast. Since 2007, ICC ADR has boasted an average settlement rate of around 60%, although in 2010, the rate was closer to 100% (naturally, statistics fluctuate year on year). The average duration of proceedings, from filing of the request for ADR to completion of the case is 117 days (i.e. less than four months).

Combined, these statistics are telling. Arbitration and litigation are expensive and time consuming. If they can be avoided in the majority of cases by a process lasting less than four months, and assumedly at a fraction of the cost of arbitration or litigation, it justifies serious consideration.

The question is not *why* should ICC ADR be used in oil and gas contracts, but *why* not use it for such contracts?

Indeed, ICC ADR is already being used to resolve energy disputes, albeit in limited numbers. At present, 15% of cases filed under the ICC ADR Rules relate to energy disputes, most involving stakes of between US\$10 million and US\$30 million, although with some cases ranging up to US\$250 million.

ICC ADR would be applicable to a broad range of oil and gas related disputes. Indeed, one of the beauties of institutional ADR is that it can be used for almost any type of problem.

4. Conclusion

To many, litigation is like that film Woody Allen cited in the 1975 edition of Esquire magazine:

"Making a funny film provides all the enjoyment of getting your leg caught in the blades of a threshing machine. As a matter of fact, it's not even that pleasurable; with the threshing machine the end comes much quicker."

The analogy will not be lost on parties to what may seem interminable disputes. Of the ideas presented above, one (final offer arbitration) may well shorten the pain. The other candidates – dispute boards and institutional ADR – will work only if taken seriously and used when appropriate. If not, they can obviously lengthen the process and thereby achieve the opposite of what was intended. So handle with care!

Endnotes

- 1 Lord Donaldson, in a speech delivered in 1986, cited in *Chern on Dispute Boards* (Blackwell Publishing 2008), p.1.
- 2 Hew Dundas, *Dispute Resolution in the Oil & Gas Industry: an Oilman's Perspective*, Oil, Gas and Energy Law Intelligence (2004), 2(3), p.1.
- 3 Christian Borris, *Final Offer Arbitration from a Civil Law Perspective*, Journal of International Arbitration (Kluwer Law International 2007), 24 (3), p.307.
- 4 Carl Stevens, *Is Compulsory Arbitration Compatible with Bargaining*, Industrial Relations (1996), 5(38).
- 5 Elissa Meth, *Final Offer Arbitration: A Model for Dispute Resolution in Domestic and International Disputes*, The American Review of International Arbitration (1999), 10(3), pp. 413-415.
- 6 P. D. Friedland, *Arbitration Clauses for International Contracts*, 2nd ed. (2007), Appendix 9, p. 215.
- 7 Robert Gaitskell, *Oil, Gas & Energy Disputes: Trends in Tough Times* (Keating Chambers Article 2009), p. 22.
- 8 Note that worldwide, dispute board valuations are computed in US dollars.
- 9 C. Chern, *Chern on Dispute Boards* (Blackwell Publishing 2008), p.1.
- 10 *Ibid.* ("Some practitioners have calculated that a DRB [Dispute Board] will generally cost in the order of 0.2% of the project costs. Obviously, the bigger the project, the less the size of the procedure in relative terms. US experience shows DBs are cost effective for medium sized (e.g., \$50m) projects upwards. [In comparison,] Arbitration is said to cost, typically, about 4% of project costs.")
- 11 Dyala Jiménez-Figueres, *Amicable Means to Resolve Disputes: How the ICC ADR Rules Work*, Journal of International Arbitration (Kluwer International Law 2004), 21(1), p. 91.

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