HFW

LNG BULLETIN
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Welcome to the inaugural edition of the HFW LNG Bulletin.

I am delighted to introduce HFW's first LNG bulletin, with articles from some of our lawyers in Singapore, London and Houston. We begin with a piece from Singapore partner Dan Perera and senior associate Justine Barthe-Dejean, assessing the impact of Russia's invasion of Ukraine on the LNG market and energy security in Asia. I have written an article on how to minimise the risks involved in trading in such a volatile market. Force majeure declarations are a topical issue in the LNG sector and London partner Brian Perrott and Knowledge Counsel Amanda Rathbone reflect on two recent judgments in our third piece. Glenn Legge, a partner from our Houston office, has provided a helpful update on the regulatory response to the booming LNG sector in the US and we finish with a piece from London partner Adam Topping and associate Colin Chen on EU emergency regulation to tackle high gas prices and volatility. We hope you enjoy reading them all.

We welcome your feedback so please do not hesitate to share comments or suggestions for future content.

Wishing you a Merry Christmas and a very Happy New Year.

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THE LNG MARKET AND ENERGY SECURITY IN ASIA

The world's energy markets are so globalised and regionally interlinked that changes in one region can have a huge effect in another. In this article, we consider the impact of the Russian invasion of Ukraine on the LNG market in particular and energy security in general in Asia.

Context

Many countries – including in Asia - have sought recently to move away from burning low net calorific value energy coal as the core of their national energy supply. This is for a number of reasons, including better air quality experienced during COVID lockdowns; the weight of nationally determined contributions for greenhouse gas emissions reductions under the Paris Agreement; and the challenges now associated with seeking regulatory approvals or financing for coal production projects.

Whilst also a hydrocarbon fossil fuel which is certainly responsible for the generation of greenhouse gasses in its production, transportation, storage and consumption. LNG is nonetheless significantly less environmentally unfriendly than older generation fuels such as coal or oil. In addition, recent technological developments (particularly in respect of floating storage and regasification units, or FSRUs) have considerably reduced the cost of installing technically complex LNG receiving terminal infrastructure. These factors have led to LNG becoming the 'interim' fuel of choice for energy transition purposes in Asia, and beyond.

It is now widely anticipated that LNG will continue to bridge the gap between 'dirty' hydrocarbons and 'clean' energy sources that are not yet sufficiently advanced to meet global energy requirements. This transitional role looks likely to last – by design or by necessity - for many years to come, as borne out in practice by many Asian nations including Pakistan, Thailand, Sri Lanka and the Philippines looking to construct new complex and expensive LNG receiving facilities to alter their national energy mix going forward. This can only reasonably be viewed as a medium- to long-term investment strategy, given that such facilities cost hundreds of millions to billions of dollars to construct or assemble.

Impact of the Russia-Ukraine conflict

Against this backdrop, there are many ways in which the Russia-Ukraine conflict has had a significant impact on the LNG market and on energy security challenges in Asia. We consider a few below.

- Russia was widely anticipated to be one of the world's largest future sources of production and supply of LNG. Global sanctions imposed on Russia have had a significant effect on its technical and financial ability to proceed with the construction and implementation of scheduled gas liquefaction projects.
- While many Asian states have not necessarily implemented energy sanctions against Russia themselves, many other states, or blocks such as the EU, have. This has had a significant impact on parties' ability to either produce or lift LNG cargoes in Russia, as well as on the construction of liquefaction facilities. Such processes are complex and may well require the involvement of third parties that are subject to sanctions, including international survey companies; vessel owners and operators; and banks necessary for the establishment of the high value security instruments commonly used in international LNG sale and purchase. As such, even where Asian parties are legally free and clear from applicable sanctions and want to lift Russian cargoes, doing so is not necessarily that simple.
- Some Asian market participants are struggling with the potential reputational impact of continuing to purchase Russian LNG, or of participating in Russian upstream LNG projects. The impact on those projects of the Russia – Ukraine conflict is still playing out but as a minimum, intended purchasers from them, or parties retaining

equity stakes in them, may be subject to significant scrutiny from the international community and risk a potential reputational impact or, worse, international counterparty boycotts, or sanctions breaches. It is still too early to assess the full effects of this situation; time will tell.

