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Oil, Gas & Energy Law Intelligence

LNG Disputes beyond Price Reviews by L. Agosti and B. Moselle

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LNG Disputes Beyond Price Reviews

Luis Agosti, Boaz Moselle¹

Abstract / Introduction

In this article we describe several types of commercial disputes in long-term liquefied natural gas (“LNG”) contracts that are not directly related to the more common price review type disputes. We identify a common thread to many such disputes: differences between contract and short-term prices give rise to arbitrage opportunities, and parties are unable to agree on how the payoff from arbitrage should be shared between them.

LNG trade has increased at double digits in the last three years, and LNG markets have become increasingly complex over the last decade, with more diverse market players and more varied forms of contractual arrangements. One notable development has been the growth of spot and short-term LNG trading, which was less than 20% of all trade in 2010 but by last year made up 34%.² However the majority of LNG is still traded under long-term contracts indexed to oil or to US hub prices. It is the difference between those prices and short-term prices that at times gives rise to large arbitrage opportunities.

We begin this article with a brief introduction to LNG markets and contracts. We then explain how these price differentials appeared in the past and why they are likely to continue to arise in the future, given the prevalence and variety of long-term contracts that today coexist with a growing LNG spot market. Next, we describe some examples of such disputes. Finally, we also discuss potential disputes related to force majeure events arising from the COVID-19 outbreak as some LNG buyers in China, among others, have notified force majeure that have been rejected by sellers, leading potentially to a new wave of disputes.

As a word of caution, we note that this article provides a general discussion of LNG disputes. It is not an expert report, and in the interest of space and readability we therefore avoid excessive detail. Any application to an individual contract or dispute will of course depend on the specific legal, factual and economic context, which may create circumstances that would modify the general conclusions presented here.

The LNG Market Today

Global LNG trade has grown rapidly in recent years, and in 2019 amounted to 355 MTPA, up from approximately 313 MTPA traded in 2018.³ The situation is strikingly different compared to earlier in the decade: between 2012 and 2015, LNG trade was stagnant at below 250 MTPA, and significant increases in trade emerged only in the last 3 years. In 2019, the International Energy Agency (“IEA”) suggested that LNG would overtake piped gas as the main method for trading gas internationally as early as 2020.⁴ In the first quarter of 2020 however the COVID-

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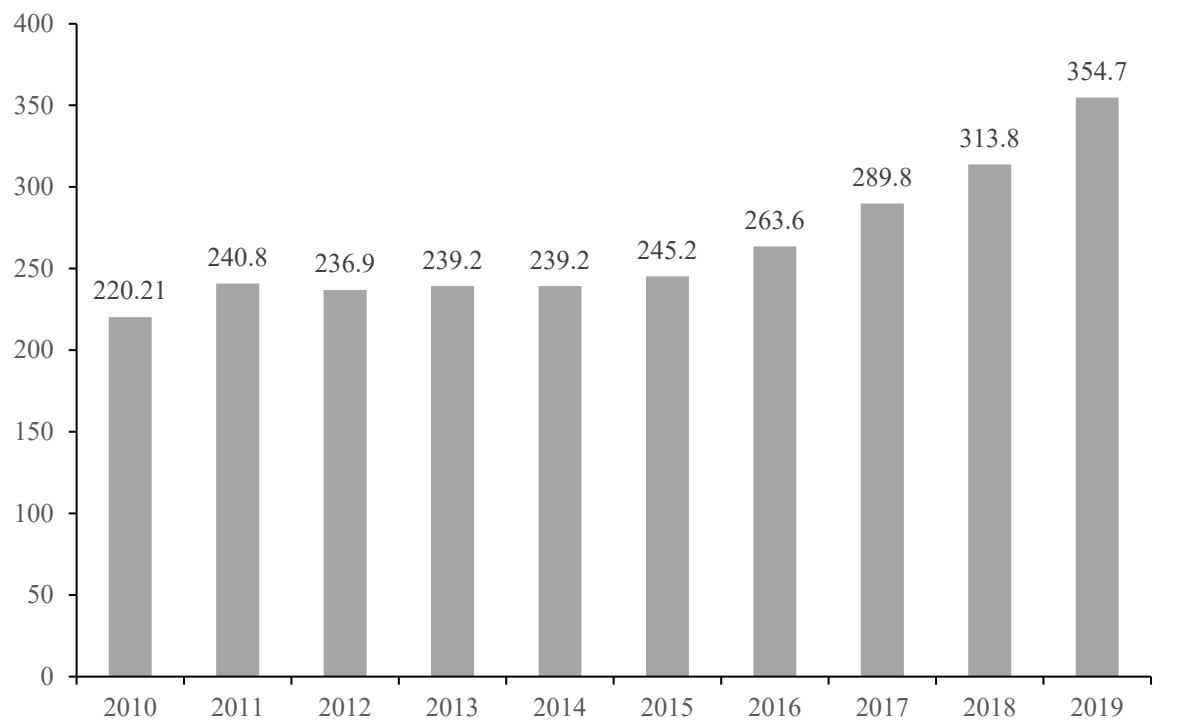
² GIIGNL 2020 Annual Report, Report, page 34.

