Innovations in LNG Contracting

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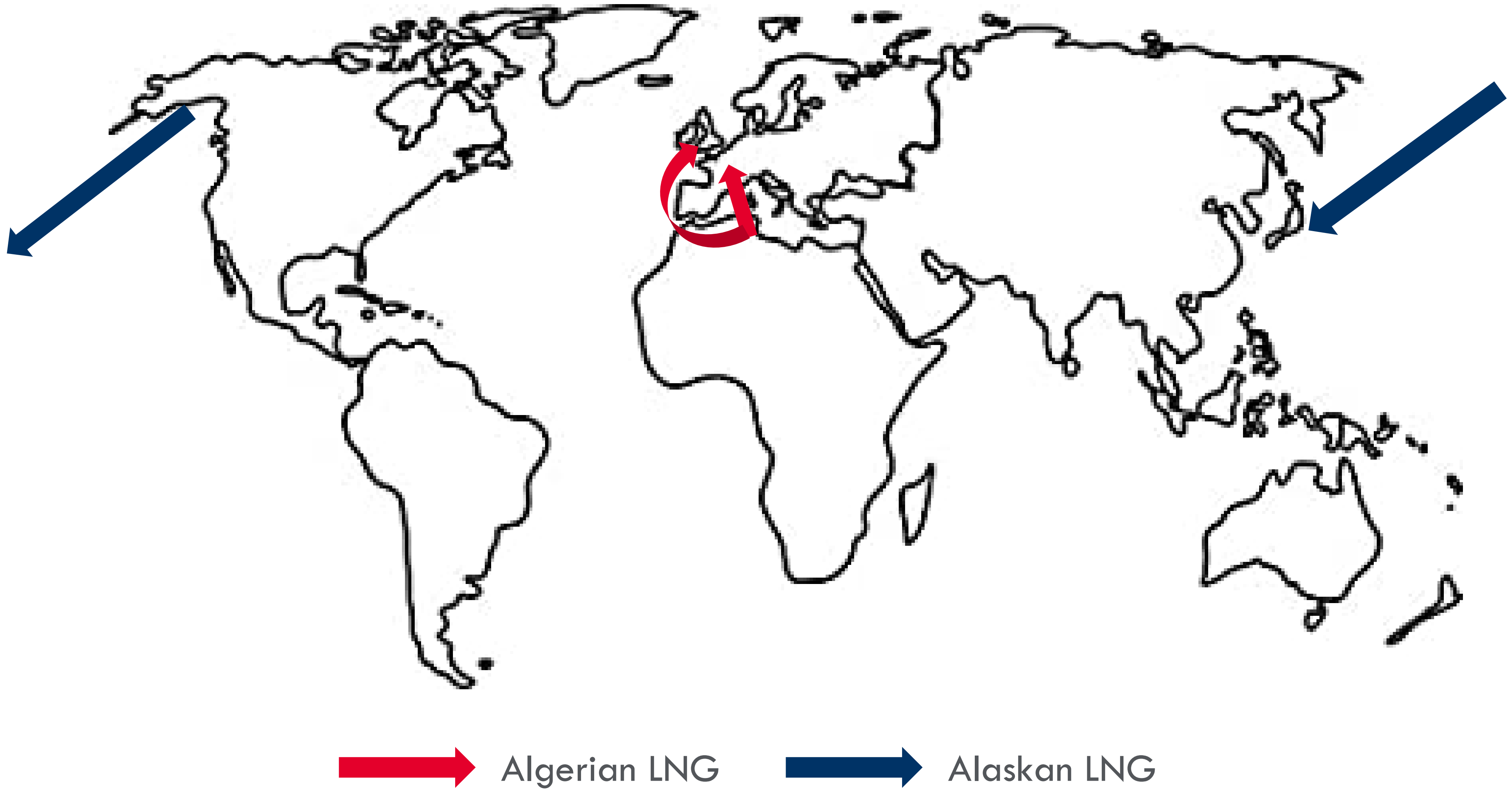
Outline

1. Evolution of international LNG sales contracts
2. Novel features of Asian long-term LNG contracts (LNG SPAs)
3. Impact of COVID-19 on Asian LNG SPAs
4. Conclusions and outlook
5. Q&A

1. Evolution of international LNG sales contracts

LNG trade in the 1960s



The first Asian LNG Sale and Purchase Agreement

- Signed in March 1967
- Sellers: Phillips Petroleum and Marathon Oil
- Buyers: Tokyo Electric and Tokyo Gas
- For deliveries of Alaskan LNG to Japan
- 960,000 metric tons of LNG/y for 15 years
- Subject to governmental approvals
- Required investments in LNG infrastructure
- First delivery: November 1969

"Polar Alaska." Photo: JERA.