- Europe is now diversifying its own energy mix and moving away from what has been shown to be a significant overdependence on Russian pipeline gas. This is likely to involve the construction of multiple new LNG receiving terminals (including many FSRUs) across coastal Europe, capable of receiving LNG shipments from North Africa, the USA, the Middle East, or further afield. It is anticipated that Europe will import up to 40% more LNG this winter than it had done last year. While import storage is presently at or around capacity, as demonstrated by queues of LNG carriers seen offshore key receiving terminals, a particularly cold winter may see those stocks depleted more rapidly than envisaged, and with limited opportunities available to secure additional unallocated capacity.
- To exacerbate the situation, there have also been some unexpected shortfalls in supply from certain major LNG production facilities globally, including for reasons of force majeure, and construction delays to new liquefaction facilities.
- The consequence of the above is that many LNG cargoes which would have otherwise made their way to Asia have now been diverted to Europe. It has been widely reported of late that a tender for the supply of LNG for 6 years issued by Pakistan LNG Ltd. received not a single response.

Outlook

In simple terms, all this (and more) has led to a scramble for LNG – particularly so in Asia. This is most obviously reflected in the market price of LNG, which has rocketed, with spot prices rising more than 1,800% in the last 18 months or so. Asian states that were previously heavily reliant on coal and oil are looking to sign up to long term LNG sale and purchase arrangements, with mixed results. Europe is looking to do the same, and has been taking supply away from Asia. There is potential for a major energy security issue to arise for many Asian states, in circumstances where global analysts had anticipated an oversupply of LNG for the next few years or even decades. We have seen the brutal reversal of that assumption in a tremendously short period of time, and certain states in Asia are now suffering from energy shortages and we have seen some recent blackouts in the region. While Asia may well struggle through this winter with its existing inventory and firm supply commitments, there are already significant concerns about how things will be looking this time next year.

Other, broader LNG market developments have added to the legal complexity of some trades and shipments. These include the move away from traditional ‘tram line’ production facility to end buyer trade routes, and the influx of proprietary traders in the LNG space. It is now not uncommon for an individual LNG cargo to be traded multiple times on the water. The LNG space has become a fertile one for disputes, as borne out by the significant range of issues on which we have, increasingly, assisted our clients over the last few months and years.

From a legal perspective, aside from the sanctions issues which will undoubtedly remain relevant for some time, the consequence of all this is that significant disputes are now emerging in the global LNG markets. These may relate to participation in upstream production projects; shortfalls in supply; or non-performance of individual cargoes. Declarations of force majeure are now more likely to be carefully scrutinised and possibly challenged, potentially aided by recent English case law on the issue of tendering alternative methods of performance when an envisaged primary method is impacted by force majeure. The exponential growth in the value of individual LNG cargoes means that such disputes are now too big for parties not to contest them. In the same way, pricing disputes under long-term LNG sale and purchase agreements are set to increase in both volume and value, with many more of these likely to be submitted to price review arbitration globally. The issue of wilful default and the favouring by suppliers of new business over old (or, higher prices over lower) has also reared its head once again, and this gives rise to some interesting questions regarding liquidated damages; limitation of liability; and duties of good faith in performance, in contracts governed by English law.

The Russia – Ukraine conflict has significantly exacerbated existing issues with the result that increasing energy security concerns and challenges in Asia will give rise to greater complexity and more disputes in the LNG space going forward.

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LNG BOOM – HOW TO AVOID THE PITFALLS AS PRICES SKYROCKET

With commodities markets currently experiencing extreme price fluctuations, commodities traders face difficult challenges, both in terms of ensuring that their contracts remain profitable and due to the increased risk of their counterparties being either unable or unwilling to perform their contractual obligations.

What is happening?

Over the last 12 months global energy markets have been making the news because of huge increases in prices, none more so than gas prices, which have been significantly affected by the ongoing war in Ukraine.

Given the uneven nature of the post-pandemic economic rebound, the impact of energy transition and continuing geopolitical tensions, it seems likely that commodities prices will continue to move unpredictably and significantly.

Where there is significant price movement between the date of contract and the date of delivery, there is a risk that a commodity contract becomes unprofitable for either a trader or their counterparty. This can expose traders to financial risk for their own business, or to the risk that their counterparty defaults, either because the contract has become commercially unappealing or because of insolvency. In the LNG market, for example, cargoes have seen a fourfold increase in prices over the last 2 years. Even the most resilient buyers will struggle to absorb that level of rise.

How can traders protect themselves?

In the current extreme trading environment, not all of the usual "common sense" measures are capable of offering cast-iron protection. Hedging against price fluctuation is much more difficult in an unpredictable market. And whilst traders may opt to limit their exposure by increasing their activity on the spot market for new contracts, many are already locked into existing longer-term contracts. We identify below some of the steps available to traders, noting limitations where appropriate.