³ GIIGNL 2020 Annual Report, Report, page 4. One “MTPA” is one million tonnes of LNG per annum (also sometimes abbreviated as “mt/y”). LNG volumes are most commonly measured in MTPA, while prices are most commonly quoted in dollars per million British thermal units (\$/MMBtu). Volumes of natural gas in gaseous state are (in Europe) most commonly measured in billions of cubic meters (“bcm”).

⁴ World Energy Outlook 2019, page 197.

19 outbreak has heavily affected gas and LNG demand, and it is unclear how demand will evolve.

Figure 1: Global LNG Trade (MT)



Source: GIIGNL

LNG trade still takes place, for the most part, in the form of long-term contracts. As of 2020 LNG is delivered under approximately 340 LNG contracts with a duration of five years or longer,⁵ covering around 66% of total LNG trade.⁶

Pricing in Long-Term LNG Contracts

Prices in long-term LNG contracts are generally indexed to oil prices (e.g., the price of Brent crude or the Japan Customs-cleared Crude price, “JCC”). According to the 2020 World LNG Report of the International Gas Union (“IGU”), around 68% of volumes sold under long-term contracts were indexed to oil while 24% were indexed to Henry Hub prices.⁷ This compares to 30% of pipeline imports being indexed to oil prices globally (as of 2018).⁸

⁵ ICIS, LNG Edge market Intelligence. The International Gas Union defines long-term contracts as those with duration at least 5 year (World LNG Report, IGU, 2018. page 69), while other sources impose a longer cut-off. Japan’s Fair Trade Commission, for example, defined long-term contracts as being at least 10 years in its 2017 Survey on LNG Trades.

⁶ GIIGNL 2020 Annual Report, Report, page 35.

⁷ IGU 2020 LNG Report, page 27. Henry Hub and other gas “hubs” such as the NBP in the UK or TTF in the Netherlands can be thought of as commodity markets where gas is traded according to standardised contracts, giving rise to a transparent price signal (in contrast to individual, non-standardised, confidential long-term contracting).

⁸ IGU Wholesale Gas Price Survey 2019 Edition, pages 31 and 32.

In the short-term, oil-indexation is expected to decrease slightly as deliveries from several new US export contracts commence, since US export contracts are generally indexed to Henry Hub prices. Oil and hub-indexation coexist however with less common pricing arrangements. One buyer in Japan, Tokyo Gas, has signed recently an LNG long-term import contract with the price linked to coal prices,⁹ and US exporter Tellurian is expected to conclude two LNG contracts with prices indexed to LNG spot prices in Asia.¹⁰

Nonetheless oil-indexation is likely to remain the most common pricing mechanism in LNG long-term contracts in the foreseeable future. According to Shell's 2020 LNG Outlook, around 50% of the LNG contracts signed in 2019 had prices linked to oil, with around a further 20% having hybrid formulas that include both hub and oil-indexation.¹¹

Oversupply of LNG as of 2020

The current situation (i.e., as of spring 2020) is one of abundant LNG production capacity and general oversupply. As new LNG production trains in the USA, Australia and Russia became operational in 2018 and 2019, unexpectedly low gas demand in China and (thanks to warm winters) in Europe resulted in significant oversupply. In addition, the COVID-19 outbreak in the first quarter of 2020 has decreased economic activity globally and is having a dramatic impact on global gas and LNG demand, adding to the oversupply. We note three major effects.

The first is a dramatic decrease in spot LNG prices, which by their nature reflect short-term supply and demand. As of April 2020, LNG spot contracts for delivery in May traded at a historical low of \$3.00/MMBtu, down from \$7.00/MMBtu in February 2020. The situation in May 2020 remains similar. Figure 2 shows the evolution of various price series, and the fall in spot LNG prices can be seen in the East Asian Index ("EAX"), which aims to represent the prices seen in spot LNG trades in East Asia.

