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Energy disputes in China: main trends and developments

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Summary

IN SUMMARY

This article discusses the main trends in the Chinese energy sector and the legal developments that have gradually clarified regulatory control in this area over the past few years. In particular, following an overview of the full spectrum of energy disputes in China, this article provides an in-depth analysis of several of the most disputed aspects in our experience, including the take-or-pay clause, delay and disruption in construction disputes, and the force majeure clause. Finally, the article explores the choice of dispute resolution mechanisms in energy disputes.

DISCUSSION POINTS

- Overview of energy disputes in China
- Take-or-pay clause
- Delay and disruption in construction disputes
- Force majeure
- Dispute resolution mechanisms

REFERENCED IN THIS ARTICLE

- China National Petroleum Corporation and China Petrochemical Corporation
- Special Administrative Measures (Negative List) for the Access of Foreign Investment (2018 and 2019)
- Singapore Convention on Mediation

OVERVIEW

As part of the government's Going Abroad strategy and the Belt and Road initiative, Chinese energy companies have long been major players in the international energy market.[1] Growth in energy demand in China has been a major driver for all manner of energy trends over the past two decades.[2] We have seen an increasing number of energy disputes involving Chinese parties in international arbitrations, most of which relate to China's outbound investments. The International Chamber of Commerce (ICC) has, in identifying and noting this development, created the Belt and Road Commission to focus on the dispute resolution needs of the full spectrum of Belt and Road disputes. Similarly, the Hong Kong International Arbitration Centre has established an advisory committee and website to assist parties with Belt and Road projects and related disputes. [3]

The whole process of an energy investment is roughly divided into three phases: upstream, midstream and downstream. Disputes can occur in any of these three stages and some disputes may span multiple stages.

Upstream Disputes

The upstream of an energy investment generally refers to anything relating to the exploration and production. This includes the steps involved in the actual drilling and bringing of resources to the surface.

A rigid licensing regime applies to upstream exploration and production (E&P) in China. In the past, exclusive rights were given to China National Petroleum Corporation and China Petrochemical Corporation for onshore oil E&P, China National Offshore Oil Corporation for offshore oil E&P, and four state-owned enterprises (SOEs) for coal-bed methane E&P.[4] Foreign companies seeking to invest in E&P activities in China were required to partner with one of these SOEs, mainly through production sharing contracts (PSCs). However, these restrictions were lifted on 1 May 2020; as of this date, foreign companies registered in China with minimum net assets of 300 million yuan are allowed to take part in oil and gas E&P, pursuant to the Opinions of the Ministry of Natural Resources on Several Matters Concerning Promoting the Reform of Mineral Resources Administration (For Trial Implementation).[5]

The PSC is the dominant form of contract used in relation to the exploration and development of resources over a considerable period (usually more than 20 years). Pursuant to a PSC, the state typically retains ownership of the resources and compensates the investor with a share of production, from which the investor recovers its costs and earns its profits. Common disputes involving PSCs include those related to profit oil allocations, price reviews, term extensions, terminations, assignments or transfers, environmental clauses, stabilisation clauses, changed circumstances and force majeure, among others.[6]

Midstream Disputes

Midstream activities typically relate to transportation and storage processes. For example, in relation to the oil and natural gas industry in particular, the midstream segment refers to anything relating to the transportation and storage of crude oil and natural gas before they are refined and processed.

In China, the midstream sectors remain dominated by China Petrochemical Corporation and China National Petroleum Corporation, although some activities are being opened up to private and foreign investors. According to the White Paper titled 'Energy in China's new era' issued by the State Council Information Office in December 2020, the Chinese government has gradually relaxed restrictions on foreign capital flowing into midstream operations. In particular, the Special Administrative Measures (Negative List) for the Access of Foreign Investment issued in 2018 removes the mandatory provision for the Chinese party to be the controlling shareholder in the construction and operation of power grids and gas stations.-[7] Moreover, the Special Administrative Measures (Negative List) for the Access of Foreign Investment issued in 2019 removes access restrictions relating to the construction and operation of pipeline networks for gas and heat supply in cities with a population of more than 500,000.

