

# **Market Price Reopeners in Long-Term Coal Supply Contracts: The Lessons of Recent Litigation and Arbitration**

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**§ 6.01. Introduction.**

The long-term coal supply contract between coal operators and electric utilities involving large amounts of coal had its genesis in the mid-1950s, a period of relative efficiency and stability in the coal industry.<sup>(1)</sup>

Tremendous increases in productivity and a resulting stability in price marked the period, leading producers and utilities to enter into these commitments with an eye towards cementing long-term relationships.

[T]he long-term coal supply contract is a unique kind of transaction. Surely no other major industry transacts so much of its trade under complex, long-term arrangements involving substantial commitments by both buyer and seller in reliance upon the other.<sup>(2)</sup>

There are obvious and substantial benefits to be derived by both parties to a long-term coal supply contract. In the United States, electric utilities consume more than 85 percent of the domestic production of coal.<sup>(3)</sup>

Electric utilities are, to a large degree, the "reason for being" for most coal producers. Utilities need reliable sources of large quantities of a consistent quality of coal to produce sufficient power to supply their customers. Utilities also want to minimize contract administration problems in the future.<sup>(4)</sup>

On the other hand, the enormous capital required to install new coal mines and the resulting necessity for an assured market once the mines begin production motivate operators to sign long-term contracts.<sup>(5)</sup>

A long-term contract also facilitates capital investment in specialized equipment to meet a buyer's unique needs.<sup>(6)</sup>

When accepting the security and benefits that both parties derive from long-term commitments, a

corresponding risk each must consider is the inevitable fluctuation in market price over the term of that commitment. Coal markets have historically been cyclical and have, especially in the past thirty years, seen enormous fluctuations. Neither buyers nor sellers are willing to accept all of the risk of the precipitous rises or falls that have occurred and might continue to take place over the life of a twenty- or thirty-year contract. The method of allocating the risk of such fluctuations in long-term coal supply contracts has changed markedly since the 1950s, as changes in the supply and demand for coal and electricity have created the need for new approaches to risk allocation.

In the mid-to-late 1960s, despite some flirtation with nuclear power, most utilities chose to stay the course and continue to rely on coal for the production of electric energy.<sup>(7)</sup>

Relative stability in coal prices had continued from the 1950s.<sup>(8)</sup>

Many long-term contracts made during this period reflected the shared confidence of producers and utilities that the "era of labor peace, efficiency and price stability would continue."<sup>(9)</sup>

For example, coal supply contracts during this era frequently provided little or no opportunity for price review during the contract term.<sup>(10)</sup>

The shared assumptions of price stability and an increasing demand for electricity were shattered by the realities of the 1970s. Labor unrest and wildcat strikes, coupled with increased regulatory requirements under the newly enacted Federal Coal Mine Health and Safety Act of 1969, resulted in plummeting productivity.<sup>(11)</sup>

That drop in productivity, along with staggering inflation and high interest rates spurred in part by the Arab Oil Embargo of 1973, were essential factors in the increase in the real cost of electricity by 60 percent from 1970 to 1973.<sup>(12)</sup>

The "marriage made in heaven" between operators and public utilities was "on the rocks." The one constant factor which contributed to the survival of these strained relationships was the improvement in coal's competitive position. In response to high demand, pressures exerted by the decline in productivity, increased regulation, and inflation, the average price of a ton of U. S.. bituminous coal rose from \$4.99 in 1969 to \$8.53 in 1973, to a high of \$20.50 in 1977.<sup>(13)</sup>

Those prices resulted in large profits for many coal producers fortunate enough to have long-term contacts. All indications were that prosperity would continue for those producers.

These same trends sparked a corresponding desire among utilities to secure long-term supplies of coal.<sup>(14)</sup>

As long as their fuel costs were recovered or "passed through" to consumers by way of an automatic fuel adjustment clause in their rate tariffs, utilities had little incentive to reduce the cost of fuel procurement.<sup>(15)</sup>

In contrast to these forces supporting the formation of long-term supply contracts, the decades of the 1980s and 1990s have seen the convergence of at least three significant and heretofore unanticipated events which contributed to a marked increase in the frequency of price renegotiation, arbitration and litigation of long-term contracts. First, contrary to the expectations of industry experts as late as 1978-1979, coal prices began to fall sharply in 1980, in consort with falling world oil prices.<sup>(16)</sup>

Industries were not converting to coal as expected. While the use of electricity continued to grow, it was at

a much slower pace than anticipated. Growth in the demand for electricity was estimated at approximately 2 to 3 percent per year. At the same time, utilities were overbuilding nuclear and coal-fired generating plants, resulting in substantial excess capacity and increased competitive pressures.<sup>(17)</sup>

There would be no real recovery for coal as the industry was forced to weather the recession of 1982 as well as the cost of compliance with new environmental mandates.