The second effect is a rapid change in global LNG trade flows. Amidst a global LNG oversupply, Europe remains the "market of last resort" for homeless LNG cargoes. Third party access combined with ample regasification capacity gives LNG producers and sellers access to liquid and transparent gas markets in large parts of Europe. In 2019 European import volumes of LNG were above 108 bcm, compared to 60 bcm in 2018 and 55 bcm in 2017.¹² As of today European LNG terminals continue to receive large volumes of LNG from producers and exporters in the Atlantic Basin (USA, Nigeria, Russia) and in the Middle East (Qatar) displacing pipeline gas imports (mainly from Russia and Algeria)

The third effect is a consequence of the second: the increased flows of LNG to Europe have put exceptional downward pressure on European hub prices (i.e., the price of gas traded wholesale within national markets, in gaseous form), which at the moment are at historically low levels (below \$3.00/MMBtu).

⁹ IGU 2020 LNG Report, page 27. See also, *Tokyo Gas, Shell sign LNG deal linked to coal pricing in rare move*, Reuters, April 5, 2019.

¹⁰ Tellurian Corporate presentation January 2020, page 24.

¹¹ Shell's LNG 2020 Outlook, page 27.

¹² European Commission, Quarterly Report on European Gas Markets, DG Energy Volume 12 (issue 4, fourth quarter of 2019).

At the same time, LNG prices in oil-indexed contracts remained comparatively high in 2019. With oil prices at an average of \$65/bbl during the year,¹³ oil-indexed contract prices ranged from \$5.00/MMBtu in Europe to around \$10/MMBtu in Asia Pacific. However, the coronavirus outbreak has also impacted oil markets heavily.¹⁴ As of April 2020, Brent oil traded at prices between \$20/bbl and \$30/bbl. Given the oil-indexation lag,¹⁵ LNG prices in long-term oil-indexed contracts will decrease gradually in the coming months if the low oil price environment persists, eventually reducing the price gap between prices in oil-indexed long-term LNG contracts and spot LNG and gas prices.

Prices as of May 2020

Figure 2 below summarises the price situation today. Average Japanese import prices (black line) reflect, for the most part, long-term contracts indexed to oil prices. As of January 2020, those imports were priced at around \$10/MMBtu, significantly above spot LNG prices as indicated by the EAX Index (grey line), which stood at approximately \$3/MMBtu. In the Atlantic Basin, TTF prices (green line), reflecting gas traded in liquid European hub markets, have converged with spot LNG and are also materially below long-term import prices in Europe, as indicated by the North West Europe (“NWE”) index (blue line) at approximately \$5/MMBtu. US export prices (red line) remained materially above spot LNG and gas prices.¹⁶

As Figure 2 shows, the LNG market today is still far from being a global market. LNG prices differ not only globally but also regionally in terms of price formation. Long-term oil-indexed contract prices are significantly above spot LNG and gas prices. We can see also that long-term oil-indexed contract prices in Europe are below long-term import contract prices in Asia. In addition, US exports, which represent the larger share of the incremental LNG production capacity in 2019 and 2020 and are indexed to US Henry Hub prices, appear to have prices higher than spot LNG and spot LNG prices in Europe.

