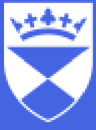

Centre for Energy, Petroleum
and Mineral Law and Policy
University of Dundee

Negotiating Price Terms Under Commodity Supply Agreements: Practical Legal Considerations

Author: David Amakiri *

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// Abstract

This paper discusses several issues that parties to a supply agreement should consider when negotiating the price terms under such agreements. The paper adopts a normative approach to assess the critical negotiation issues relating to price terms and how such thorny outcomes could be mitigated. The paper highlights frequently encountered issues when negotiating such agreements, then discusses the problems that drive price changes under such contracts and the methods with which parties can counteract the effects of such changes on the parties' expectations. Having discussed a couple of practical considerations and resolution strategies, the paper finalizes by considering how price-related disputes are resolved under supply contracts. The paper finds that there is no one-size-fits-all approach to reaching a suitable bargain; therefore, parties much be willing to explore several options when seeking to arrive at a workable supply agreement whilst conceding in some instances to gain a better deal in others.

Keywords: Negotiation, price terms, price changes, price uncertainties.

* David Amakiri is a Nigerian-trained commercial and energy lawyer working with industry teams and advising energy industry players in Sub-Saharan Africa on disputes and transactions in the industry. He worked with two top law firms in Nigeria as well as a stint as an in-house contracts advisor for an indigenous company that provides renewable energy solutions to the telecommunications service industry in Nigeria. He assisted the Extractives Hub, UK, in providing research tools for the policymakers in the Nigerian extractives industry. He is currently a senior consultant at Norwood Advisory, a boutique advisory firm, where he advises new businesses in Nigeria's energy space, especially in relation to transactions and disputes in renewable energy investments.

He has an LLM with distinction in International Energy Law & Policy from the CEPMLP, University of Dundee, and is also a doctoral researcher at the University of Strathclyde, School of Law.

David holds an LLB Honours and is a Barrister and Solicitor of the Supreme Court of Nigeria. David is a member of the Nigerian Gas Association, the Nigeria Bar Association; the Energy Institute, Association of International Energy Negotiators; and Society of Petroleum Engineers.

Contents

1. Introduction 4
2. Price Negotation Issues 5
2.1 Currency 5
2.2 Invoicing and Timing....7
2.3 Fixed, Variable and Escalatable Prices 7
2.4 Price Indexes 8
2.5 Reference Prices....8
2.6 Regulated Prices 8
3. What Can Drive Price Changes in a Contract....9
4. Methods to Counteract Pricing Uncertainty 10
4.1 Price renegotiation and reopeners....10
4.2 Stabalisation Clauses 11
4.3 Hardship and *Force Majeure* Clauses....12
4.4 Hedging and Derivative Instruments 13
4.5 Restrictions on Change of Control 13
5. Negotiation Considerations and Resolution Strategies....14
5.1 Price Clause, First or Last? 14
5.2 Price Formula or Reference Price? 15
References....18

1. Introduction

The provisions of most contracts underpinning relationships in the extractives industry can typically be divided into three broad categories, namely: commercial, legal, and administration provisions.[1] Commercial provisions are those operative provisions in a supply agreement that set out the balance of commercial risk agreed between the parties when fulfilling their primary obligations.[2] The major commercial issues which should be decided upon by the parties revolve around the term of the agreement (length of obligations), the quantity to be supplied (quantum of obligation), how costs will be recovered, and the price to be paid (purchase price).

However, because the movement of money is the fundamental basis for the parties' economic bargains in an agreement, the purchase price clause and the terms thereof become a significant point of negotiation between the parties to the contract.[3]

This paper discusses several key considerations in negotiating the price terms of supply agreements and factors that influence changes to price terms, either by the mutual agreement of both parties or by the interference of external considerations.

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[1] Stickley D. C., *A Framework for Negotiating and Documenting Petroleum Industry Transactions* (The Barrows Company 2006).
[2] "Commercial Clauses—Overview" (LexisNexis) <https://www.lexisnexis.com/uk/lexispsl/commercial/document/391297/594F-9S11-F186-64VG-00000-00/Commercial_clauses_overview> accessed 12 February 2022.
[3] Paul Griffin, 'English Law in the Global LNG Business: International LNG Sale and Purchase- A Relational Arrangement' (2019) 12 Journal of World Energy Law and Business 216.

