Bloomberg Law Reports® Asia Pacific

Optimising the Value of LNG Sale Agreements by Formulating Strategic Cargo Diversion and Destination Flexibility Clauses

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Introduction

The liquefied natural gas (LNG) market has experienced many changes since the first deliveries of LNG were made from Algeria to France and the United Kingdom in 1963, and then in the Pacific Basin from Alaska to Japan in 1969. During that formative period, there were a limited number of LNG buyers, and sellers were keen to ensure their existing buyers were committed to providing funds for the purchase of LNG, whether the relevant cargo of LNG was taken or not. This is the so-called "take-or-pay" arrangement. Also, to ensure an LNG project was economically viable and could secure project financing, buyers were often required to agree on a floor price for LNG being supplied. In turn, whilst there may have been an intermediary buyer, such as a trading company acting on behalf of a gas or electric utility company in the supply chain, end-buyer utility companies provided a real demand for LNG being produced. If LNG was not supplied the lights would literally go out. LNG contracts used during this period were often referred to as "A to B" linear contacts, which required buyer to unload LNG at a specific destination without any flexibility for the buyer to divert to another receiving terminal, whether within the same jurisdiction or otherwise.

However, since those early days, there has been a transformation in the scale and range of the LNG market. Numerous jurisdictions now supply LNG: the Middle East acts as a swing producer to both the Pacific Basin and the Atlantic Basin markets; North Africa, West Africa, Latin America and the Caribbean traditionally supply to the Atlantic Basin; whilst South East Asia, Australasia and Russia supply the Pacific Basin. Receiving terminals have also been built in numerous new markets and recent developments in technology have enabled the use of floating re-gasification facilities. As a result, new markets have opened to sellers as nations seek to diversify their energy supply and achieve security of supply. LNG is also a relatively clean hydrocarbon based fuel, which is increasingly attractive given concerns of global warming. Therefore, volumes of LNG being traded in the global market have increased together with the range of sources and destinations, coupled with certain established sellers no longer being constrained by project finance arrangements on their liquefaction facilities. As a result, the scope for agreeing flexibility of destination for LNG cargoes has increased.

This article considers the different grounds upon which a buyer (Buyer) or seller (Seller) may seek flexibility rights with their counter-parties on the destination of a cargo in an LNG sale agreement, and the key legal issues which need to be addressed for the grant of any such flexibility rights.

Diversion Rights v. Destination Flexibility

A key issue for all LNG sale negotiations is determining which party will be responsible for arranging the shipping. If Seller is responsible for delivery of LNG to

Buyer's receiving terminal, LNG sales will be on a DES (delivery ex-ship) basis. For such sales, any right to change the agreed destination of the LNG will be a "diversion right". In the alternative, if Buyer agrees to collect LNG from Seller's liquefaction plant, LNG sales will be on a FOB (free on board) basis. Any ability to change the destination of LNG in an FOB sale agreement will be a right of "destination flexibility".

DES Sales

For DES sales, Buyer is often an end user or an aggregator for a downstream market of LNG. As a result, Buyer may not wish to incur the cost of procuring the necessary LNG fleet. However, if Seller controls the shipping arrangements, Buyer will need Seller's co-operation to divert a LNG cargo. In such LNG contracts, diversion rights may be negotiated either for the benefit of Buyer, to allow Buyer flexibility if the contracted volume of LNG is not required due to local market conditions or operational constraints affecting Buyer's receiving terminal, or in favour of Seller if there are more commercially attractive markets to sell LNG. However, before agreeing to Seller having diversion rights, Buyer will need to confirm it will have sufficient flexibility: (i) through its storage facilities; (ii) its contractual arrangements at the receiving terminal; or (iii) its ability to use an alternative fuel to be able to accommodate any such diversion rights.