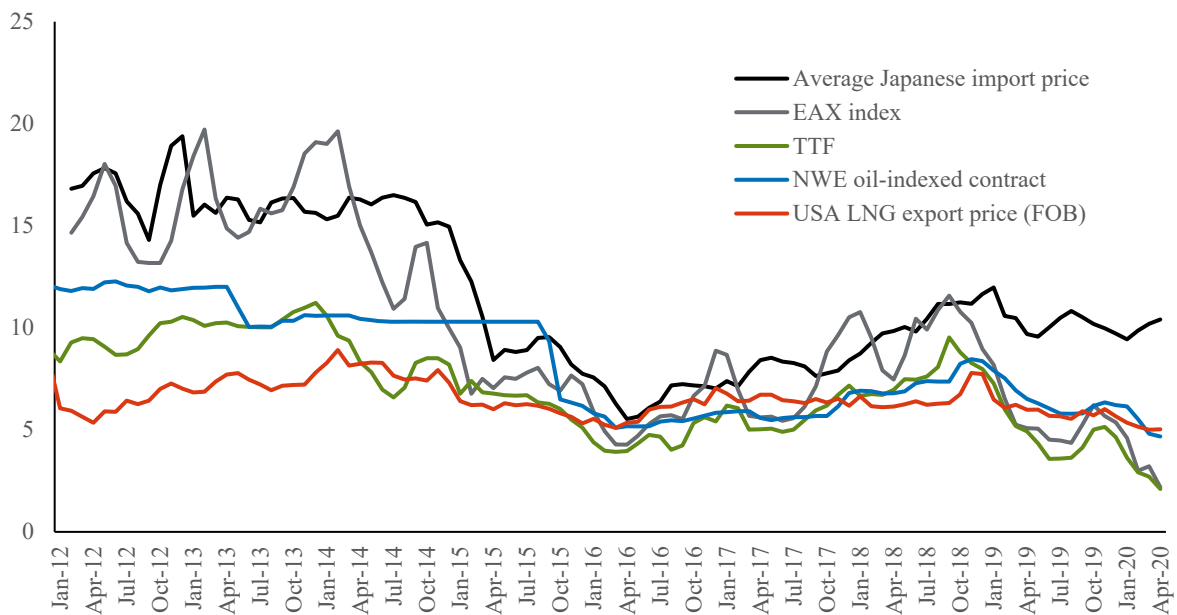
¹³ Average price of Brent oil in 2019 according to the EIA

¹⁴ Global oil demand to decline in 2020 as coronavirus weighs heavily on markets, IEA press release, March 9 2020.

¹⁵ Prices in oil-indexed long-term contracts are generally indexed to a 3-, 6- or 9-month trailing average of oil prices.

¹⁶ The US export price line shown represents an FOB price, based on a standard US export price equal to Henry Hub prices x 1.15 plus a \$3.00/MMBtu liquefaction fee.

Figure 2: Global LNG and gas prices (\$/MMBtu), 2012-20



Sources: ICIS

Price Differentials Create Arbitrage Opportunities

In the past, price differentials led to arbitrage opportunities, providing buyers and sellers incentives to sell LNG under low-priced long-term contracts at higher prices in the spot market. Today, spot prices are generally below long-term contracts, giving buyers under long-term contracts incentives to minimise their take under long-term commitments and instead rely on purchases in the spot market. Given the current configuration of the global LNG market in terms of contract diversity and regional price differences, price differentials are likely to continue, and thus to give rise to various types of disputes depending on the nature and direction of price differentials.

Flexibility in LNG supplies

From a global trade perspective, LNG has obvious advantages compared to gas transported via pipeline. While piped gas can only physically go from its point of production to those consumers connected by pipeline, transporting gas in liquefied form is cheaper over long distances, and allows for flexibility in the destination of the gas.¹⁷ LNG is almost by definition traded overseas, and it can be transported from its point of production/ liquefaction to many if to all regasification facilities in the world.¹⁸

¹⁷ In one respect long-term LNG contracts are typically less flexible than long-term piped gas contracts: long-term LNG buyers typically commit to take a certain number of cargoes per year, with little or no flexibility. In contrast, long-term piped gas contracts typically allow for greater variation, albeit usually still with a very significant minimum annual quantity (the so-called “take-or-pay” level).

¹⁸ An LNG cargo can be delivered to any receiving terminal provided it satisfies technical and size specifications at that terminal.

Historically however the destination of LNG cargoes bought under long-term contracts has been subject to tight contractual restrictions. The form of these restrictions varies between the two major types of LNG agreements: Free on Board (“FOB”) or Delivery Ex-Ship (“DES”).

In FOB agreements the buyer takes title to the LNG at the liquefaction plant, typically when it is loaded onto the LNG tanker. The buyer is then responsible for transporting the LNG to the regasification terminal. FOB contracts provide the buyer with flexibility to choose the location at which they will ultimately sell the gas, unless they contain explicit provisions to the contrary in the form of so-called destination clauses that limit the destination of the LNG to a specific region or country. That flexibility enables the buyer to arbitrage between price differentials across markets, taking advantage of higher price opportunities when these arise.

In DES agreements the buyer takes title to the LNG at the regasification terminal, usually located in the market of the buyer. DES agreements typically (though certainly not universally) specify that the LNG will be delivered at one or at a limited number of receiving terminals in a particular country or region.