2. Price Negotation Issues

These supply contracts are usually relational and have huge financial implications, often running into billions of dollars.[4] They are relational because they are of such a nature and effect that the parties to the agreement build a relationship over a considerable time. Sometimes, this duration may not be precise when the contract was formed. But it is not the duration that matters most, instead, it is the relationship created by the parties that ascribes a long-term character to the agreement.[5] As a result, the pricing arrangements of such agreements need to reflect these long-term relationships. In reality, an agreement that is being performed after a lapse of time from when it is signed is bound to throw up some challenge(s). With one or more of the parties realising a change is required at that moment or further down the line. The parties could even agree to provide for such change in future at the time of contract formation - all these requiring negotiations.

The following are some key negotiation issues typically encountered in negotiating price terms in supply agreements in the extractives industry:

2.1 Currency

The currency in which the purchase price of the commodity will be denominated is one of the first issues to be negotiated and agreed upon in these supply agreements, especially where the transaction involves cross-border elements. It is customary that where the transaction is of an international nature or is an international contract, the parties denominate the price in a 'foreign' currency such as the United States Dollar (USD) or the British Pound (GBP). An international contract involves parties who are based in or conduct a significant part of its business in a different jurisdiction and or where the parties' obligations are to be carried out in different jurisdictions.[6] As per contracts in the extractive industry, it would involve those with substantial elements involving a jurisdiction outside the host country. Therefore, to determine whether a contract is international requires a consideration of the following issues:

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[4] All dollars quoted are United States Dollars.

[5] Ibid. See also J Bell, 'The Effect of Changes in Circumstances on Long-term Contracts' in D Harris and D Tallon (eds), Contract Law Today: Anglo-French Comparisons (Clarendon Press 1989) 195.

[6] Gowling WLG, "International supply of goods—checklist" (LexisNexis, 2020) <https://www.lexisnexis.com/uk/lexispsl/commercial/document/391299/5HM9-V6F1-F185-N326-00000-00> accessed 12 February 2022.

i. one of the parties to the contract is a foreign company registered outside the host state;

ii. one of the parties hold substantial assets outside the host state;

iii. the agreement is being performed outside the country of any of the parties;

iv. the parties rely substantially on foreign currency-denominated production inputs; or

v. the cash flow of the project is in a foreign currency.

The existence of one or more of these factors could act as a basis to resort to a foreign currency. Foreign currencies are resorted to due to their ubiquitous nature - acceptability, convertibility, and stability in international markets. For instance, over the past ten years, the USD has traded stably at between $1.25 and $1.7 to £1 GBP.[7] In comparison, the Nigerian naira has fluctuated in value from 243 to 562 naira to a British pound in the same period. similarly, the Indian Rupee fluctuated between 78 and 103 Rupees to £1 in the past ten years.[8] These examples show how the instability of a currency in comparison to the GBP reflects negatively on their suitability for international agreements that are entered for a fairly long period of time. An unstable currency could lead to severe cash flow problems for either of the party and ultimately affect the performance of their obligations under the supply agreement, hence the need for circumspection in choosing the currency(ies) which the agreement will be denominated.

It is not to be taken for granted that in all such supply agreements, foreign currencies must be used by default. Foreign currency obligations result in currency exchange risks for the parties.[9] Where a foreign currency is used, the local currency benefits little and the applicable exchange rates could expose the local party to cash flow challenges and ultimately result in its inability to fulfil its obligations.

[7] All £ are GBP.

[8] Yahoo! Finance, 'Currencies - Historical Data - GBP/NGN' (*Yahoo! Finance*, 15 February 2022) <https://finance.yahoo.com/quote/GBPNGN%3DX/history?period1=1123718400&period2=1644883200&interval=1mo&filter=history&frequency=1mo&includeAdjustedClose=true> accessed 15 February 2022; Yahoo! Finance, 'Currencies - Historical Data - GBP/INR' (*Yahoo! Finance*) <https://finance.yahoo.com/quote/GBPINR=X?p=GBPINR=X&.tsrc=fin-srch> accessed 15 February 2022.

[9] I. Perez, and D. Howell, *A Roadmap to Foreign Currency Transactions and Translations* (2019), Independently Published.

Importantly for resource rich countries, the use of its local currency in international contracts involving its entities helps to develop the local economy. In fact, economic instability is partly related to the fact that local currencies are sometimes under-utilised in many countries. In practice it is difficult for foreign counterparties to concede to the purchase price being denominated in the local currency mainly because of a lack stability and convertibility of many local currencies in resource-rich countries.

