FINANCIER WORLDWIDE .COM corporatefinanceintelligence

FORUM: Managing Energy And Natural Resources Industry Disputes

November 2013

*FW moderates a discussion on energy and natural resources industry disputes between **Kai-Uwe Karl** at GE Oil & Gas and **Jonathan Leach** at Hogan Lovells Lee & Lee.*

THE PANELLISTS

Kai-Uwe Karl is senior counsel at GE Oil & Gas. He can be contacted on +39 055 458 9129 or by email: kai-uwe.karl@ge.com.

Jonathan Leach is a partner at Hogan Lovells Lee & Lee. He can be contacted on +65 6538 0900 or by email: jonathan.leach@hllnl.com.

FW: Are you seeing an increase in disputes involving energy and natural resources companies? To what extent are market challenges and conditions fuelling commercial conflict?

Karl: We are not really seeing an increase in disputes. We are in the supply of technology and services to the oil and gas industry, which is in a growth mode with demand for more products. There are always ups and downs but I would say the amount of conflict in our part of the industry is fairly constant. I remember discussions several years back as to whether the financial crisis would impact the amount of disputes in our business; I don't think it did.

Leach: Yes, we are seeing an increase but the nature of this industry has consistently thrown up disputes. They are a fact of life given the size and complexity of most energy and natural resource projects, and the stakes are normally high enough to fight over. However, the origins of many of the disputes we now see bubbling to the surface are more likely due to structural and technological changes, in particular in the gas sector, rather than due to the wider global economic challenges we have seen.

FW: What particular types of dispute seem to be surfacing frequently in the energy and resources sector? In your opinion, have there been any significant cases in recent months?

Karl: In our sector, it is generally about equipment, engineering or project management issues, and intellectual property disputes are always an area of concern for technology companies. We have not seen significant matters in recent months that are out of the ordinary. Let me add that 'significant matters' are probably also not the type of cases that worry us most from the perspective of how to manage disputes: significant matters, by definition, get the right level of attention. What may be an even greater challenge is how to efficiently manage small to medium-sized cases, which requires a much more process focused approach to dispute resolution. The standard law firm pitch goes "take us, because we're great at handling very large, very complex, multi-jurisdictional matters" but the reality is that there are very few of those cases. On the other hand, we don't see as much creativity in developing dispute management tools that suit smaller matters. Fixed price arrangements for early case assessments are still considered noteworthy.

Leach: Gas supply disputes are frequently surfacing, in particular arbitrations resulting from price revision requests. The drivers include increasing liberalisation and competition, particularly in Europe, and the development of other supply sources, such as LNG from emerging markets and shale gas from the US and China. These have helped to stabilise gas prices while oil has continued to rise, causing difficulties for buyers in long-term gas purchase contracts with pricing formulae which are still oil-linked: they will want to renegotiate or get out, leading to inevitable conflict. We have also noted a rise in disputes against states or state-owned entities, in particular in emerging markets, with more and more foreign investors showing a willingness to start proceedings against states to enforce protections afforded under investment treaties. We also frequently see high-value construction disputes, perhaps inevitable as production facilities become more and more complex and technologically sophisticated. In Asia, we regularly see partner disputes concerning the allocation of costs under joint operating agreements and similar operational issues, which are perhaps more connected to continuing financial market challenges. And many players operating in the region are of course keeping a very close eye on the South China Sea boundary disputes.

FW: What key considerations should energy and resources firms make when trying to resolve a dispute? How important to a successful outcome is the chosen method of dispute resolution?

Leach: It is difficult to generalise. Considerations will of course depend on case-specific factors such as the claim value, strength of legal position, relative bargaining power, local political circumstances and longer-term commercial objectives. Companies should, however, focus on what is within their control, in particular how to avoid or minimise the chance of disputes arising in the first instance: by, for example, ensuring clear and well-drafted contracts – which include workable and not overly complicated dispute resolution provisions – followed by effective project management from beginning to end. The path for dispute resolution will be normally laid by the contract. 'Escalation' dispute resolution clauses are still very common and some have resorted to innovative methods to try to resolve disputes early on, thereby maintaining relationships and minimising delay to project completion, but keeping it simple and workable is always key. Arbitration, rather than court litigation, is now the usual default.

Karl: The chosen method of dispute resolution is critical. We have increasingly included in our contracts a mandatory mediation step before arbitration or litigation. This significantly reduces the cost and impact of conflicts on the business, and we are seeing this as more of a regular practice in the industry. Beyond that, we typically try to have arbitration clauses in our contracts, but in recent years many of our customers have grown tired of the cost, duration and expense of arbitration, and are insisting on resolution of disputes in the courts. The other key point is, of course, to have processes that allow you to resolve disputes early and ideally as soon as they arise. In the construction arena, disputes quickly become extremely complex. If you wait for too long, you essentially end up trying to reconstruct the entire project history, which is nearly impossible and clearly not economical.

FW: What unique challenges often arise in disputes involving energy and natural resources firms? What is your general advice to parties on overcoming such issues?

Leach: This industry has always had a political dimension and, by their very nature, energy or natural resources projects are capital intensive and involve long-term commitments. When a dispute arises there will often be a narrow line to tread, between standing up for commercial rights and maintaining good longer-term government relations. Although, at times, political posturing may need to be confronted by a degree of sabre-rattling, a successful outcome will often not be defined by a 'win' in court or in an arbitration hearing.

Karl: In our area it is often technical expertise, and getting it early, that is critical. As noted, it's key to have a systemic approach to dispute resolution rather than addressing disputes on an ad hoc basis.

FW: What trends are you seeing with regard to settlements in energy and resources disputes? Are today's firms more likely to reach a settlement out of court?

Leach: The inherent risks and costs of oil and gas exploration, together with the high level of investment and technical expertise required, have often resulted in a need to collaborate, not only with the host state but also with other industry players: competitors often become partners and future business may depend on being regarded as a good partner. Consequently, there have always been strong incentives to settle out of court in this industry and we have no reason to believe that cases are settling more nowadays than in previous years.

Karl: I don't think there has been a significant change in recent years in approach to settlements. Settlement has always been, and will always be, the preferred method of dispute resolution.

FW: Resource nationalism has emerged as a significant risk for firms operating in emerging nations. What advice can you give to natural resources companies involved in disputes with host states?

Karl: We are a technology provider to the industry so we typically do not have this risk. Also, when we are dealing with an national oil company (NOC) or a state, we would be very reluctant to resort to arbitration, especially investment arbitration. It is a shame that there is no investment mediation, at least yet, which would be better suited to our industry. There are some projects in the pipeline to create this field, and it would be a positive development.

Leach: Companies should consider whether they can benefit from the various protections afforded by investment treaties. Although their terms differ such treaties will typically prohibit a host state from expropriating foreign investments without adequate compensation and will require the state to afford the foreign investor 'fair and equitable' treatment. They also typically provide a mechanism for the investor to start international arbitration against the host state. Many companies will be understandably cautious about initiating an investment arbitration but, whether or not they decide to do so, the existence of such a remedy can serve as a powerful bargaining tool. Advice should be sought at the investment planning stage on how to best structure a deal so as to maximise the available treaty protection; but it should be borne in mind that it will usually be too late to re-structure for this purpose after a dispute has already arisen.