Over time there have been continued efforts from different stakeholders to limit the use of LNG destination restrictions, particularly in FOB contracts, beginning (to our knowledge) with the European Commission’s investigation (on the basis of EU competition law concerns) of territorial restrictions in gas and LNG agreements back in 2000. That investigation led to a number of LNG exporters to Europe, including Nigeria LNG and the Algerian producer Sonatrach, agreeing to delete destination restrictions from certain sales contracts to EU-based customers.¹⁹ Effectively, these agreements meant that sellers could not impose limits on the destination of the LNG in FOB agreements with European buyers because they prevent cross-border trade and undermine the goal of a single integrated gas market in Europe.²⁰ Once the buyer has taken title to the LNG at the liquefaction terminal, they are free to decide where the LNG is to be resold.

More recently the Japanese Fair Trade Commission conducted an investigation in 2017 to assess the impact of destination restrictions on competition. The Commission concluded that “it cannot be said that providing destination clauses itself under a fixed-term FOB contract is necessary and reasonable, and such a provision is likely to be in violation of the Antimonopoly Act”.²¹ It also concluded that “when LNG sellers conclude a new contract or revise a contract after the expiration, LNG sellers (including sellers who were users) should not provide competition-restraining clauses nor take business practices which lead to the restrictions of resale and so on”.²² In the case of existing contracts the Commission also found that “as for the existing contracts before the expiration, LNG sellers, at least, should review competition-restraining business practices which lead to restrictions of resale and so on.”²³ As we explain

¹⁹ European Commission Press Release IP/02/1869, Commission settles investigation into territorial sales restrictions with Nigerian gas company NLNG, Brussels, 12 December 2002. European Commission Press Release IP IP/07/1074, Commission and Algeria reach agreement on territorial restrictions and alternative clauses in gas supply contracts, Brussels, 11th July 2007.

²⁰ Steven P Finizio, Destination Restrictions and Diversion Provisions in LNG Sale and Purchase Agreements, *The Guide to Energy Arbitrations - Second Edition*, global Arbitration Review, July 2017.

²¹ Survey on LNG Trades (Chapter 4 Ensuring of fair competition in LNG trades), The Japan Fair Trade Commission, June 2017, page 9.

²² Survey on LNG Trades (Chapter 4 Ensuring of fair competition in LNG trades), The Japan Fair Trade Commission, June 2017, page 20.

²³ Survey on LNG Trades (Chapter 4 Ensuring of fair competition in LNG trades), The Japan Fair Trade Commission, June 2017, page 20.

later, we believe that revising these potentially restraining business practices, and in particular the removal of destination clauses, is complex and likely to be contentious.

Flexibility and Pricing in Long-Term LNG Contracts

The combination of delivery basis (e.g., FOB or DES) and territorial restrictions give rise to various pricing arrangements that reflect how buyers and sellers agree to share various types of risks, and specifically, how they choose to allocate price and volume risk.²⁴ Below we describe at high-level some common arrangements. Our description is by no means exhaustive, given the diversity of contracting seen in practice, but it captures a number of commonly seen features. Any individual contract requires specific analysis of its terms, in the context of relevant market conditions at the time of analysis.

An FOB agreement that sets the contract price according to the price of gas in the market of the seller allocates both price and volume risk to the buyer. This is the case for most US export contracts, where the LNG price is set at a fixed premium on the U.S. gas market price, the Henry Hub (in theory to cover liquefaction costs), plus a fixed “capacity fee” that the buyer must pay regardless of the volumes of LNG taken. The result is a cost-plus structure where the seller makes a quasi-guaranteed return on its investment and operational costs. The capacity fee covers the seller’s investment costs while the variable price covers the per unit cost of purchasing the gas at market prices and converting it in LNG ready for loading and export. The seller is bound to make the same (or a very similar) return regardless of the volumes taken by the buyer, or the price at which the buyer resells the LNG.

The buyer on the other hand has complete flexibility in terms of where and how it resells the LNG and bears entirely the risks associated with re-selling the contractual volumes. In this type of agreements, the buyer is said to fully bear price and volume risk. Notably, these type of export agreements do not include price review provisions.

A second category of LNG contracts are FOB contracts with prices indexed to oil prices. In this type of agreement, sellers and buyers share price risk to different degrees. The seller’s revenues will vary with oil prices. At higher oil prices, producers/ sellers will make high returns while at sufficiently low oil prices they risk not even covering their investment costs. Buyers also face price risk. This risk however is limited if the buyer is able to resell the LNG in markets where the price of gas is also indexed to or correlated with oil prices. Buyers are exposed to higher risk if the price of gas in the resale markets is not indexed to/ correlated with oil prices (e.g., if it is set by hub prices and/ or LNG spot prices). In Europe, and to a lesser extent in Asia, these types of LNG FOB contracts generally include price review provisions that *inter alia* help to mitigate these risks for the buyer.