Midstream activities also include the construction of pipelines and all other infrastructure needed to move resources over long distances, such as the construction of pumping stations and transcontinental tankers. It follows that a large number of construction disputes could occur in the midstream stage. Typical disputes arising under construction contracts include those pertaining to delay and disruption in construction works and changes in the scope of work, among others. These tend to be highly technical and complicated construction disputes. Other frequent disputes occurring in the midstream stage relate to supply chains.

In the past few years, the covid-19 pandemic has resulted in numerous uncertainties in the energy sector, especially regarding supply chains. The interpretation of force majeure clauses has become a critical issue in some disputes.

Downstream Disputes

The closer a company is to supplying consumers with the products, the further downstream it is said to be in the industry. In the oil and natural gas industry, the downstream sector includes everything relating to the turning of crude oil and natural gas into thousands of finished products upon which we depend every day as well as the distribution of these finished products to end users.

In China, the downstream sector has opened up to private and foreign investments more than the upstream and midstream sectors have. For example, the Special Administrative Measures (Negative List) for the Access of Foreign Investment issued in 2018 removed the mandatory provision for the Chinese party to be the controlling shareholder in the manufacturing of complete vehicles using new energy.

Disputes in the downstream typically relate to delays in the connection to local grid and breaches of power purchase agreements (PPAs), among other things. One of the most disputed clauses in a PPA is the price review clause. Given the volatility of the energy market, instead of stipulating one fixed contract price, parties typically include a pricing formula along with provisions stipulating the review and adjustment of the price over the term of the contract. In recent years, there has been a proliferation of arbitration cases involving price review clause disputes.[8] Another frequently disputed clause in the PPA is the take-or-pay clause.

OUR EXPERIENCE

It is impossible to provide complete and exhaustive coverage of all the types of disputes mentioned above. For this year's review, we have chosen to focus on the following: the take-or-pay clause, delay and disruption in construction disputes, the force majeure clause and dispute resolution mechanisms. We discuss some of our observations in handling cases involving such disputes in the hope that these experiences will be helpful to practitioners when handling similar energy disputes.

Take-or-pay Clause

As mentioned above, the take-or-pay clause is one of the most frequently disputed clauses in a PPA. It typically requires the buyer to take delivery of a minimum quantity (and pay) or, in any event, to pay a minimum amount as an alternative obligation. As the seller usually makes a substantial capital investment at the preliminary stage of the project, the minimum payment stipulated in the take-or-pay clause ensures a stable income stream for the life of the contract to underwrite the costs and is part of the seller's return on investment.

In a China International Economic and Trade Arbitration Commission case that we handled, a Chinese energy SOE entered into two gas supply contracts with a foreign invested enterprise (FIE) in April 2012 for the supply of oxygen and nitrogen by the FIE. Several months into the contracts, the SOE was informed by local authorities that the factory that had been receiving the gases would be closed down. Accordingly, the SOE stopped taking gas from the FIE supplier. The FIE demanded payment under the take-or-pay clause and requested the continued performance of the contracts.

The issues at the heart of the dispute were the interpretation of the minimum take-or-pay clause and whether this clause was applicable to the situation. The parties agreed in the contracts that, if the receiver (ie, the SOE) receives, in any calendar month, products in an amount smaller than the actual hours of the calendar month multiplied by the minimum flow rate of the products, the receiver shall pay for the shortfall at the month's average effective price.

The arbitral tribunal found that, first, the minimum take-or-pay clause was not a clause of liquidated damages but a payment clause, because the contracts contained separate clauses for remedies in the case of a breach of the contracts. The arbitral tribunal then held that the minimum take-or-pay clause was binding upon the parties and should be complied with before the termination of the contracts. The most contentious issue was whether the receiver needed to pay any amounts in the situation where the receiver had completely stopped taking in any gas. The receiver argued that:

- the basis on which the minimum take-or-pay clause was to apply was the existence of a supply and demand relationship;
- the clause did not apply when there is no supply of gas; and
- according to the contracts, the effective average price of the month was to be adjusted based on the change of electricity price to reflect the biggest component of the costs (ie, electricity fees).

