LNG sale and purchase agreements

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1. Introduction

Long-term liquefied natural gas (LNG) sale and purchase agreements are the linchpins which link upstream gas supply and liquefaction, shipping and downstream regasification and the gas sales elements of the LNG chain. Although a common group of core issues is included in every sale and purchase agreement, a model agreement 'fit for all purposes' for long-term LNG sales does not exist because of:

- the diversity of participants involved in supply and offtake;
- the different commercial models utilised (third-party sales or equity sale/affiliate offtakes); and
- the variety of gas markets that are supplied with LNG (liquid, liberalising and non-liquid or traditional).

Other factors which contribute to the development of a more diversified approach in the terms of sale and purchase agreements include:

- the strong growth of the international LNG trade and, in particular, the number of new LNG sellers and buyers;
- the dramatic shift in the overall gas supply/demand balance experienced over a short period of time; and
- regulatory changes affecting local gas markets.

Long-term LNG sale and purchase agreements with the 'traditional' Asian buyers (Japanese, South Korean and Taiwanese) have historically tended to be significantly shorter in length than comparable LNG sale and purchase agreements with other buyers. Some attribute this to the greater involvement of Western lawyers in the drafting of this second group of LNG sale and purchase agreements, adding ever greater detail to ensure that issues are comprehensively covered and dealt with. Others attribute this to the 'traditional' Asian consensus approach to dispute resolution: namely, that disputes are resolved in a spirit of mutual understanding and trust. Whatever the reason, a common set of core issues are dealt with by both groups, although issues that are dealt with in excruciating detail in the second group of LNG sale and purchase agreements may be barely touched upon in a traditional Asian LNG sale and purchase agreement. This historical difference in approach is changing with the growth in the international LNG trade and, as a result, the "traditional" Asian LNG sale and purchase agreements are becoming lengthier.

Model agreements have been developed by various industry groups to use for 'spot' or 'short term' LNG sales and purchases. These master LNG sales and purchase agreements (MSA) models can be quite detailed and intricate, although they typically will either not address at all or address only generically some of the crucial provisions found in tailored long-term LNG sale and purchase agreements. This is a reflection of both the short-term nature of the trades contemplated to be undertaken and the MSA contract structure, which leaves many of the key commercial terms to be agreed by the parties on a trade-by-trade basis in the confirmation notice. MSAs are discussed in greater detail in a later chapter.

The aim of this chapter is to provide an overall survey of some of the most significant commercial and legal issues in long-term LNG sale and purchase agreements within the context of current LNG market dynamics.

2. Parties

While it is axiomatic that there must be a seller and buyer in an LNG sale and purchase agreement, the identity of the seller and the buyer and the particulars of the supply source(s) and destination market(s) are crucial in determining the individual structure of a long-term LNG sale and purchase agreement and whether it is commercially viable.

The project development structure selected by the sponsors of an LNG development project will determine whether the seller of LNG is:

- the upstream gas developer or one of its wholly owned affiliates;
- a 'project company' generally comprised of and owned by the upstream gas developers; or
- an 'aggregator'.

The buyer may be:

- a large utility or industrial company, buying LNG primarily for its own uses;
- a marketing company or natural gas aggregator, buying LNG to on-sell into a given market; or
- as the spot market for LNG evolves, a trading company buying LNG to arbitrage the LNG to other buyers based on market conditions.

In all cases the technical competence and creditworthiness of the seller to bear its performance and financial obligations under a long-term LNG sale and purchase agreement, and the creditworthiness of the buyer to bear the very significant financial obligations associated with performance and payment under a long-term LNG sale and purchase agreement, are of critical importance.

On the seller's side, the costs of developing the LNG production facilities are substantial and will often be financed on an equity and third-party project finance basis by the LNG production facilities owning entity, which may or may not be the LNG seller. The financial institutions providing the project finance will carefully scrutinise the creditworthiness and technical capabilities of the entire chain of participants, from the upstream gas supplier to the terminal developer and finally the LNG buyer. If any participant in the chain is an undercapitalised entity, the financial institutions are likely to require security, which may include completion, performance and/or payment guarantees from the creditworthy parent company of any undercapitalised/non-creditworthy entity or, where the parent companies do not meet the financial institutions' creditworthiness threshold (as evidenced by an acceptable credit rating from a recognised credit rating agency), security in the form of a bank guarantee or letter of credit from an entity, including another financial institution, that does meet the creditworthiness threshold.