2.2 Invoicing and Timing

The purpose of price clauses in the contract is to assure the parties (especially the seller or investor) that there is stability in the payments or repayments regime and to deal with risks associated with payment default(s) that impact on contractual revenues. Payment timings and invoicing under the contracts should take into cognizance debt service obligations, accounting procedures and practices in the industry/country, third party obligations, and tax remittance obligations (e.g., import or export duties and Value Added Tax (VAT) remittance stipulations). In respect of tax for example, one may ask: when does the applicable law require VAT remittances to be made? This is because while some countries stipulate remittance to be made a certain number of days after collections other stipulate a specific date for remittances irrespective of when collections were made.

2.3 Fixed, Variable and Escalatable Prices

Fixed prices are price components which are meant to be fixed over the life of the contract as against those that are variable. Variable prices rise and fall in line with price indexes or inflation. Escalatable prices are those pricing elements that can be escalated (increased) by reference to a set of fact(s) or reference to a price index. The predictability of the revenue flow under the agreement is determined by whether the contract price is fixed or variable – with fixed prices offering more predictability. Where the determinants of the purchase price are stable, parties would prefer to adopt fixed prices but if they are subject to periodic or seasonal changes, prices will be structured to vary and escalate. Some resource-based contracts include all the above categories. This is because the extractives industry is characterized by significant rising and falling of prices in an almost cyclic manner with disruptive consequences for the parties.[10]

[10] Peter D Cameron and Michael C Stanley, *Oil, Gas, and Mining: A Sourcebook for Understanding the Extractive Industries* (World Bank Publications 2017).

2.4 Price Indexes

Price indexes measure the weighted average of prices of a set of goods and services over a period.[11] The price in a commodity contract may be tied a price index, for example a Consumer Price Index or a Producer Price Index, such that changes in such indexes will impact the price of the underlying commodity in the contract. Many times, the price index is used as a measure of inflation to determine how prices in the contract will be escalated or varied.

2.5 Reference Prices

This is usually relevant for every type of resource-related contracts whether they deal in minerals, metals, or natural gas. This is because investors would generally prefer commodity prices to be tied to some price index determined by a neutral third party, an example of which is the Henry Hub for Natural Gas or Platts – this can also be a function of the agreement of parties. Where prices are to be determined by reference to a standardised price, it would be expected that this reference be clearly spelt out to avoid discretionary reference to various rates.

2.6 Regulated Prices

These are close to reference prices but here the government determines what the purchase price of the commodity is within its territory. This is usually common markets where the government is seeking to ensure security of supply of such product, a common example of this is the regulation of domestic gas prices in many provinces around the world.

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[11] Organisation for Economic Co-operation and Development., and World Bank., *Export and Import Price Index Manual: Theory and Practice* (International Monetary Fund 2010).

3. What Can Drive Price Changes in a Contract

Supply contracts are often long-term in nature and over their term, several underlying factors could change. For example, the market conditions under which the parties negotiated the agreed terms would be affected by changes in the wider economy and changes within the contract. Some of these factors that could influence changes in price terms are highlighted below.

A. *Changes in the prices of underlying commodity*: Taking cognizance of cyclical price movements in international commodities markets, a change in the price of the commodity will likely result to a change in the purchase price set out in the supply agreement.

B. *Economic conditions*: These conditions include those that touch on tax and changes to the rate of tax, exchange rate fluctuations and currency devaluations, inflation, economic recessions, etc. The purchase price could sometimes be determined by these factors external to the contract most especially where the agreement already recognizes that should have an impact on the purchase price.

C. *Political considerations:* Contract dynamics could be obstructed by changes in the following areas: change of laws, change of authority or regime, civil or political instability, and weak institutions (government official placing personal gains over all others thus jeopardizing a country's negotiations), expropriation or nationalization.

D. *Financing considerations*: These considerations include foreign or local loan interest rates, credit crunches, capital markets, equity ownership changes, refinancing costs.

E. *Geological and technological changes*: The discovery of new resources, new fields/mines, adoption of new technologies could all lead to changes in the cost of production for one or both of the parties. Geological changes to the environment could also be key to a price change.

F. *Legal issues*: Stipulations of applicable law such as consequential changes in the legal system, price control laws, competition and antitrust rules, etc. could all lead to changes in the price terms of a resource-related contract. For instance, some countries outlaw the use of foreign currencies for certain types of commodities or sectors, where this is the case, parties will be hard strung to utilize a foreign currency.