FOB Sales

In contrast, Buyer retains its own shipping fleet for FOB sales. However, Seller may wish to limit Buyer's right to destination flexibility to protect its own markets. Seller will not wish to provide Buyer with LNG to enable Buyer to compete with Seller's own customer base. In recent years this concern has increased as certain Sellers have sought to maximize profits and minimize operating expenses by selling LNG to their affiliated companies on an FOB basis, with destination flexibility rights. Such affiliated company Buyers, known as LNG aggregators, generally control their own shipping and have capacity rights at a receiving terminal located in a fluid natural gas market, such as the United States. Such an arrangement allows the LNG aggregator to minimize shipping costs by maximizing utility rates for its fleet, whilst maximizing revenues by directing LNG to optimal value markets. Consequently, Sellers may seek to limit destination flexibility rights for Buyer to mitigation rights if Buyer's receiving terminal is affected by an event of force majeure or other operational constraints.

However, whilst Sellers and Buyers have competing concerns in respect of destination flexibility and diversion rights, these issues regularly arise during the negotiation of LNG sale and purchase agreements. As a result, it is important to consider the operational and commercial issues associated with such rights, together with the legal implications of any such rights. The issues are considered in more detail below.

Grounds for Requesting Destination Flexibility or Diversion Rights

Operational Constraints and Force Majeure

As noted above, generally accepted grounds for agreeing to destination flexibility or diversion rights in an LNG sale agreement are to mitigate the effects of operational constraints and force majeure events affecting Buyer's receiving terminal. However, even under such circumstances, Seller may wish to limit Buyer's right to claim such relief. For example, as Seller will want to protect its LNG sales market, Seller may wish to limit Buyer's right to change the destination of an LNG cargo to an alternative receiving terminal in Buyer's jurisdiction, or an alternative receiving terminal in which Buyer has an ownership interest or holds capacity rights. Consequently, Seller will ensure demand for LNG in its alternative target markets is not reduced due to over supply.

Similarly, Seller will be keen to ensure that it receives full value for any cargo of LNG diverted due to operational constraints affecting Buyer. As a result, Seller may demand that any additional costs incurred in the diversion of an LNG cargo will be borne by Buyer, whilst any cost savings associated with such a change in destination will be retained by Seller. In addition, if there is any commercial upside in the sale of LNG to an alternative market, Seller will wish to receive such an upside. Alternatively, if the sale of LNG in a different market has to be at a discounted price, Seller will want to ensure Buyer is obliged to "make good" the price difference so Seller remains whole. This may be acceptable to Buyer, particularly if the sale of LNG will mitigate Buyer's take-or-pay liability. In this respect, such concerns only apply to diversions and changes of destination requested due to operational constraints affecting Buyer's facilities as Buyer should be relieved of its take-or-pay obligation upon the occurrence of a force majeure event.

In any event, an associated concern for both Buyer and Seller will be to determine which party will be responsible for identifying an alternative buyer for the relevant LNG. Depending on the nature of Buyer, it may be preferable to allow Seller, with its wide customer base and trading operations, to perform the marketing of such LNG. This will certainly be preferable for Seller as it seeks to minimize the impact of any such diverted cargo on its existing customer base. If any change in destination is driven by Buyer with Seller obliged to conduct the necessary marketing arrangements, Seller may also wish to recover the associated marketing costs. Similarly, Buyer may wish to have the right to approve or reject the terms of any alternative sale, particularly if Buyer will be obliged to make good any shortfall in the LNG price agreed.

Seller will also want to ensure that any mitigation arrangements available to Buyer during the occurrence of an event of force majeure are subject to a backstop date, after which Seller will have the option to terminate the LNG sales agreement. Seller may also seek to require that any change in destination of an LNG cargo remains subject to Seller's prior approval, particularly if sales are being conducted on a DES basis and Seller is concerned to confirm the alternative receiving terminal has a safe port, safe berth, acceptable conditions of use, is in a jurisdiction which has generally acceptable tax and environmental laws and which does not violate any trade

sanctions which may be applicable to Seller or the relevant cargo of LNG. These issues are discussed in more detail below.