A guarantor may be required to be an additional party to the long-term LNG sale and purchase agreement, or may execute a separate guarantee agreement.

3. Conditions precedent

Contracts with a large number of conditions precedent are correspondingly uncertain. Therefore, it is generally viewed as desirable to minimise, to the extent possible, the number of conditions precedent and the time period within which they must be satisfied. If all major contracts relating to the project can be signed simultaneously, conditions precedent can be greatly reduced or eliminated. However, due to the interrelated nature of the contracts in such projects (especially where parties are project financing), it is common practice to fix the central LNG sale and purchase agreement terms by executing the agreement first. The subsidiary agreements (eg, ship charters, engineering, procurement and construction (EPC) contracts, and gas supply and sales) can then be finalised as conditions precedent.

Other common conditions precedent included in LNG sale and purchase agreements are key governmental approvals required by either party, the reaching of the final investment decision and/or finalisation of financing arrangements if either party is developing/project financing new infrastructure.

It is advisable to limit, to the extent possible, the number of conditions precedent consisting of commercial arrangements to be made by one of the contracting parties with third parties, as well as to limit the time allowed for their fulfilment. The existence of such conditions precedent increases the uncertainty that the LNG sale and purchase agreement will become effective and may create a commercial option to cancel the contract, should market conditions change after the LNG sale and purchase agreement is signed.

Buyers and sellers face a major challenge during negotiations where both parties are building new infrastructure and trying to coordinate the attendant timing uncertainties of obtaining the necessary governmental approvals and finalising project finance arrangements, among other things.

The parties should also carefully think through subsidiary issues, such as whether a condition precedent can be waived by the party responsible for its satisfaction, whether approval of waiver by both parties is required and the standard of conduct required of a party to satisfy the conditions precedent applicable to it.

Where conditions precedent are included in a long-term LNG sale and purchase agreement, the time allowed for their satisfaction and the consequences for failure to satisfy (or waive, where waiver is provided for) them must be considered. The time allowed for satisfaction of conditions precedent needs to reasonable in light of the circumstances of the transaction. Typically, a long-term LNG sale and purchase agreement will contain a 'sunset date' by which the conditions precedent must be satisfied (or waived, where waiver is provided for). If any of the conditions precedent are not satisfied or waived by the sunset date, then either:

- the long-term LNG sale and purchase agreement will automatically terminate and neither party will have any further rights or obligations under the agreement; or
- either party (or in some cases, only the 'other party' – that is, the party which has no outstanding conditions precedent to satisfy/waive) may, by written notice prior to the satisfaction or waiver of the conditions precedent, terminate the long-term LNG sale and purchase agreement, after which neither party will have any further rights or obligations under the agreement.

There is no obvious reason to prefer one approach to the other, as should the parties wish to allow more time to satisfy a condition precedent, they can always agree to extend the satisfaction period; and if one or both do not, the party wishing to terminate may give notice immediately after the sunset date. Some practitioners believe that the requirement that a party give notice to effect a termination will act as an encouragement for the parties to maintain the agreement in effect while the responsible party/ies are still working in good faith to satisfy one or more outstanding conditions precedent.

The agreement will also state what provisions of the long-term LNG sale and purchase agreement will be operative and effective upon signature regardless of whether the conditions precedent are ever satisfied, which typically includes the provisions covering satisfaction of conditions precedent, confidentiality, anti-corruption, governing law and dispute resolution.

