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COVID-19 and LNG Contracts

The recent coronavirus disease 2019 (COVID-19) outbreak has added another layer of disruption to an already depressed LNG market in Southeast Asia.

It comes in the wake of market players addressing drops in demand growth caused by an unseasonably warm winter period and record low JKM spot market prices – falling to as low as US$2.713/MMBtu last month. While LNG markets have historically taken seasonal demand in their stride, the recent warmer weather has come at a time of rapidly rising supply (in particular, from the US market, which continues to grow its exports).

These factors have all contributed to a growing disruption in the LNG market in Southeast Asia. On top of historically low prices in the spot markets, there will now be a downwards price trend under long-term SPAs indexed to oil. Even with the recent fall in oil prices to around US$30/bl, it will only be if oil prices are sustained over a longer period that long-term buyers will reap the benefits, plus there will be a time lag in the short-term, whilst prices adjust.

Faced with these concerns, the advent of the virus has inevitably (and understandably) led market participants to consider what contractual options they have to alleviate the difficulties facing them. The rapid spread of the virus and resulting government lockdowns have prompted various players to actively consider exercising *force majeure* over scheduled cargoes. In some cases, buyers (including CNOOC and PetroChina in the Chinese market) have gone ahead and declared *force majeure*. However, such measures should be carefully considered.

Questions of *force majeure* are rarely straightforward, as the present pandemic illustrates. *Force majeure* has no inherent meaning under English law, but is rather a label given to a common type of contractual term allowing parties to suspend or delay performance of a contract where that performance is affected by a particular event beyond their control. An extenuating event, an inability to perform the contract and a causal link between the two must usually all exist for *force majeure* to apply.

With respect to trigger events, clauses will often contain a non-exhaustive list of types of disruptive situation that a party may rely on. Price dislocation or a fall in demand are in themselves rarely valid triggers (for good reason, given the careful allocation of price and volume risk that underpins long-term LNG supply contracts).

In terms of the disruption, the extenuating event and its consequences will generally need to be beyond the party's control. It follows that the party seeking to rely on the provision will often need to show that they have taken steps to mitigate or overcome the effects of the event.

In each case, the application of *force majeure* will depend on the specific wording of the contract. With regard to the present COVID-19 outbreak, some SPAs may include accommodating wording (e.g. "epidemic" or "pandemic") within the list of specified events. It is possible to imagine a tribunal or court agreeing with a party seeking to rely on *force majeure* in this context, and parties may soon put this to the test. At the same time – and subject to the wording of the particular contract – parties are likely to be expected to explain how the event has disrupted their ability to perform their obligations, and what steps they have taken to mitigate or avoid that disruption. *Force majeure* does not generally entitle a party to "fold their arms and do nothing"[1], so if the outbreak has merely made the contract more difficult or expensive to perform, a party may find that *force majeure* cannot come to its aid.

The complex and fact-specific nature of *force majeure* disputes may be part of the reason why regional buyers have historically been unwilling to declare *force majeure* in times of distress, not to mention fears of any possible associated reputational damage. It may also explain why sellers immediately appear reluctant to accept such declarations – as was recently witnessed with Total, Shell and Qatargas, who rejected claims of *force majeure* from their Chinese counterparties.

What, then, should parties to a long-term LNG or natural gas contract do? The answer is to carefully study the contracts in its portfolio. What does the contract contemplate as properly constituting a *force majeure* event and can it be applied to the present situation? If so, what other requirements will need to be met to make a valid declaration? A party may be required to notify the counterparty within a particular timeframe, or have taken specific steps to mitigate the event and its consequences. In this regard, it is important to consider what other provisions the parties included in the contract to address periods of difficulty. For example, diversion rights to unaffected terminals or other markets, downward flexibility options and adjustments to cargo delivery schedules (e.g. moving volumes to later in the same or next contract year) are all common contractual mechanisms that a court or tribunal may expect a party to have explored before declaring *force majeure*.

1 *Bulman & Dickson v Fenwick & Co* [1894] 1 Q.B. 179.a.

A strong understanding of the contract is a good platform for dialogue between the parties on how to address the present crisis and, thereafter, encroaching into price discussions, if required. The mechanisms mentioned immediately above are all generally used as sources of flexibility within long-term contracts. Such flexibility might apply also to other prevailing circumstances in the coming months or years. COVID-19 will undoubtedly curtail short-term regional growth, but a strong economic recovery in large LNG importers, such as China and South Korea, could send spot and short-term prices higher as demand rebounds.

Times of genuine crisis often elicit a desire to put aside differences and work constructively toward a shared outcome. It may be that parties are able to capitalise on this sentiment, but it is vital they have a solid understanding of what their contracts say before doing so.

If you have any questions regarding the subject matter of this bulletin, please contact one of the authors or your usual firm contact.

Contacts

Max Rockall
Partner, London
T +44 20 7655 1354
M +44 771 230 4908
E max.rockall@squirepb.com

Tim Flamank
Associate, London
T +44 20 7655 1062
M +44 754 511 0740
E tim.flamank@squirepb.com

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