Price and volume risk allocation also varies in DES contracts depending on the agreed pricing structure. Similar to FOB agreements with oil-indexed prices, in DES agreements with oil-indexed prices price risk is shared by both parties. Sellers will bear most of the price risk, but the buyer will also bear some price risk, limited if the buyer is able to resell the LNG (regasified or not) at oil-indexed prices. Price risk increases if the buyer’s resale market is a liquid gas market with prices disconnected (“decoupled”) from the price of oil. Again, in Europe and to

²⁴ Price risk can be described as the impact on a party’s cash flows and profits arising from variations in the contract price of gas supplied under the contract. Volume risk refers to the risks that arise from variations in a party’s cash flows and profits related to the amount of gas sold into a market at a given point in time. The relationship between the two depends on the nature of the markets in which the product is being sold.

a lesser extent in Asia such agreements generally include price review provisions that *inter alia* help to limit the buyer's price risk.

Finally, in the case of DES agreements with hub-indexed prices, the price risk lies almost entirely with the sellers. Such agreements generally index the LNG price to the price of gas in the market where the LNG is delivered, so that the seller is exposed to the variations in the market price of gas. In most markets with mature trading hubs, the buyer may then bear limited price risks because the price in its LNG contract moves with the price of gas in its resale market.

The four types of LNG agreements described above represent just four broad categories of contracts (1. FOB hub-indexed contracts 2. FOB oil-indexed contracts 3. DES oil-indexed contracts and 4. DES hub-indexed contracts). The reality however is more complex, and most LNG sales and purchase agreements present additional unique characteristics. As we explain in the next section, the degree of complexity, and the probability of dispute, increase with the introduction of destination clauses and pricing provisions that allocate the value of LNG flexibility in potentially ambiguous ways.

Non-price LNG Disputes

Many LNG (and gas) disputes are about pricing and relate to the application of price review provisions that require the parties to adjust the contract price according to various specified criteria. In this article however we focus on non-price review disputes. Below we describe a number of examples of LNG disputes that instead relate to other issues: antitrust concerns, reloads and “netback pricing”, and under-deliveries of LNG.

Antitrust Disputes

As discussed above, a general trend in FOB contracts in Europe and Japan has been the removal of territorial restrictions that limit the ability of the buyer to resell the LNG freely. In the cases of Algeria and Nigeria, the parties and the European Commission were able to reach an agreement whereby the selling party agreed to delete territorial restrictions from all existing LNG contracts.

In the case of Japan however, resolving the issues that arise from the Japanese Fair Trade Commission's finding that territorial restrictions in FOB contracts are likely to be anticompetitive is likely to be far less amicable.

LNG agreements for delivery in Japan are numerous and involve a large variety of sellers, including national oil and gas companies, private producers and “portfolio players”.²⁵ A general deletion of territorial restrictions appears unlikely as a practical outcome. Moreover, we understand that as a matter of law each contract would need to be assessed on a case by case basis, since, we understand, the Japanese Fair Trade Commission has not concluded that destination restrictions are illegal *per se*.

In particular, we note the Commission's observation that in the case of existing agreements “it is not fair to abolish destination clauses or relax requirements on diversion while maintaining

²⁵ Portfolio players hold a diversity of procurement and sale LNG agreements allowing to optimise shipping costs and providing them with increased flexibility in terms of LNG sources and destinations.

a trade price based on the premise of specific destinations.”²⁶ This would suggest that the Commission’s view is that territorial restrictions cannot simply be deleted from current agreements without a simultaneous renegotiation of the pricing provisions.