The second factor leading parties away from the bargaining table and into the courtroom was the increased scrutiny by state Public Service Commissions (PSCs) of the fuel procurement practices of electric utilities. The recovery of fuel costs did not and does not contain any direct element of profit for the utility. For years, those costs were usually automatically passed directly through to the consumer. This led to skepticism about whether utilities had any real incentive to enter into "prudent" contracts.<sup>(18)</sup>

PSCs, at the urging of some "cynical consumers," began to scrutinize in earnest long-term coal supply contracts and, in some cases, adopted regulations which gave PSCs the power to disallow improvident fuel costs.<sup>(19)</sup>

Finally, increased environmental regulation, particularly in the form of the Clean Air Act Amendments of 1990,<sup>(20)</sup> has had a significant and adverse impact on the market for high-sulfur coal.<sup>(21)</sup>

Not surprisingly, utilities bound by long-term contracts for such coal have demonstrated keen interest in price renegotiations.

The foregoing factors have provided utilities a substantial incentive to escape the comparatively high, imbedded coal prices they found themselves paying under long-term contracts entered into in an earlier era. When falling spot coal prices and energy demand collided with rising contract prices in the 1980s, many utilities carefully evaluated their agreements to determine the least cost basis to excuse their performance.<sup>(22)</sup>

In the words of one court, some utilities "searched the law books to unearth every conceivable cause of action."<sup>(23)</sup>

Not surprisingly, long-term coal supply contracts negotiated in the 1970s have come under particularly harsh scrutiny. Many of these contracts include the efforts of both buyers and sellers to allocate the risk of the end of the era of relative price stability and to reflect more recent market experiences. One common device used for that risk allocation was the "market price reopener." The ability to "reopen" the contract to renegotiate pricing terms was seen as a means to protect buyers and sellers from being "locked into a bad deal."<sup>(24)</sup>

If market prices rose or fell, the price paid under the contract could be adjusted to reflect those fluctuations without threatening the long-term commitment between the parties.<sup>(25)</sup>

As billing prices under many of the long-term contracts of the 1970s become the subject of reopener negotiations, one of the inherent flaws in market price reopeners becomes manifest. In many respects, these provisions are little more than an "agreement to agree" in the future.<sup>(26)</sup>

Such an agreement is a dangerous prospect unless the specific parameters of the "future agreement" are set forth in detail. The cases discussed herein illustrate just how tenuous these "agreements to agree" can be when they are tested in the context of a multi-million dollar dispute over the performance of large tonnage, long-term coal supply contracts in a highly competitive atmosphere. What was originally intended by the parties as an effective tool for risk allocation may be the litigation fodder of the future.

This Chapter seeks to focus attention on the "market price reopener," how it fits into the scheme of typical pricing provisions in long-term coal supply contracts, the essential characteristics of reopener provisions, and how these provisions have spawned dispute. Section 6.02 briefly summarizes the different pricing provisions typically utilized by buyers and sellers. Section 6.03 sets forth the basic characteristics of a price reopener, with Section 6.04 devoted to three specific disputes involving "market price reopeners." This Chapter concludes with some words of caution for operators and utilities regarding the implications of drafting "market price reopeners" and long-term contracts in the future.

## **§ 6.02. Typical Pricing Provisions in Long-Term Contracts.**

No other feature of a long-term contract is as important from both the seller's and buyer's perspective as the provision for the price to be paid for a long-term supply of coal. Every such provision comprises the agreement of the parties as to an acceptable allocation between them of the risk of fluctuations in the market price of similar coal during the life of the contract. A number of different pricing mechanisms and variations have been used to allocate that risk in coal supply agreements.

In the early days of long-term contracts, when greater price stability prevailed, a fixed price throughout the term of the contract was common.<sup>(27)</sup>

Obviously, where the price remained fixed throughout the term of the contract, the buyer accepted the full risk of a falling market, and the seller took the risk that prices would rise. The only common example of a fixed price term in today's market is the short-term, spot contract.<sup>(28)</sup>

Another popular risk allocation mechanism in the 1950s and 1960s was "cost-plus" pricing which provided that the producer's costs would be "passed through" to the buyer.<sup>(29)</sup>

Such provisions assured the seller a known return on investment, but might bear little, if any, relationship to market price. In addition, the assurance of that return to the seller was accompanied by a ceiling on the amount of profit the seller could make.<sup>(30)</sup>

Such contracts were disfavored by regulatory commissions because they minimized the incentive for increased productivity.<sup>(31)</sup>

A variation of cost-plus pricing involved "target costs" and a "target fee" to be established at periodic intervals, with some mechanism for dispute resolution where the parties were unable to agree. The "target fee" was increased or decreased in relationship to the variation between actual costs and target costs.<sup>(32)</sup>

This mechanism was designed to reward sellers for increased efficiency and overcome the disincentive associated with typical cost-plus contracts.

A third common risk-sharing mechanism, which grew significantly in popularity as price stability in the coal market eroded, was the "base price plus escalator" (or "BPE") provision, in which a base price per ton was established for coal at the outset of the contract and then adjusted during the remaining term on the basis of changes in preselected government indices or in actual costs of various components, such as labor costs.<sup>(33)</sup>

### **[1] Base Price Plus Escalator (BPE) Provisions.**

A typical BPE provision sets an initial "base" price for various components of the seller's cost of mining coal, such as labor, materials, employee benefits, depreciation, royalties, taxes, fees, supplies and profits.<sup>(34)</sup>