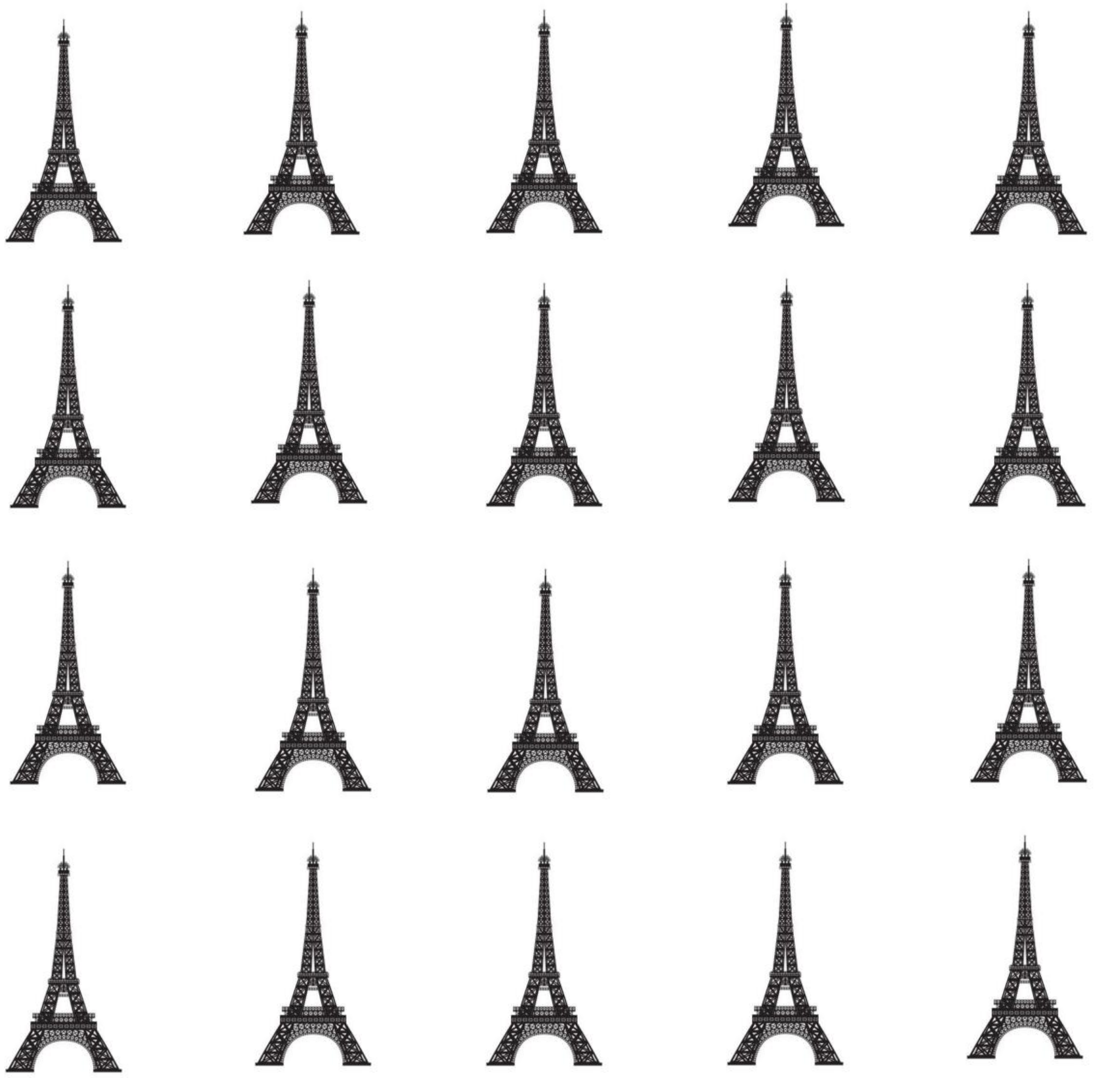
Predominance of long-term contracts

20+ years, point-to-point delivery, 100% take-or-pay SPAs

1960 1970 1980 1990 2000 2010 2020

The emergence, and growing relevance, of short-term and spot trade.

