

LNG PROJECTS: ALL IN AGREEMENT

Liquefied Natural Gas ("LNG") projects are unique in the sense of the significant capital requirements required to set up the infrastructural elements of an LNG trade and the long term supply and demand necessary to make the project viable. The amounts of money involved are big even for the energy industry.

Typically, any new LNG project will involve the construction of a liquefaction plant at the point of supply and a regasification plant at the point of delivery, as well as significant investment in the transportation of LNG. Due to the absence of second-hand LNG vessels an LNG project will require the construction of a fleet of LNG vessels. These vessels are usually built for a specific project and will be placed on charter for the life of the supply agreement, sometimes 20 or more years. This type of investment is underpinned by the supply agreement for the LNG which is a contract for supply from point to point. Without this in place, or at least anticipated, there is no prospect of the very significant sums being invested in the infrastructural elements of the supply chain. There are also numerous attendant timing issues which need to be borne in mind so as to ensure that the various elements of the supply chain are as far as possible complete together. Government consents for any LNG project must be obtained and, as in the case of the LNG terminals proposed in Southern New England, opposition from conservation pressure groups needs to be overcome.

The supply chain basically comprises extraction, liquefaction, transportation, regasification, storage and distribution. Each stage of the supply chain will involve contracts being put in place but these will rarely be between the same parties. The supply chain is only as strong as its weakest link and because it is a chain all the contracts are interrelated and interdependent. For example, a supplier of LNG will not be able to comply with his supply obligations unless he has guaranteed and reliable access to LNG shipping. LNG ships are not generally available on the market for charter and their construction (which will be supervised and contracted for by the ship owner with the shipyard) and long term chartering are thus integral parts of the project as a whole. The responsibilities for arranging and paying for the eventual transportation will be set out in the supply agreement and will often be shared.

It is thus essential that, if the supply contract confers rights on the seller in certain eventualities to suspend deliveries or on the buyer to suspend his obligation to accept delivery by reason of say force majeure (which entitles, in certain listed circumstances one or other of the parties to suspend performance), or even to terminate the contract, other obligations such as the obligation to perform and pay for shipment can also be suspended. The former rights will of course be contained in the supply agreement (between seller and buyer) and the latter rights will be contained in the charterparty contract between the ship owners or pipeline owners and either the seller or buyer. Similar rights will also need to be contained in any agreements, for example, between the liquefaction plant and the producer of natural gas, where the liquefaction function is to be performed by a separate entity. In the event that a right is conferred to terminate the supply contract, because it is this contract on which the rest of the LNG supply chain is dependent, both commercially and financially, it is essential that the same series of events allow termination of all other contracts in the supply chain. Similarly, it is essential to provide for similar contractual duration in the various contracts, so that the parties' obligations expire at substantially the same time.

This requirement that contracts should contain the same rights to claim force majeure and the same rights of termination, so that a set of events will have the same consequences on the rights and obligations of all parties in the supply chain, requires that the relevant clauses be construed in a uniform fashion. In turn this requires that all contracts in the supply chain should be subject to the jurisdiction of the same tribunal applying the same set of legal principles. Usually English or New York law are chosen by the parties as the law governing the contract. Additionally, where, as often occurs, contracts are drawn up in different languages, it should be agreed which version is to be the official version to take precedence in the event of a conflict between the two.

As mentioned above, the agreement underpinning the supply chain is the LNG Sale and Purchase Agreement. A necessary part of the supply agreement is the buyer agreement to take minimum quantities. LNG contracts will therefore specify minimum amounts that the buyer is obliged to take or pay for. The market itself will determine the precise balance between the buyer's wish for maximum flexibility in supply and the seller's wish for definite minimum purchase obligations. Also relevant will be provisions relating to the ability to increase or reduce supplies during the contract life, or defer the obligation to take quantities in any particular period. Price review clauses are an area which are of special significance allowing for adjustments in price to reflect the current market price, thus allowing account to be taken of future market conditions, or changes in the costs of gas or other alternative fuels which may have made gas uneconomic for sale in the buyer's market. From a legal perspective the principal challenge is to ensure that such clauses are sufficiently certain to be enforceable and they are not construed as an unenforceable agreement to agree. The events which entitle the party to invoke any price review provisions are relatively easy to define and it is easy to provide that a price should be reviewed so that it is in line with market prices. However, difficulties can arise where there is an obligation imposed to meet and negotiate in good faith a price review. Practical difficulties can also arise in price review discussions because, apart from in the US and UK, there are no publicly available market prices, so evidence of price in markets other than the US or UK is virtually impossible to obtain. Of course buyers and sellers are likely to have diametrically opposed views. All these clauses are the product of the length of the contract and the desire for some flexibility to take into account future unforeseen events or market fluctuations and, although commercially desirable, can lead to difficulties, if activated.

Issues can also arise out of the situation where the seller fails to deliver or delivers late. The sellers, where there is a failure to take delivery by buyers, are usually protected by the existence of take or pay clauses which oblige buyers to pay for minimum quantities irrespective of whether they take delivery. The buyers do not have similar protection and must rely on the provisions applicable by reason of the choice of law clause. In the event special provision is not made, English sale of goods law limits the buyer's damages to the cost of buying alternative supplies of LNG, so that if the price has gone down the buyers have suffered no loss. Contracts often therefore specifically set out clauses which specify the seller's liability for failure to deliver, and buyers operating in a short term or spot market will usually want to see the issue of non-delivery be treated on a cargo by cargo basis as opposed to an annual basis. These clauses may limit the seller's liability, provide for liquidated damages or, in an attempt to overcome foreseeability defences, set out the type of losses that a buyer will suffer in the event of non-delivery by the seller.

Historically much of the LNG trade has been on a point to point basis and deliveries were restricted to the buyer's re-gasification facilities. However, as the LNG market has matured, a LNG short term and spot market has developed with price variations in different areas. Some LNG agreements contain clauses allowing cargo diversion to enable the parties to take advantage of higher prices in other markets. From a legal perspective this has the potential to undermine the need for regular minimum supplies and the viability of the project as a whole and thus such clauses will provide for a sharing of the additional profit made between buyer and seller, taking into account costs of an alternative supply and any extra costs incurred such as shipping.

Those engaged in the LNG industry should view these developments with particular caution. The desire for a fluid market, on the one hand, and the dangers of departing from carefully constructed interlocking contracts, on the other hand, will lead the unwary into a potential minefield where the legal outcomes may be uncertain and costly.

This article was first published in the March edition of European Oil & Gas.