SQUIRE PATTON BOGGS

# Gas and LNG Alert:

## All Hands to Contract Management Stations

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Regardless of whether certain countries have (or have not) passed the "peak" of the coronavirus disease 2019 (COVID-19) outbreak, other LNG market forces remain; possible second or third waves of the virus cannot be ruled out and the impact of the April 2020 OPEC+ deal remains to be seen. Even without the virus, parties to LNG contracts need to maintain a solid grasp of the contractual tools at their disposal.

This bulletin explores various contractual management tools that may be available in a highly changeable LNG market, and some common issues associated with them. These tools may provide leverage to parties seeking to recast (or preserve) the contractual bargains contained in their SPA portfolios. This bulletin discusses generalities. The availability of any contract management tool in a specific situation will depend on various factors, such as contract terms, the applicable law of the contract and the surrounding facts.

**Downward flexibility rights** entitle a buyer to take reduced quantities of LNG during a particular period. This may mitigate a buyer's short-term fall in demand from its own customers due to, for example, a pandemic. However, long-term SPAs often constrain the exercise of this right. A buyer may be required to provide a fixed period of notice before being able to receive reduced quantities – for example, restricting its ability to respond to sudden market shocks. Further, there is often a parallel obligation to take increased "make-up" quantities in later periods – something that buyers should plan to accommodate. It should also be noted that downward flexibility may not be an inexhaustible remedy. If a party has relied on it in the past, its ability to do so now may be restricted.

**Cargo rescheduling** options may be available. Parties may be permitted to reschedule cargoes to later in an existing annual programme, or even into subsequent ones. This is an obvious way of managing short-term fluctuations in demand caused by disruptive events, but often requires the agreement of both parties. An agreement to reschedule may rest on the goodwill of the counterparty. Future shipping capability may be limited. The contract may restrict rescheduling to within the same annual programme, making the accommodation of a request made towards the end of the relevant contract year or annual programme potentially difficult. Accordingly, it is important to check the wording of the contract and to understand the impact of any constraints on the unaffected party's ability to consent to a proposed rescheduling, such as an obligation not to unreasonably withhold consent or an express duty of good faith in considering such requests. Depending on the wording and governing law of the contract, there may be scope for negotiating a rescheduling to mitigate the impact of the disruption.

**Diversion rights** may allow a buyer to take delivery of a cargo at a different receiving terminal. This can be helpful in circumstances where the primary receiving terminal (or terminals) prescribed in the contract are unable to operate or supply an area experiencing disrupted demand, but other viable terminals or markets are less affected. In considering this option, the marketability of the diverted LNG must be considered. The diverting party should consider their contractual liability for any increased transportation costs, in case these outweigh the desired benefit – in terms of marketing the LNG, attractive spot or short-term sale opportunities are few and far between in today's market, with the JKM price routinely hovering around the US$2.5-US$3/MMBtu mark.

If a diversion is economically viable, parties will need to ascertain whether it is permitted under the contract – frequently, an SPA will contain geographical restrictions, for example, to receiving terminals within a particular region. If disruption is not uniform across the region, diverting cargoes to less affected areas may be a good way of managing supplies, but this may not assist if a shutdown is more widespread. Thereafter, parties should consider if any parallel contractual obligations are triggered. For example, a period of notice may be required and parties may be obliged to exercise other measures, such as downward flexibility, in tandem with diversion rights.

**Material adverse change clauses** could apply. These commonly trigger a requirement for collateral support to be provided (rather than an adjustment to the contractual terms) on the occurrence of a material adverse change. However, like *force majeure* provisions, parties seeking to rely on these provisions should ensure that they fall within the four corners of the clause, which may require that any changes be material and of non-transient effect.

There could be **price and/or hardship reviews**. Where a contract price has become dislocated from market trends, buyers may attempt to secure lower prices and more take-or-pay flexibility from sellers in a struggling market. The availability of a price review will, however, depend on the procedural and substantive requirements set out in the applicable SPA.

## The Road Ahead

The COVID-19 outbreak is only one factor contributing to a period of turbulence in LNG markets. While positive steps are being taken to reduce oil production under the OPEC+ deal – which may, in turn, help to stabilise contract price formulas in the months to come – demand side struggles, coupled with the impact of COVID-19 on the global economy, are having a considerable impact on the LNG market.

As with our last bulletin, a detailed legal analysis of the existing bargain is an essential starting point. The contractual landscape may be quite different from that that initially meets the eye and certainly from the original bargain struck, often years previously. Whether contractual frustration or *force majeure* based on so-called economic impracticality caused by increased costs or harsh economic conditions (brought about by, for example, COVID-19) will depend on the contract language, the specific circumstances at issue, and the governing law.[1]

For that reason, this bulletin addresses other mitigation routes parties may try to operate. For market participants evaluating these options, the interpretation of contractual wording may be given more latitude than at first glance. Equally, some concepts, such as reasonable consent or implied contractual terms, may require greater legal unpacking. Commercial LNG supply managers will be familiar with many of these concepts, but it is worth studying the viability and availability of these mitigation routes, to see how they can address the present challenges being faced. Buyers and sellers alike should brace themselves for potential requests for good faith price and volume discussions in the near future.

1 For example, under English law, see *Tennants (Lancashire) Ltd v CS Wilson & Co* [1917] AC 495.

## Contacts

If you have any questions regarding the subject matter of this bulletin, please contact:

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

**Ben Holland**
Partner, London
T +44 20 7655 1176
M +44 773 445 9697
E ben.holland@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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