1. Credit checks

It is common for sophisticated commodities traders to carry out credit checks and other due diligence on their counterparties, particularly for longer term, higher value or higher risk trades. Such processes are even more important in the context of today's market, in which circumstances can change rapidly and a previously reliable party's creditworthiness may be affected suddenly or unexpectedly. As cargoes increase in size and value, credit checks will need to be renewed and assessed.

Furthermore, where previously the LNG market was dominated by a relatively small number of sophisticated players with contracts negotiated over a considerable period of time, in the last few years the LNG market has seen a number of new market entrants and the development of a spot market. This will inevitably lead to more issues in respect of the creditworthiness of counterparts.

2. Credit insurance

For similar reasons, credit insurance may be a prudent option for higher value or higher risk trades, even in the face of increased premiums.

3. Payment guarantees

Payment guarantees are simple in principle: if you are concerned about your buyer's creditworthiness, you can require that another party guarantees their payment obligations. However, this offers effective protection only if the guarantor (e.g., a parent company) is themselves good for the money and so carrying out credit checks on both is advisable. It will also depend upon the terms of the guarantee and careful drafting is therefore critical.

The best protection is offered by a demand guarantee (such as a standby letter of credit) which is a "primary" obligation, enforceable independently of the sale contract. A standard guarantee is less effective because it is a "secondary" obligation, only enforceable if the beneficiary can demonstrate breach of the payment obligations under the sale contract

– which can give rise to challenge, dispute and a delay in recovery

4. Payment clauses

It is common in most LNG contracts for the payment mechanism to be that the buyer pays the seller by direct wire transfer approximately 10 days after receipt of the invoice from the seller (which is issued after loading / unloading and testing analysis is complete). This obviously runs the risk of the buyer not paying. Consequently, we are now seeing more LNG traders requiring payment via a documentary letter of credit, which will offer more protection to the seller.

5. A 'pre-mortem' on key clauses

A counterparty seeking to walk away from a contract made unprofitable by market movement is likely to look to particular clauses to offer an escape route. These include termination rights; description and quality clauses giving rise to a right to reject; and force majeure provisions. For some trades, it will be appropriate to carry out a 'pre-mortem' on those clauses. This is undertaken before the contract commences to identify what could happen to put the contract at risk by a counterparty relying on one or more of those clauses. It is then possible to plan ahead to prevent or mitigate against those risks and increase the chances of the contract's successful completion.

Particular attention should be given to "Failure to Deliver" clauses and the limitations of liability these include. It is common in LNG agreements to see the seller attempt to limit its liability for failure to deliver by imposing a cap on its liability of between 20% to 50% of the contract sales price multiplied by the quantity that is not delivered. Some sellers are taking advantage of such liability caps to breach their delivery obligations deliberately and instead obtain a higher price in the spot market. Buyers should review closely the terms of these clauses to ensure they have sufficient protection in the event the seller fails to deliver.

6. Ipso facto clauses

'Ipso facto' clauses are relatively common in commodity sale contracts and permit the termination of a contract due to a party's insolvency. However, the local laws in certain jurisdictions including the UK, Australia, Singapore, and the USA will affect the enforceability of such clauses. Traders should therefore seek advice as to whether an ipso facto clause will offer them the protection they expect in the event of counterparty insolvency.

7. Stress test your price clauses

Despite the volatile commodities markets, it is surprising that we still see a number of fixed price clauses, even in LNG contracts. More sophisticated counterparts will have a pricing clause that moves and adapts to the changing markets. These will also be supplemented by price review clauses that will allow either party to request changes to the pricing mechanism in cases where the market position has moved away significantly from the original intention of the parties.

Some standard price review clauses may not be adequate to deal with the current volatility. Taking action to remedy this could avoid exposure. We have advised a number of parties to existing long term contracts seeking to renegotiate such clauses.

Conclusion

It is possible to take early action to protect against the impact of such a volatile market and to minimise or prevent the risk of contract defaults and we are actively advising clients on these issues

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A CHALLENGING ENVIRONMENT: FORCE MAJEURE IN THE LNG MARKET

With the LNG market booming, the dramatic escalation in prices over the last two years will place some buyers under tremendous financial pressure. Conversely, some sellers may feel constrained by the more conservative pricing levels to which they are committed in their existing long-term contracts. In such circumstances, it is inevitable that some parties will look for a contractual escape route from their agreements - and we are already seeing evidence of this in the market. One option parties typically consider is to rely on a force majeure (FM) provision in order to avoid or suspend performance of their contractual obligations. Two recent FM cases are therefore of particular interest, one because it is a reminder of how difficult it can be successfully to claim FM and one for its controversial outcome.