Long-term contracts are still needed, primarily for financing



Changing terms in Asian LNG SPAs

- General shift towards more flexibility in Asian LNG SPAs
- Removal of supply source / destination restrictions
- Reduction of take-or-pay percentage
- Novel features

2. Novel features of Asian LNG SPAs

Novel features of Asian LNG SPAs

1) **Alternative price mechanisms**
2) New-generation price review clauses
3) Enhanced termination rights

Traditionally: fixed and oil-indexed prices

- **Fixed prices in the very early Asian LNG SPAs**

’Buyers shall pay Sellers for all LNG delivered to Buyers hereunder prior to June 1, 1984, a price of United States fifty-two cents (**52¢**) per million Btu’s delivered.’

Phillips Petroleum Co v Comm’r 101 T.C. 78, 81 (1993)

- **Oil-indexed price formulae since the 1970s**

$$P_{LNG} = A\ (\text{slope}) \times JCC + B\ (\text{constant})$$

Alternative price mechanisms

- **Hub pricing**

  Example: CSP = (1.15 x HH) + Xy

- **Hybrid pricing**

  Example: 50/50 oil and HH

- **Spot pricing**

  Example: Platts' Japan Korea Marker (JKM)

Novel features of Asian LNG SPAs

1) Alternative price mechanisms
2) **New-generation price review clauses**
3) Enhanced termination rights

Traditionally: no / general price review clauses

Sample clause

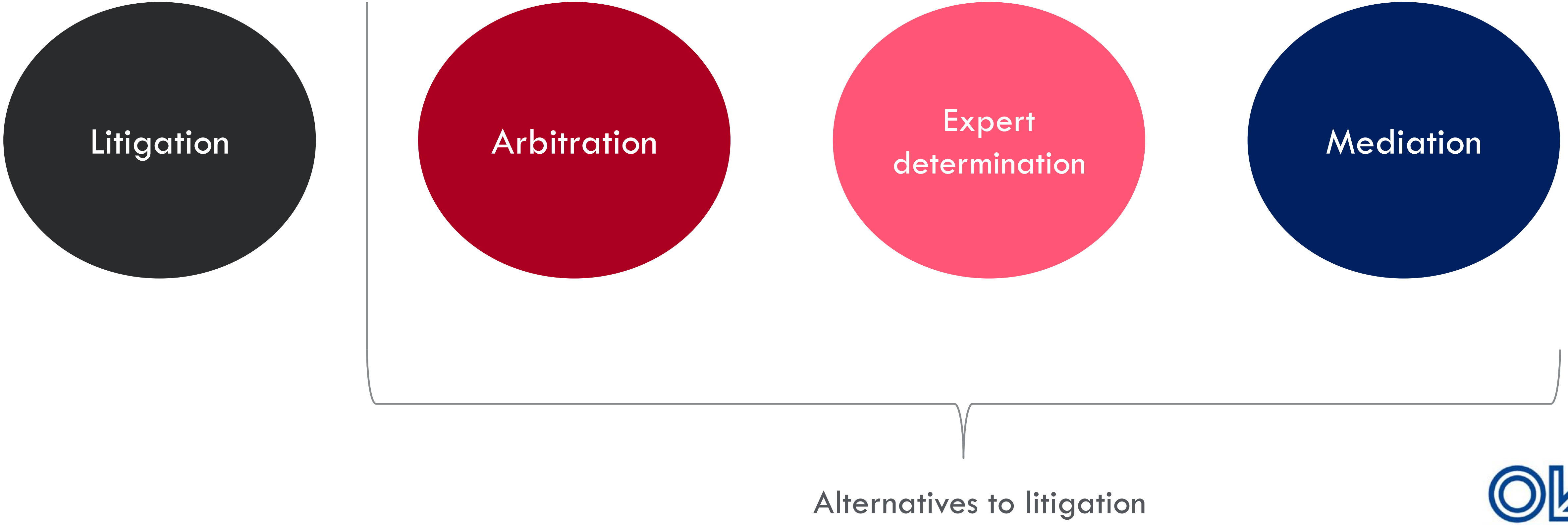
Within 6 months after the beginning of every consecutive 10 Contract Years, commencing on the 10the anniversary of the Commercial Start Date, either Buyer or Seller may request a review of the Contract Price whereupon the Parties shall meet and discuss the matter in good faith with a view to agreeing what Price Adjustment (if any) is required.