Whether and how territorial restrictions are anti-competitive is essentially a legal question, albeit one whose answer is informed by economic analysis. The modification of pricing provisions is however to a great extent an economic question. Consider for example the (hypothetical) case of an FOB contract that is indexed to the price of electricity in the market of the buyer in North West Europe, and includes a clause prohibiting resale of the LNG outside Europe. The removal of territorial restrictions would allow the buyer to resell the LNG at higher prices if an arbitrage opportunity outside of Europe was to appear. Logically, and consistent with the Japanese Fair Trade Commission’s observation above, the seller could argue that the original price provisions were not intended to reflect the value of LNG in the new markets and that the price provisions need to be amended. In some cases, this change might be accomplished via a price review. In other cases, however, the agreement may not include a price review clause or if it has one, it might not be suited to deal with this type of contractual changes (for example, if the price review criteria are specific to the market where the destination restrictions applied). In any case however the underlying economic question is similar: how should one adjust the pricing provisions in the contract while maintaining (to the extent possible and appropriate) the initial commercial bargain of the parties. This involves considering, among other issues, how adjusting the price provisions changes the allocation of price and volume risk.

Disputes Related to “LNG Reloads”

In the case of FOB contracts, a dispute may arise when territorial restrictions are eliminated, and the increased value of flexibility needs to be allocated between the buyer and the seller. In the case of DES contracts a similar (in some respects) type of dispute may arise if the delivery points agreed by the parties are effectively “bypassed” by the buyer.

This bypass occurs when buyers take title of the LNG at a receiving terminal with reloading (also known as “re-exporting”) capabilities, i.e., where the terminal can receive LNG from an incoming tanker and load it into a different LNG tanker for re-export.²⁷ Indeed, this is precisely what happened in Europe after the Fukushima nuclear disaster in Japan in March 2011. Between 2011 and 2014 (see figure 1) LNG spot prices in Asia increased significantly above prices in oil-indexed LNG contracts delivering to Europe. As a result, buyers in Europe re-exported the LNG they received at the European terminals and sold it at premium prices in Asia. This same phenomenon has been seen (albeit in less extreme form) at other times when spot prices have increased significantly above European prices.

The additional revenues captured by LNG buyers in Europe caught the attention of LNG sellers, who sought to capture at least part of the extra profits that the buyers were making through resale. This resulted in disputes between buyers and sellers at various levels.

First sellers have attempted to adjust the DES price via price reviews. The seller typically argued that (i) the contract price must reflect the value of gas (or LNG) in the markets in which

²⁶ Survey on LNG Trades (Chapter 4 Ensuring of fair competition in LNG trades), The Japan Fair Trade Commission, June 2017, page 8.

²⁷ The reloading can be done directly from the incoming tanker to the outgoing tanker (“trans-shipment”), or via a storage tank after being downloaded from the incoming tanker.

the buyers resells the LNG; and that (ii) in this case, the re-export market is one such downstream market, and hence the price must reflect the value obtained or obtainable via re-export.

In response we have seen LNG buyers argue that price review provisions are irrelevant in this context, particularly if those provisions refer to a specific geographic market. For example if the price review provisions refer to the market of the buyer in North West Europe, the buyers will claim that the resale of the LNG via reloads are not part of the market of the buyer.

A second type of dispute related to reloads arises when a long-term LNG contract has “netback” pricing arrangements. In this type of dispute the issue is not whether the contractually agreed pricing provisions need to change, but how they should be applied as they stand.

In very simple terms, in a netback pricing arrangement the LNG seller receives something like the market value of gas (however that is defined) in the market in which the LNG is ultimately delivered, adjusted to allow for transport and similar costs and (often) for a profit margin for the buyer.²⁸ In this particular case, reloads allow the buyer to deliver the LNG to a destination where the local market price is relatively low, pay the low netback price to the seller, and then reload the LNG and re-export it to a “premium market”. By doing so it would appear to retain the full upside value of the re-export, whereas if it had sold directly into the premium market it would have had to pay a higher netback price.

Interestingly, this phenomenon gave rise to an ICSID dispute between Perupetro and Pluspetrol Perú Corporation *et al* resolved in 2015.²⁹ The dispute was not specifically about an LNG agreement, but related to the royalties that Pluspetrol Peru and others had to pay the Peruvian Government for the development of a gas field in Peru. These royalties were set in relation to the market value of LNG in the market on which the gas would be resold via an on-sale LNG agreement. Perupetro Corporation was paying royalties on the basis of the market value of gas in the market in which the LNG was first delivered, even though in some occasions, the same LNG was reloaded and resold at a higher price in a different market. The Peruvian Government considered that the royalties had to be paid on the basis of the value of LNG in the market in which the LNG was ultimately delivered, and eventually went to arbitration to claim back the difference in royalties. The economic question in this case was therefore not related to the adjustment of the price provision in the LNG on-sale agreement, but to the assessment of damages suffered allegedly by the Peruvian Government.