There are, however, alternative forms of flexibility which may be built into an LNG sales agreement to provide Buyer with relief from its take-or-pay obligation if the receiving terminal or Buyer's LNG vessel for FOB sales is affected by an operational constraint or there is a reduction in demand amongst Buyer's customers. For example, Buyer's take-or-pay obligation may be fixed at a percentage (less than 100 percent) of the adjusted annual contract quantity, or Buyer may have the right to exercise downward volume flexibility for a pre-agreed number of LNG cargoes each contract year, possibly linked to a make-good obligation over a period of time. Therefore, the negotiation of diversion and destination flexibility rights involves the consideration of a number of associated issues.

Commercial Diversions

Increasingly in LNG sale negotiations, each party aims to secure destination flexibility and diversion rights for commercial reasons, to maximize revenues from the sale of LNG. The concerns for Seller with such rights will reflect those out-lined above, that is, Seller will want:

a.) to ensure Buyer remains liable for the contractually agreed price for such LNG;
b.) to protect its existing market; and
c.) if such sales are conducted on a DES basis, to make such rights subject to operational constraints of both the liquefaction plant and its shipping fleet.

Similarly, from Buyer's perspective, if Seller wishes to have such rights, Buyer will want to ensure Seller's ability to divert an LNG cargo from Buyer's receiving terminal is restricted to reflect Buyer's ability to be flexible and if Buyer is required to use an alternative fuel in replacement of a diverted cargo of LNG, that Seller provides Buyer with appropriate compensation for the additional costs associated with the use of such an alternative fuel.

However, a key issue for both Seller and Buyer with any commercial diversion will be to determine how any profit achieved from the sale of LNG to an alternative market, as compared to the price achievable under the terms of the LNG sales agreement executed between the parties will be shared. This in turn may require an analysis of the basis of calculating the price payable for LNG under the parties' LNG sales agreement as compared to the price payable for the alternative sale. For example, a price formula which has been calculated on a net-back basis may make comparison to an index based formula problematic. In the alternative, if a price formula is index based, it may be difficult for the parties to compare competing indexes in advance. In this respect, it is worth noting there is no single pricing basis for LNG in the global market.

Different indexes are used to price natural gas in the various markets of the Atlantic Basin and the Pacific Basin. For example, in the United States (Henry Hub) and the United Kingdom (National Balancing Point (NBP)) there are established natural gas markets which allow for market based gas prices. However, in Continental Europe

(noting prices at the Zeebrugge and TFF Hubs are reflective of prices set at the NBP) natural gas prices are often linked to a basket of alternative fuels, such as fuel oil or gasoil, together with elements linked to coal and electricity prices and consumer indexes. Similarly in Asia, there is no established natural gas market price. Instead, LNG prices are linked to the Japanese Crude Cocktail price published in Japan or the Indonesian Crude Price. Therefore, as LNG prices are usually determined on the basis of the pricing index applied in the destination into which the LNG is to be delivered, it can make a comparative assessment of LNG trades complex.

This issue has been partially addressed, at least for Atlantic Basin trades of LNG, by the Chicago Mercantile Exchange's introduction of a new gas swap futures price which is calculated on the basis of the spread between Henry Hub and NBP. However, the absence of a global LNG price, which is reflective of the cost of alternative fuels in each market, can make the commercial decision to divert an LNG cargo for profit problematic. Also, depending on the proposed terms of the alternative sale, it may be necessary for the parties to put in place hedging arrangements to mitigate any currency exchange risk.

As a result, profit sharing mechanisms need to be carefully structured to ensure clarity. It is also necessary to address any concerns which may be raised, particularly by European competition regulators, as to the sharing of price sensitive information and any perceptions of anti-competitive behaviour caused by the inadvertent restricting of LNG sales to certain markets. These issues are considered in more detail below.