4. Methods to Counteract Pricing Uncertainty

Despite negotiating a firm price and its associated clauses, certain factors (sometimes outside the purview or control of the parties) could lead to a situation where it is no longer commercially viable for both or one of the parties to have the price remain as negotiated under the agreement. Such factors could be commercial in nature such as where the dynamics of demand and supply in the market no longer suit the legitimate expectation of the parties. They could relate to the general economic or political situation of the host country such as where there is a change of political power leading to changes in government policies – especially where such policies were hitherto favourable to both or either of the parties. The factors could also be beyond the control of either party, even where they use their best endeavours, for example, a breakout of a widespread pandemic such as the Coronavirus disease 2019 (COVID-19), or Ebola Virus outbreak (2013-2016). Such factors would inevitably lead to uncertainty and negatively affect the ability of one party to perform its obligations thereunder.

To counteract the effects of the foregoing, parties may adopt any of the following contractual mechanisms:

4.1 Price renegotiation and reopeners

Contracts could be drafted to allow for renegotiation of pricing terms where certain pre-determined circumstances so warrant. This invariably allows the previously agreed price in the agreement to change but conditioned upon certain trigger events. The clause must deal with the trigger events, the timing of renegotiation, and the consequences of failure to renegotiate or failure to reach an agreement.[12] This is a complex but necessary task – complex because it is usually impossible to anticipate all likely renegotiation trigger events and necessary because in the absence of such a clause, the agreement may become unworkable and ultimately become subject of disputes. Despite the complexity involved it is important for the price renegotiation clause to clearly capture the trigger scenarios so that the renegotiation does not lead to a breakdown in trust between the parties. With

[12] Ibid.

commitment from the parties, the ominous task of trust preservation while renegotiating is achievable.[13]

A price reopener allows a revision of the purchase price in the agreement also under certain circumstances. It will identify the trigger event, the procedure for review of the price formula and accounting adjustments, and resolution of any dispute.[14] Price reopeners are similar to renegotiations with the marked difference being in the degree of change that the parties should expect. Price reopeners allow the parties to review the price and the underlying mechanism used in arriving at same – this is not just a renegotiation of price terms but a total unearthing of all factors that make up the final price. The purpose here is to allow for a review of the entire pricing mechanism.[15] Price reopeners or reviews can be achieved without renegotiations if the parties clearly anticipate the future reopener triggers, outline them in the agreement and state clear procedures for review.

4.2 Stabalisation Clauses

Due to the volatile nature of commodity market, government entities in exercise of their sovereign powers seek to change the dynamics of obligations to suit; the demands of local conditions (whether economic or political) or their anticipated revenue profile.[16] These result in steps that are not always popular amongst investors, such steps could include seeking to unilaterally change the pricing arrangement in international agreements or change the fiscal regime of the extractives industry which then has an impact of contract pricing and investors profit. To cushion the effect of any such change to the law or tax, counterparties seek to stabilise the agreements by introducing provisions in the agreement that have the effect of "freezing" the bargain of the parties at the point when the agreement is being executed, or economically "rebalancing" the affected party's position. The purpose of such clauses is not to stabilise the entire market or country but to provide a cushion to the counterparty against political decisions that could change the price or the economic bargain of the parties.[17]

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[13] Atsegbua L, "Acquisition of Oil Rights under Contractual Joint Ventures in Nigeria" (1993) 37 Journal of African Law p. 10-29.

[14] Peter D Cameron and Michael C Stanley, *Oil, Gas, and Mining: A Sourcebook for Understanding the Extractive Industries* (World Bank Publications 2017).

[15] Esso Petroleum & Production UK Limited v Electricity Supply Board [2004] EWHC 723 (Comm).

[16] Peter Cameron, *International Energy Investment Law: The Pursuit of Stability* (Oxford University Press 2010).

[17] Cameron and Stanley (n 8).