As such, when the FIE supplier stopped supplying gas, the costs of electricity (and, in turn, the effective average price of the month) was zero, thus no payment should have been made under the minimum take-or-pay clause. The arbitral tribunal rejected the receiver's arguments and reasoned that, despite the fact that the effective average price was indexed to the electricity price, the electricity price only acted as a component of a calculation formula. The tribunal concluded that, even if there were no costs of electricity due to no supply of gas, the electricity price would still exist, and the receiver should therefore comply with the minimum take-or-pay clause until the termination of the contracts.

Despite the fact that the take-or-pay clause is quite frequently seen in PPAs and that arbitral tribunals deciding energy disputes are quite familiar with its interpretation and application, we would recommend carefully drafting the clause so that each element in the calculation formula is clear and easy to ascertain. We would also recommend a receiver client to send a prompt notice to the supplier if, for any reason, the receiver can no longer take further supply of gas. An earlier termination of the contract is sometimes more cost-effective than having to make payment under the take-or-pay clause, especially when there is a valid contractual cause for termination.

Delay And Disruption In Construction Disputes

According to a survey conducted jointly by Pinsent Masons and Queen Mary University of London, the disputes that have traditionally most commonly arisen in the energy sector relate to the 'construction of energy infrastructure and provision of equipment (including supply chain)'.[9] In particular, these disputes often involve construction delay and disruption, and consequently feature highly technical construction details and professional analyses in respect of delay timetables. Parties would typically spend a lot of time with their expert witnesses in these cases.

We have assisted a client in a potential ICC arbitration involving the construction of two coal-fired power plants. Under the underlying contract, the client was to be responsible for supplying and commissioning the works, and the project owner was responsible for erecting the plants. Disputes arose as certain parts of the power plants did not meet the required standards or performance expectations. Since the work of the main contractor, subcontractors and the project owner was tightly interwoven and parties frequently deviated from the contract without clear record-keeping, ascertaining liability for delays became a highly complex undertaking.

In such construction projects, we recommend strict implementation of the contract and rigid management of project risks. Parties are sometimes willing to overlook minor deviations from the contract, minor delays to the milestones or small deficiencies in the work when the relationship between the parties is good. When the relationship turns sour and parties enter into arbitration, all such events could be evidence of breaches of contract. Parties to the contract should maintain good records of project implementation and any agreed deviations from the contract should be recorded in writing.

Another key takeaway from this case is that the parties should try to narrow down the issues before entering into arbitration. In some construction disputes, the parties' disagreements are limited to certain parts of the project and it may be possible to persuade the owner to accept other parts of the project first. This would greatly narrow down the scope of arbitration, which would potentially be cost-effective for both sides.

Force Majeure

The covid-19 pandemic has resulted in numerous uncertainties in the energy sector, especially in relation to the energy supply chain. Force majeure provisions have been increasingly invoked in the context of energy disputes, contributing to a heightened demand for force majeure determinations.[10] Force majeure clauses serve to relieve the parties from performing their contractual obligations when certain circumstances beyond their control arise and render performance commercially impracticable, illegal or impossible.

In a recent case, our client, an affiliate of a Chinese SOE, signed multiple sale and purchase contracts with overseas suppliers to purchase liquefied natural gas (LNG). Our client imports LNG into China and stores it at LNG storage stations before distributing it to downstream buyers. Due to the covid-19 pandemic, the LNG storage stations informed our client that the storage tanks were full and could not take in more LNG. At the same time, downstream buyers wished to reduce the purchase quantity of LNG due to the closure of factories and staff shortages. Facing such a situation, our client issued force majeure notices to overseas suppliers in accordance with the force majeure clauses in the sale and purchase contracts. We assisted our client in obtaining the certificates of force majeure from the China Council for the Promotion of International Trade/China Chamber of International Commerce in support of our client's force majeure notices.

We provided a number of suggestions when assisting our client with issuing the notices.