Issues to Address when Negotiating Destination Flexibility or Diversion Rights

Scheduling

A key concern for both parties will be the timing of exercise of destination flexibility or diversion rights. One option will be to agree that certain volumes of LNG may be committed for delivery to an alternative destination during the development of the annual delivery programme. As noted above, the parties should have a reasonable understanding of Buyer's ability to agree to such volumes being diverted, based on Buyer's known operational constraints at the receiving terminal, which may include:

a.) the availability of storage capacity at the receiving terminal and in any pipelines downstream of the receiving terminal, together with any contractual rights Buyer may have to access additional storage capacity at the receiving terminal;
b.) Buyer's ability to use third party LNG stored at the receiving terminal and Buyer's ability to use an alternative fuel; and
c.) Buyer's ability to receive and unload an LNG vessel at the receiving terminal, either before or after the diverted cargo of LNG, with a larger capacity than LNG vessels generally used for LNG sales by Seller to Buyer.

In the alternative, the parties may wish to have the right to exercise destination flexibility and diversion rights within a contract year, after the annual delivery programme has been fixed. Again, each party's ability to agree to such flexibility

rights will be subject to practical operational constraints. However, the ability to exercise such rights within a contract year, whether within the 90 day schedule[1] or otherwise, will be necessary if an event of force majeure occurs. Similarly, it will be preferable not to limit the exercise of such rights for commercial diversions to the period during which the annual delivery programme is formed as the parties may need to react promptly to market opportunities. However, in such circumstances, Buyer will usually want to make the exercise of any such rights subject to its consent, to mitigate the risk of Buyer being in breach of its commitments to its downstream customers. In turn, Seller may wish to impose an obligation on Buyer to accept a diversion request, limiting Buyer's right to reject a request, for example, to the extent that such a diversion will have a material adverse effect on Buyer or its operations. There are a range of options the parties may consider to form the parameters to the exercise of any such rights.

Shipping Arrangements

Whichever party is responsible for the transportation of LNG will need to be comfortable with the operational arrangements and legal and regulatory regime applicable at the alternative receiving terminal. For example, such party will want to ensure that the LNG vessel is compatible with the alternative receiving terminal. If it is not, the parties will need to agree which party will bear the costs associated with ensuring the LNG vessel is compatible with the alternative receiving terminal. The alternative receiving terminal may also require the owner and/or charterer of the LNG vessel to execute conditions of use for the receiving terminal, which allocate liability for any damage caused to the LNG vessel and the receiving terminal amongst the owner of the LNG vessel, the owner of the receiving terminal and port facilities and any third parties operating within the vicinity of the receiving terminal. The party responsible for transporting LNG will need to carefully review its insurance policies, to ensure it will have adequate coverage upon execution of any such conditions of use. Similarly, as any change of destination could impact the shipping schedule of the relevant LNG vessel, a Party may wish to limit the number of cargoes that may be diverted each contract year, whilst also ensuring diverted cargoes are conducted on a rateable basis to mitigate the impact of diversions on the shipping schedule.

The parties will also want to confirm in advance the environmental and tax laws which may be applicable to their sale of LNG in the alternative jurisdiction. In this respect, the parties should consider taking legal and tax advice as to the possibility of transferring title to the LNG in international waters before the LNG vessel enters the territorial waters of the alternative jurisdiction as it may be possible to limit the relevant party's exposure to such laws by structuring the sale of LNG in this way.

In addition, given the number of jurisdictions in which re-gasification facilities have been constructed, including the availability of floating re-gasification and storage facilities, the parties should engage legal counsel to confirm that any proposed sale of LNG to an alternative jurisdiction will not breach any trade restrictions applicable to the parties or the jurisdiction from which the LNG is sourced. Similarly the parties should confirm that any sale of LNG to an alternative jurisdiction will not be prevented by the flag under which the relevant LNG vessel operates.

European Competition Law Issues

For sales of LNG into the European Union, parties need to be careful not to structure any profit sharing mechanism (PSM) in a way which may be deemed to infringe European competition law.[2] In this respect, the Directorate-General for Competition has suggested that for DES sales, a PSM is unlikely to infringe European competition law as the agreement to divert is reached between the parties before title and risk in the LNG is transferred to Buyer. This view is reflected by Sonatrach's settlement with the European Commission in 2007 in which Sonatrach agreed to only apply PSMs to DES sales.[3] In contrast, for FOB sales, if the parties agree to share profit made from the sale of LNG to an alternative market after title and risk in LNG has passed to Buyer, such a PSM may be deemed to infringe European competition law if it reduces the incentive for Buyer to sell the relevant LNG in another jurisdiction within the European Union.