New-generation price review clauses

- **Shorter price review intervals**
- **Guidance on price review methodology**
  - Factors to be considered
  - Limits to price adjustment
  - Effects of price adjustment
- **Structured price review process**

Price review process

Recourse to third-party dispute resolution



Price review arbitration

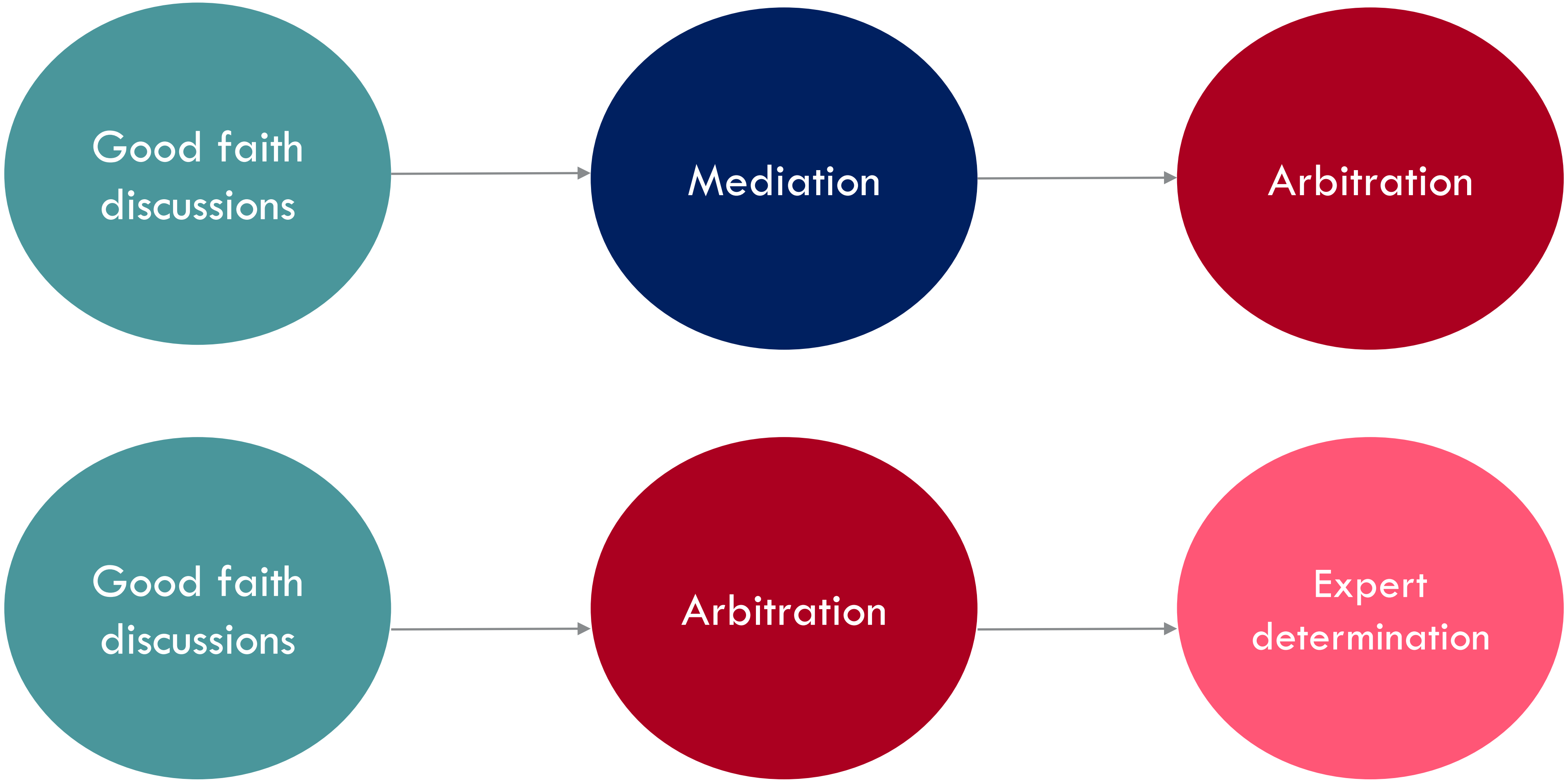
Sample clause

Failing an agreement within 120 days from the date of the Price Review Notice either Party may refer the matter to arbitration in line with the provisions on arbitration of the Contract.

Choices in price review arbitration

- Arbitrators
- Seat of arbitration
- Institution / rules
- Language
- Timetable
- Bifurcation
- Cost allocation

Price review arbitration in a multi-step dispute resolution process



Emerging alternative: contract termination

Sample clause

Failing an agreement within 120 days from the date of the Price Review Notice either Party may terminate this SPA upon giving immediate notice to the other Party.