4. Quantities

The quantity clause sets out the LNG quantity obligations of the seller (ie, obligation to make available for delivery at its facilities (if the buyer is providing for the LNG shipping – namely, free on board (FOB) as per Incoterms®[1]) or to deliver to the buyer's facilities (if the seller is providing for the LNG shipping – namely, delivery at terminal (DAT) or delivery at place (DAP), as per Incoterms® 2010[2]). These obligations include:

- the base annual quantity (ACQ) obligations;
- the amount of any downward quantity flexibility (for the buyer and, in certain cases, the seller);
- any requirement for the buyer to take delivery of ('make-good') the quantities previously exercised as downward flexibility;
- the buyer's obligation to take or pay for a minimum quantity of LNG;
- the parties' obligations with respect to force majeure make-up quantities;

1 The International Chamber of Commerce's rules on the use of domestic and international trade terms. Incoterms® were created in 1936 and the most recent publication is Incoterms® 2010.

2 The former delivery ex-ship (DES) rule was deleted in Incoterms® 2010. The current rule is either DAT or DAP, although parties can continue to use DES, provided that the long-term LNG sale and purchase agreement refers to Incoterms® 2000.

- the parties' rights and obligations, if any, with respect to quantities in excess of the ACQ – namely excess quantities; and
- the buyer's right or the seller's obligation to take or supply make-up quantities of LNG for any take-or-pay payments made by the buyer.

The prevailing market fundamentals (ie, whether it is a buyer's or a seller's market) will determine to a large degree the level of flexibility that the seller is willing to give to the buyer in terms of its firm offtake obligations. Because the seller has made a large investment in the upstream and liquefaction facilities (and, in the case of DAT or DAP sales, in shipping), and because of the relatively limited (at least until recently) potential market for spot sales of any LNG that the buyer has chosen not to take in any year, the seller usually prefers to limit the buyer's ability to use downward quantity flexibility to reduce its take-or-pay obligation for any year and, where such downward quantity flexibility has been allowed, to require the buyer to take equivalent quantities at a later date as 'make-good'. The seller's position will also be influenced by whether it is a FOB or a DAT/DAP sale: the seller will feel more exposed where, as a FOB seller, it must rely on excess shipping capacity being available to dispose of any untaken quantities in a year when the buyer elects to exercise downward quantity flexibility. During the early decades of the LNG trade, the buyer's annual downward flexibility entitlement was limited to 5% (or, at most, 10%) and the buyer was required to use 'reasonable endeavours' to make-good the quantity of any downward flexibility exercised in later years.

For a brief period during the buyer's market from the late 1990s to 2002/2003, buyers were able to achieve annual downward quantity flexibility entitlements of 15% (sometimes more in the initial contract years) with no make-good obligation and, in some cases, the right to carry forward overtakes as credits against subsequent years' take-or-pay obligations, as is traditional in pipeline gas sales contracts. As the market shifted to a seller's market since 2003, there has been a return to very limited downward quantity flexibilities, reasonable endeavours and firm make-good obligations for buyers; downward quantity flexibility rights for sellers have even been introduced. It is still the norm to have a life of contract cap on the buyer's exercise of downward quantity flexibility which is less than the sum of the annual allowances (generally, in the range of 50% to 100% ACQ). Typically, this cap is a cumulative downward quantity flexibility limit, so that make-good quantities taken by the buyer allow the buyer to free up quantities under the cap for additional future downward quantity flexibility.

While downward quantity flexibility is not contained in every long-term LNG sale and purchase agreement, when it is included the parties need to be clear whether there is a firm obligation on the buyer to make good the downward quantity flexibility exercised during the term of the agreement or after the term, or whether the obligation to make good exercised downward quantity flexibility terminates at the end of the term. Typically, the buyer may request only make-good quantities which are in addition to its minimum annual take quantity for the year, and the seller's obligation to make available make-good quantities requested by the buyer in any year is typically limited to using its reasonable endeavours to do so.