However, a distinction is also drawn between "Raw" PSMs and "Net" PSMs. A Net PSM is applied to profits made from the alternative sale after costs associated with the diversion of the LNG have been deducted from the additional profit margin. Such a PSM is presumed to be acceptable as it does not reduce Buyer's incentive to sell LNG into an alternative jurisdiction. In contrast, a Raw PSM applies when the gross price differential between each market is split between Buyer and Seller, with Buyer required to bear the associated costs of the diversion. A Raw PSM is presumed to reduce Buyer's incentive to sell LNG into an alternative market and as a result restrict competition and may be presumed to be anti-competitive. Therefore, for sales into the European market, it is important to clearly structure a PSM in a way which will not be deemed to infringe European competition law, if there is a possibility the relevant cargo of LNG could be diverted from one European Union country to another.

In addition, Parties may need to provide that the calculation of a PSM is verified and confirmed by a third party auditor to mitigate the risk that a PSM could cause the sharing of price sensitive information between market participants which could breach principles of European competition law. Also, for sales of LNG into the European market, any restrictions on the proposed resale or end-use of LNG are likely to be deemed to infringe European competition law.

Impact on Take-or-Pay and Deliver-or-Pay Provisions

If a cargo of LNG is delivered to an alternative destination, it will be necessary to ensure that such a delivery of LNG is treated by the parties as a delivery of LNG duly made by Seller to Buyer under the terms of their LNG sales agreement. Accordingly, Buyer should be relieved of its take-or-pay obligation, subject to making good any reduction in price received from the alternative sale if the diversion was requested by Buyer to mitigate the effect of an operational constraint or a reduction in demand in Buyer's market. Similarly, Seller should be relieved of its deliver-or-pay obligation, subject to an obligation to reimburse Buyer for the cost of using an alternative fuel, if necessary. The allocation of such relief against both the take-or-pay obligation and the deliver-or-pay obligation will need to be carefully structured to reflect the timing of each party's right to exercise diversion rights and destination flexibility, that is, prior to the formulation of the annual delivery programme or within a contract year.

Also, please note that for the purposes of this article, we have only considered the scenario where the parties agree to a proposed delivery of LNG to an alternative destination. There are complex issues associated with the structuring of contractual remedies applicable if Seller diverts LNG or Buyer changes the destination for LNG without the other party's prior consent. However, to address such issues would require an analysis which is beyond the scope of this article.

Conclusion

Is it possible to optimise the value of LNG sales agreements by formulating strategic cargo diversion and destination flexibility clauses? The answer to this question would seem to be "yes", but any such rights captured in an LNG sales agreement must necessarily be restricted to reflect the demands and operational constraints of both Buyer and Seller. As a result, such rights are unlikely to be "optimal" for both parties. Global LNG markets, as with all other commodity markets, fluctuate significantly over time between being a seller-market and a buyer-market, as seen in the last couple of years. As a result, the relative negotiating strength of each party and their consequent ability to fix the terms for the exercise of any diversion or destination flexibility rights will similarly change. However, provided both parties appreciate the competing pressures of its counter-party, as with any other contractual mechanic, it should be possible to achieve a balance which achieves an optimal result for both parties.

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[1] The 90 day schedule is typical in LNG sales contracts as the preferred period within which a Buyer and Seller fix the near-term delivery schedule for LNG. The 90 day schedule is a

rolling three month scheduling process which is usually confirmatory of the delivery schedule set-out in the annual delivery programme, agreed between the parties before a contract year. Such a period is a matter of operational convenience rather than a statutory obligation.

[2] H. Nyssens and I. Osborne, "Profit splitting in a liberalized gas market: the devil lies in the detail", Competition Newsletter 2005, Spring (1) p. 25.

[3] IP/07/1074 of 11 July 2007. See press release "Commission and Algeria reach agreement on territorial restrictions and alternative clauses in gas supply contracts".