This type of dispute has the potential to occur whenever long-term contract prices fall below spot LNG prices. Given the inherent volatility of both oil and spot LNG prices, it is hard to predict when those circumstances will next arise, but unwise to assume that they will not.

LNG Disputes Related to Under-Deliveries

We are familiar with multiple disputes where the seller in a long-term contract has failed to deliver one or more cargoes of LNG, claiming that the failure to deliver was due to logistical problems such as temporary LNG production shutdowns or reductions; and the buyer has sought compensation because it suspects that the sellers have in fact intentionally failed to

²⁸ For example, under an LNG netback pricing structure LNG could be priced according to hub prices in North West Europe if delivered to Europe.

²⁹ Pluspetrol Perú Corporation and others v. Perupetro S.A, ICSID Case No. ARB/12/28.

deliver, so as to sell the “missing LNG” at a higher price in the spot market. Such an arbitrage can be very profitable for the seller, since even if the contract specifies compensation for under-delivery, it will often require only payment of a specified percentage of the contract price (a kind of liquidated damages provision), which may be a price worth paying for the extra profit from a spot sale.

Whether or not the under-deliveries are a breach of contract, and whether liquidated damages provisions apply, are question of law and fact. From an economic perspective the challenge is to measure, assuming it is relevant, the damages that the buyer may have suffered as a result of receiving the lower volumes.

COVID-19 and Force Majeure Events

As noted earlier, the coronavirus crisis has heavily impacted global gas and LNG demand, and given rise to very low spot LNG prices.³⁰ In the current price situation the incentives are therefore reversed. Buyers may have an incentive to reduce their take under their long-term commitments, so as to address the demand reduction in their markets and/ or take advantage of the lower prices in the spot market.

In that context, a recent prominent event is a set of Force Majeure declarations by CNOOCs and PetroChina, China’s largest LNG importer. These declarations were issued because of logistical constraints at receiving ports and weak domestic demand.³¹ Our understanding however is that those force majeure notices have been rejected by the sellers, paving the road for disputes and arbitration.³²

Whether or not issues related to weak domestic demand might conceivably be dealt with through price review provisions is a question of law. However, in our experience such provisions in long-term Asian LNG contracts do not make any reference to downstream market conditions (instead they typically focus on the price in other long-term LNG contracts). In any case, the buyer may feel that price adjustments via price review provisions are too slow to deal with their urgent need to reduce contractual volumes, and in some extreme circumstances (a COVID-19 lockdown) they may argue that no price is low enough to address short-term demand reduction.

As described earlier, a number of new contracts bringing LNG from the US allow the buyer freedom to decide whether or not to take cargoes, but with a “two part tariff” type payment structure comprising a fixed fee per cargo (payable whether or not the buyer takes the cargo) plus a variable fee (e.g., 115% of the US spot gas price, the “Henry Hub price”). At current prices and given current levels of demand buyers under such contracts may choose not to take deliveries, as is already happening.³³ However, buyers will be obliged to pay the fixed fee component specified in the contract. At this point, we understand (though it is entirely a matter of law) that the probability of revising prices in these contracts or adjustment volume and capacity commitments is rather low, because these contracts do not contain price review provisions and in many cases have limited force majeure and hardship provisions. We note

³⁰ ICIS Press Release, Coronavirus to hit LNG demand at world’s largest LNG importers, 7 April, 2020.

³¹ Agnieszka Ason, Michal Meidan, *Force majeure notices from Chinese LNG buyers: prelude to a renegotiation?*, Oxford Institute for Energy Studies, March 2020.

³² *Ibid*, page 2.

³³ S&P Global Platts, *Wave of LNG cargo cancellations to start as soon as June: shipbroker*, 23 Apr 2020.

however that the situation is generating significant losses to buyers, giving rise in some cases to a question as to how long the buyer can sustain these losses.

Summary: “Disputes are all about Flexibility”

As the examples above illustrate, there is a common thread uniting many LNG disputes. Market circumstances create arbitrage opportunities, in the form of sales or resales of LNG in new and often unanticipated ways. The party with physical control takes advantage of the opportunity, or is alleged to have done so, whether through diverting, reloading and re-selling, under-delivering and selling elsewhere, declining to take a cargo and buying from elsewhere, or some other means. Each of these is in a sense an exercise of flexibility, and in most cases is made possible because of the ease of moving LNG (compared to piped gas). The parties then disagree over who should enjoy the benefits of the arbitrage opportunity, giving rise to disputes.