The effect of stabilization clauses on pricing under the contract could be to freeze any price changes or to allow changes in so far as the affected party is allowed to make additional financial recoveries. Such that it is in the same position as the parties had anticipated at the outset of the contract. In this second function, the freezing clause is simply rebalancing the economic impact of any changes made.[18]

4.3 Hardship and *Force Majeure* Clauses

These two concepts (clauses) deal with fundamental changes to the circumstances within which the parties are required to perform their obligations. *Force majeure* involves a situation where one or both parties cannot perform contracted obligations due to the occurrence of an event beyond their control that human foresight and exercise of due care could not have anticipated or avoided.[19] The *force majeure* clause typically lists events that qualify as such (in addition to other natural events). In relation to the price terms, circumspection is necessary because the emphasis is on the inevitability of the events and the inability to change them despite exercising all human effort. Difficulty of the market conditions will not qualify as *force majeure* as an English court once stated that a party could not resort to force majeure if the price it was required to pay for goods were in excess of the price it could sell them.[20]

This could however be akin to a contractual hardship necessitating a renegotiation or price review. In Article 6.2.2 of the UNIDROIT[21] Principles of International Commercial Contracts 2016 hardship is defined as "*the occurrence of events [which] fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished…*" For an event to qualify under hardship, the event should have been unknown before the agreement was concluded and the risk involved was not allocated or mitigated in any other way under the contract.

[18] Cameron (n 15).
[19] See Article 7.1.7 of the UNIDROIT Principles of International Commercial Contracts. See also Bridge M, "Force Majeure and International Supply Contracts" (2020) 1 Transnational Commercial Law Review 76-99.
[20] *Brauer and Co v James Clark* (1952) 2 All ER 496.
[21] UNIDROIT is the International Institute for the Unification of Private Law.

With hardship, the performance of the contract has become extremely burdensome on the disadvantaged party while for *force majeure* the performance of the obligations of the agreement has been impossible during the subsistence of the event.[22]

Both hardship and force majeure clauses could allow the parties to seek a renegotiation or a reopening of the price terms for the purpose of realigning the contractual equilibrium. A price review is more suited to a hardship scenario whilst a renegotiation suits a *force majeure* situation as it allows parties to change the timing of payments rather than the entire pricing formulae.

4.4 Hedging and Derivative Instruments

Derivative instruments are risk management tools used by contractual parties to alleviate the effect of uncertainties in contractual terms such as prices. For example, if the prices are tied to a standard reference, parties could seek out derivatives such as swaps or futures to cover for any shortfalls where there are changes to the commodity reference price.

4.5 Restrictions on Change of Control

Sometimes a change in the management of one of the parties to the contract can lead to change in corporate policy which could affect pricing terms under a contract. Where one of the parties is a state entity, this will best be dealt with under a stabilization clause but where the parties are purely privately held commercial entities, a restriction on the effect of a change in control (or a restriction on change in control altogether) could provide a way to protect the counterparty(ies).

[22] Dietrich Maskow, 'Hardship and Force Majeure' (1992) 40 The American Journal of Comparative Law 657.

5. Negotiation Considerations and Resolution Strategies

5.1 Price Clause, First or Last?

A party could be tilted towards taking a softer stance on pricing issues from the beginning of the negotiations to use this as a point of strength in the future to get a more favourable bargain on other issues.[23] For example, a company may agree to take a cut on the price of the underlying commodity for a favourable tax/royalty position further down the negotiations. In some bizarre circumstances, which do occur, a party compromising on price could do so with the intention of compromising on quality or specification. Therefore, care must be taken to ensure price compromises are not succeeded by quality alterations. Price compromises at the start of negotiations should, therefore, not be viewed as an easy way out for the parties.

Some parties may choose to negotiate the price as the last major commercial component of the agreement. Claude Cellich[24] recommends this approach since, according to him, price is singularly the most import issue in business negotiations. On the one hand, this can be the case where there is already a regulated price with little or no room for manoeuvre or where there are standard industry prices to which the parties are accustomed (these standard industry price(s) may have been influenced by one of the parties in the case of multinational conglomerates or by an industry trade union or cartel – thus creating antitrust risks). On the other hand, it has been suggested that where a significant portion of the issues to be negotiated are of a non-price nature, the negotiations on the price terms should be postponed till other key issues have been discussed and agreed.[25] This is a helpful strategy where the investment or contracting decision is based on a very wide range of issues, with pricing only constituting a small part. For example, negotiations around price in a natural gas sale agreement in a country where gas prices are regulated, will adopt this strategy. Also, this strategy is helpful where the market is more sensitive to the quality or specification of the resource rather than the price. The downside to this approach will be that, where parties have expended significant time and resources negotiating on significant aspects of

[23] Claude Cellich and Subhash C Jain, *Practical Solutions to Global Business Negotiations* (Business Expert Press 2012).
[24] Ibid.
[25] Cellich and Jain (n 21).

the deal, they may be under pressure to accept unfavourable or unconscionable price terms simply because having achieved much, the deal should not be inhibited from reaching a conclusion.