- Control factor
- Time-efficiency
- Cost-efficiency?
- Untested option
- Operational and reputational risks

Novel features of Asian LNG SPAs

1) Alternative price mechanisms
2) New-generation price review clauses
3) **Enhanced termination rights**

Traditionally: limited termination rights in Asian LNG SPAs

- No separate provisions on contract termination
- Narrowly defined termination events
- Lengthy contract termination process

Enhanced termination rights in Asian LNG SPAs

- Elaborate provisions on contract termination
- Extended lists of termination events
- Expedited contract termination process

Termination rights in the context of force majeure

- Either party can terminate the contract
- Removal of quantitative / temporal restrictions
- Contract termination in a direct response to force majeure

Sample clause

Upon the occurrence of any event of Force Majeure either Party may terminate this Agreement by notice of no less than 30 days to the other Party.

3. Impact of COVID-19 on Asian LNG SPAs

Contractual responses to COVID-19

- Force majeure notices from Asian LNG buyers
- Downward quantity tolerance
- Cargo cancellations
- Cargo rescheduling
- Cargo diversions
- Price reviews

Outlook: disputes and contract terminations

- Proliferation of contractual disputes
- Performance-based claims
- Contract terminations

Three needs for changes to Asian LNG SPAs

1) The need to abandon oil-linked pricing
2) The need to increase operational flexibility
3) The need to re-examine contract adjustment mechanisms

1) The need to abandon oil-linked pricing

- The COVID-19 crisis reinforces the discussion about the rationale of tying the LNG contract price to the price of oil.
- Some LNG market participants no longer wish to risk a long-term exposure to the volatility of oil prices.
- The unique context of global disruption could push the industry to the tipping point and a commercial decision that oil price indexation in Asian LNG SPAs is no longer fit for purpose.

2) The need to increase operational flexibility

- The COVID-19 crisis has triggered an urgent need for multiple operational adjustments.
- The provisions restraining the exercise of volume and destination flexibility are particularly likely to come under scrutiny after the crisis.
- Destination and volume flexibility arrangements in Asian LNG SPAs could be subject to regulatory actions.

3) The need to re-examine contract adjustment mechanisms

- Recent events have highlighted that it is essential to diversify force majeure and price review risk in a broader pool of contractual arrangements.
- The lack of a practicable basis for a comprehensive contract renegotiation significantly affects the ability of the parties to adjust contracts in response to changed market circumstances.
- The approach to contract renegotiation calls for rethinking.

Model renegotiation clause

It is hereby agreed … that in the event of any major physical or financial change in circumstances … either party may serve notice on the other requiring **the terms of this [contract] to be re-negotiated** with effect from the date on which such notice shall be served. The parties shall immediately seek to agree amended terms reflecting such change in circumstances and if agreement is not reached within a period of six months from the date of the notice the matter shall be **referred to an Arbitrator** (whose decision shall be binding on both parties and who shall so far as possible be an expert in the area of dispute between the parties)…

ABP v Tata Steel [2017] EWHC 694 (Ch), emphasis added

Key considerations

- Clear basis for renegotiation
- Price and **non-price terms**
- Gradual contract adjustments

Modifications

- Trigger events
- Contract review process
- Limits to contract adjustment

Ason, A. (2020). 'Scenarios for Asian long-term LNG contracts before and after COVID-19', OIES Paper NG 160.

4. Conclusions and outlook

Conclusions and outlook

1. Asian LNG SPAs keep evolving.
2. The COVID-19 crisis will have a significant impact on the evolution of contractual arrangements in the LNG industry.
3. Although disputes could be on the rise in the short term, an increased level of cooperation in difficult times could make it easier for market participants to agree on the next-generation contract fundamentals.
4. Despite an increasing relevance of shorter-term alternatives, SPAs will remain the key contractual mechanism for LNG sales in the 2020s.
5. Changes to contract adjustment clauses in SPAs could be the key innovation in LNG contracting in the coming years.

5. Thank you and Q & A

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OIES publications

Ason, A. (2020). '[Scenarios for Asian long-term LNG contracts before and after COVID-19](#)', OIES Paper NG 160.

Ason, A. and Meidan, M. (2020). 'Force majeure notices from Chinese LNG buyers: a prelude to renegotiation?', Oxford Energy Comment.

Ason, A. (2019a). 'Price reviews and arbitrations in Asian LNG markets', OIES Paper NG 144.

Ason, A. (2019b). 'Price reviews: Are Asian LNG contract terms finally changing?', Oxford Energy Forum, Issue 119, LNG in Transition: from uncertainty to uncertainty.