First, special attention should be given to the drafting of a force majeure clause. Although force majeure clauses are widely used in energy sale and purchase contracts and sample clauses are easily available, it is worth giving extra consideration to the drafting of this clause. For example, if the word 'pandemic' is specifically included as one of the listed conditions of force majeure, it would become much easier for a party to invoke the force majeure clause when faced with unexpected circumstances due to covid-19. By way of another example,

force majeure clauses sometimes include a provision stating that the receiver's remaining capability to receive products should be distributed equally between the suppliers in a force majeure situation, but some Chinese SOEs may be restricted from revealing supplier names and purchase quantities to counterparties. As such, SOEs should be careful with wording.

Second, it is advisable for the client to collect evidence and keep good records of communications with upstream, midstream and downstream counterparties to substantiate the force majeure circumstance.

Third, it is recommended that the client issue the force majeure notice in accordance with the contract in a prompt manner in case the counterparty refuses to accept the notice on the grounds that the notice was not issued in time.

Dispute Resolution Mechanisms

Arbitration arising out of energy disputes is widely known for its costliness, long duration and high level of complexity. There are a variety of dispute resolution mechanisms to choose from, including amicable negotiation, mediation, mini-trials, contractual and statutory adjudication (ie, the use of adjudication boards), expert determinations, commercial arbitration, investment arbitration and litigation. It is thus pertinent to explore which dispute resolution mechanism or combination of mechanisms would be most suitable for the client.

In the past, relatively few energy disputes in China-related projects ended up in formal arbitration or proceeded to a merits hearing. Chinese parties tended to settle to maintain control over high-value disputes and preserve long-term relationships. Chinese culture is also wary of formalistic adversarial systems.[11] In-house counsel are often budget-sensitive and consider full-blown arbitration expensive. Due to the foregoing concerns, many standard form contracts for long-term or large-scale energy projects include dispute resolution clauses, which specifically provide for negotiation escalating through various levels of management. The model Sino-foreign PSCs dispute resolution clause has long contained a multi-tiered dispute resolution clause that requires the parties to consult for settlement for a fixed period before referring the dispute to arbitration.[12]

The above situation, however, may change in the coming years. According to practitioners in the energy sector, Chinese SOEs are now more prepared and willing to aggressively participate in arbitration to gain more experience in the area.[13] Recent international arbitration cases involving Chinese parties include *UNI-TOP v SINOPEC*, *Andes Petroleum v Occidental Exploration and Production*, *Addax & SIPC v ROGCI & TCHL*, *Primeline Energy v China National Offshore Oil Corporation* and *Omega Construcciones Industriales v Comisión Federal de Elec*tricidad.[14]

We agree that negotiation, mediation, adjudication boards and other forms of alternative dispute resolution (ADR) mechanisms are cost-effective ways of settling the dispute at an early stage and, at the same time, maintaining the relationship between parties. We frequently bring these ADR mechanisms to clients' attention when appropriate (sometimes before arbitration is initiated or at critical points in the arbitral proceedings) so that the client is adequately reminded of the need, and given the opportunity, to evaluate what is the most cost-effective mechanism during the different stages.

However, users should be wary of several disadvantages of ADR mechanisms.

First, ADR mechanisms can be used as a stalling tactic before or during legal proceedings. They can also be used tactically to uncover the other side's case with no real intention to settle.

Second, for most ADR mechanisms, such as mediation, the settlement agreements reached by parties are only binding contractually; they are not directly enforceable in the courts. Enforceability is dependent upon the parties honouring the deal that they have made. Where this does not happen, the parties continue to remain in dispute, and litigation may be necessary to enforce the settlement agreement or to resolve the dispute entirely. This perceived weakness is now, to some extent, addressed by the Singapore Convention on Mediation.[15] As at March 2023, the Convention has 55 signatories. These include the world's two largest economies – the United States and China – as well as several of the largest economies in Asia.[16]

CONCLUSION

With China's further promotion of the Belt and Road initiative and the announcement of the energy transition,[17] we expect to see more China-related disputes in the energy sector, especially with regard to renewable energies. These disputes are likely to be complicated and high-value, and could happen at any stage of the investment, whether upstream, midstream or downstream.

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Endnotes

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