A third approach is to deal with the issue of price sandwiched between the other several moving parts of the negotiation process so that parties can use the pricing terms as part of the points to either concede upon or insist on whilst negotiating other equally important issues.

5.2 Price Formula or Reference Price?

In adopting reference prices, the parties agree to peg the price of the contract to the price of the industry (i.e., their competitors) or the parties adopt an industry price reference, for example the parties could use the prices quoted on the London Metal Exchange. The advantage of this is that the parties are certain that their agreed price always reflects the industry standard and is competitive such that except the industry itself begins to collapse the parties could have little need for renegotiations or reopeners.

Whereas a price formula takes into cognisance the various factors of production peculiar to this agreement to arrive at a price that reflects the cost and the rate of return that is suitable for the parties. The price formula ensures that the final price arrived at is a product of the peculiarities of the parties' bargain rather than those of their competitors, which may not be a cost reflective as the parties' desire. The disadvantage with the price formula is that if it is too complex, it could give room for triggering of dispute where the parties will require a third party to interpret and or calculate the appropriate price.

Except the parties' agreement is situated within the context of a regulated price, it is understandable to see why parties would opt to set out a price formula in the agreement as a determinant of the purchase price since it is closer to the parties' bargain and it can be used to obviate the need for a price renegotiation.

6. Pricing Terms and Dispute Resolution

The issues discussed in the two proceeding sections are crucuial from a negotiating standpoint. But where the parties are in an unworkable scenario or an unconscionable bargain, disputes are likely to occur. International agreements with complex pricing arrangements involving significant technical details utilise a tiered approach to dispute resolution. The ultimate arbiter between the parties is usually an arbitrator (sometimes a judge) but this is typically not the first step. Rather, it would be the last in a series of required steps starting with the parties negotiating or renegotiating between themselves with the hope that one party's position or a middle ground position will give in, where this fails, parties would resort to an "expert" to determine the disputed area(s).

Expert determination involves referring a technical, scientific, or accounting dispute to an expert who gives a decision which, if so provided in the agreement, is binding upon the parties and can be enforced.[26] Technical disputes around pricing are typically referred to an expert in the field. However, the enforceability of the expert's decision is tied to the contract where a party disagrees with the decision, it resorts to the other dispute mechanism in the contract.

Arbitration, as mentioned previously, is the likely last resort for pricing issues. Where the parties are unable to agree on the interpretation, applicability and or enforcement of the price terms, they typically submit to arbitration. Given the confidential nature, parties do not usually want to resolve these disputes in the Courts but through arbitration.[27]

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[26] Kendall J, Freedman C, and Farrell J, *Kendall on Expert Determination* (5th Edn, Sweet & Maxwell/Thomson Reuters 2015).

[27] Levy M, 'Gas Price Review Arbitrations: Certain Distinctive Characteristics' (*Global Arbitration Review*, 2020) <https://globalarbitrationreview.com/chapter/1142623/gas-price-review-arbitrations-certain-distinctive-characteristics#_ftnref3> accessed 11 June 2020.

7. Conclusion

Parties (investors, host governments) enter into agreements for the purpose of deriving economic benefits from such agreements.[28] In the case of international supply agreements, such benefit is directly linked with the purchase price and the associated clauses as agreed by the parties during the pre-contract negotiations. The agreements are, thus, a product of negotiations between the parties involving several concessions to reach a satisfactory point. Price-related negotiations deal with a myriad of issues which have been highlighted above – from currency considerations to price renegotiations and to resolving disputes.

One thing for parties to remain attentive to is that there are various avenues to achieving their stated objective when negotiating price terms. Each party need be willing to concede on some issues in order to win others, and where the ultimate price bargain will be unfavourable to a party, it must ensure it has prepared its best alternative to a negotiated agreement – using the mechanisms discussed in section 4 of this paper.

Each individual issue highlighted or addressed in this paper are potential areas for further research to expand the literature of negotiating price terms. Many of which have already formed the basis of considerable research from other perspectives. Despite this, there is need for more consideration to be given to the effect of change of corporate management on changes to contract pricing. This area is often overlooked in legal and academic literature but is perhaps important, presently, in view of high-level corporate failures globally.

[28] Maskow (n 20).

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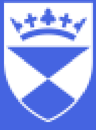

Centre for Energy, Petroleum and Mineral Law and Policy
University of Dundee
Nethergate
Dundee
DD1 4HN

e: dundee.ac.uk/cepmlp