The annual take-or-pay quantity and make-up rights in respect of take-or-pay payments are other issues that take up significant negotiation time. Buyers purchasing LNG for non-liquid gas markets are understandably concerned about the possibility of having to make take-or-pay payments and the uncertainty as to when they will be able to obtain the make-up cargos to which they are entitled. The level of the take-or-pay commitment is a heavily negotiated issue and, in the authors' experience, generally ranges from 100% of the adjusted ACQ to 70% of the adjusted ACQ ;but it can of course be any level agreed by the parties. Except during the brief period of the buyer's market, sellers have been unwilling to guarantee the availability of make-up quantities during the contract year in which buyers may wish to take their make-up entitlement, as this would imply that sellers must reserve capacity for buyers whenever they have an outstanding make-up entitlement. One might believe that buyers have every incentive to take delivery of a cargo of LNG for which payment was made in advance as soon as possible; however, many sellers insist on the inclusion of a requirement that the buyer take their make-up entitlement within a limited period of time (eg, three to five years) after the relevant take-or-pay payment was made or within a limited period (eg, six to 12 months) after the end of the normal term of the long-term LNG sale and purchase agreement. As buyers may request delivery of make-up cargoes only in years during which they can take the quantity in addition to their adjusted ACQ, buyers are often concerned that they may pay significant sums for LNG that is never delivered (or is delivered five, 10 or 2 years after payment was made).

Take or pay is being dispensed with in some long-term LNG sale and purchase agreements, particularly those involving parties selling from or buying into portfolio supplies. In its place, the standard contract law of damages applies, and similar issues to those discussed at section 7 below arise.

Other take-or-pay related issues are:

- whether interest should be paid on take-or-pay payments until make-up cargos are taken (generally, no interest is paid);
- whether make-up is calculated on the quantities for which a take-or-pay payment has been made or on the value of the take-or-pay payment (generally on a quantity basis);
- whether the make-up cargo should be delivered free of charge or whether the price differential between the take-or-pay price paid and the contract price at the time of delivery of the make-up LNG should be paid by the buyer or refunded to the buyer; and
- the length of any period allowed after expiry of the contract term for the buyer to take delivery of any outstanding make-up and whether the buyer should bear the seller's operating costs for the continued operation of the LNG facilities after the end of the term of the agreement (assuming that the facilities are being continued to be operated solely to deliver the outstanding make-up to buyer).

However, after over 30 years of international LNG trade, there are only a very limited number of reports of take-or-pay invoices having actually been sent and the few instances that are known relate to exceptional situations (eg, the collapse of the Dabhol LNG import project).

The unprecedented growth of the international LNG trade (in particular, the number of import terminals and buyers) has facilitated the resolution of certain issues. For example, a buyer developing a new gas market will typically want a period of two to four years to build or ramp-up its ACQ obligations to the full 'plateau' level. Due to the spot market growth and the interest of established LNG buyers and new traders in entering into short-term sale agreements, it is now easier for sellers to accommodate new buyers' build-up period requirements.

4.1 Start date

The start date is the date on which the parties' actual performance obligations – that is, the seller's obligations to make available or deliver, and the buyer's obligation to take or pay for if not taken – commence. Where one or both parties are building facilities to enable them to perform these obligations, the long-term LNG sale and purchase agreement effective date (ie, the date when the conditions precedent have been satisfied or waived) will typically be a date which is several years prior to the start date. The party (or partie) that is building facilities which are required to be in place in order for it to be able to perform its obligations to deliver or take is at risk to the extent that the start date mechanism doesn't take into account its construction/commissioning timetable.

The start date can be:

- a negotiated fixed and certain date. This alternative entails a degree of risk if the seller or buyer is building new facilities, but may be acceptable under the circumstances and if acceptable mitigation measures are included (eg, the right to supply/deliver cargoes from/to alternative facilities in the case of delay in completion of the new facilities); or
- a date determined through a window narrowing mechanism established by written notices from the party building the new facilities to the other party at predetermined intervals.

A window narrowing mechanism must address what happens if one or more written notices are not given. The usual default utilised is that, absent a written notice, the window shall be the latest possible date(s) in the previous window. It is also important to clarify whether and what types of force majeure events affecting the party that is constructing new facilities will delay the start date.

On the start date, the deliver and take or pay obligations are binding regardless of whether the new build facilities have been commissioned and are operational.

5. Duration

Long-term LNG sale and purchase agreements tend to have fairly long terms – generally 20 or 25 years in length – reflecting, the substantial investments required for upstream and LNG production facilities, LNG shipping and LNG receiving terminals.

Traditionally, the obligations to deliver and take end at the expiry of the contract