Case number one – a straightforward decision.

Against the backdrop of the global pandemic, in *NKD Maritime Limited v Bart Maritime (No. 2) Inc*[1] the High Court was asked whether the Indian Government's implementation of COVID-19 restrictions constituted a FM event.

NKD Maritime (the "Buyer") and Bart Maritime (the "Seller") entered into a contract for the sale of a vessel (the "MOA"). The MOA contained an FM provision which permitted either party to terminate in the event that they were unable to perform because of, among other things, "*restraint of governments*". The onset of Covid-19 restrictions, first in relation to vessel documents required on arrival and then subsequently, a full lockdown imposed by the Indian Government, caused several delays. The Buyer tendered a notice of termination pursuant to the FM clause, on the basis that the Seller could not transfer title to the vessel. The Seller rejected the notice, claiming that it in fact constituted a repudiatory breach of the MOA, which the Seller accepted.

The Court held that whilst the reason for the FM event – "*restraint of governments*" – applied, the restrictions had only delayed the Seller's performance and not rendered it unable to perform. Therefore, no FM event had occurred.

This is what might be considered a "classic" FM case and is a good reminder that the English Courts will not lightly uphold an FM claim to allow a party to escape its contractual commitments. It is challenging successfully to rely on an FM clause to excuse performance. A party seeking to do so must take great care to ensure that all requirements of the clause have been met before triggering it, or risk finding itself in repudiatory breach, as the unfortunate Buyer did here.

This is all the more pertinent in the current market where, given the enormous sums of money at stake, any party to an LNG contract wanting to claim FM should expect their counterparty to seek every opportunity to challenge them.

Case number two – a controversial decision

In *MUR v RTI Shipping Ltd*[2], MUR as owners and RTI as charterers entered into a contract of affreightment ("COA") which contained an FM clause. This provided that either party could claim FM where (among other things) an event was outside their immediate control; prevented or delayed the loading of the cargo at the load port and/or the discharge of the cargo at the discharging port; was caused by restrictions on monetary transfers and exchanges; and could not be overcome by reasonable endeavours from the affected party.

RTI's parent company subsequently became subject to US sanctions and MUR invoked the FM clause, arguing that the sanctions meant they could not accept payment in US dollars as the COA required and that it would result in a delay in loading and discharge. RTI argued that the

"The decision of the High Court had the benefit that the exercise of reasonable endeavours was linked to contractual performance, which offered some clear boundaries."

FM event would not delay MUR's performance and could be overcome by reasonable endeavours if payment were made in Euros. It also offered to bear the cost of any currency conversion so that MUR was not out of pocket.

RTI brought a claim in arbitration at which the tribunal found in their favour. Following consideration of the terms of the relevant sanctions, the tribunal held there would likely have been delay resulting from payment in US Dollars, which fell within the FM clause. However, the tribunal found in RTI's favour on the basis that the FM event could have been overcome by reasonable endeavours and with no detriment to MUR. MUR appealed.

In the High Court, the judge held that the exercise of reasonable endeavours by MUR could not require it to accept performance that was inconsistent with the express terms of the contract (ie. non-contractual performance) which required payment in US Dollars. RTI appealed.

By a two to one majority, the Court of Appeal reinstated the decision of the arbitration tribunal, finding that reasonable endeavours to mitigate against a FM event can extend to accepting performance that is strictly inconsistent with the contract, so long as no detriment is suffered in doing so.

The different outcomes at each instance and the presence of the dissenting judgment in the Court of Appeal judgment are indicative of the controversial nature of this decision. The decision of the High Court had the benefit that the exercise of reasonable endeavours was linked to contractual performance, which offered some clear boundaries. The Court of Appeal's approach raises genuine challenges for commercial parties seeking to claim FM, who may now find themselves caught between a counterparty trying to find a way to make them perform and uncertainty as to the lengths to which they must go to show they have exercised "reasonable endeavours". This challenge will be particularly acute where the reason for the FM claim is the risk of a breach of sanctions, which parties are understandably keen to avoid.

It is not yet clear whether this decision will go to the Supreme Court for further consideration.

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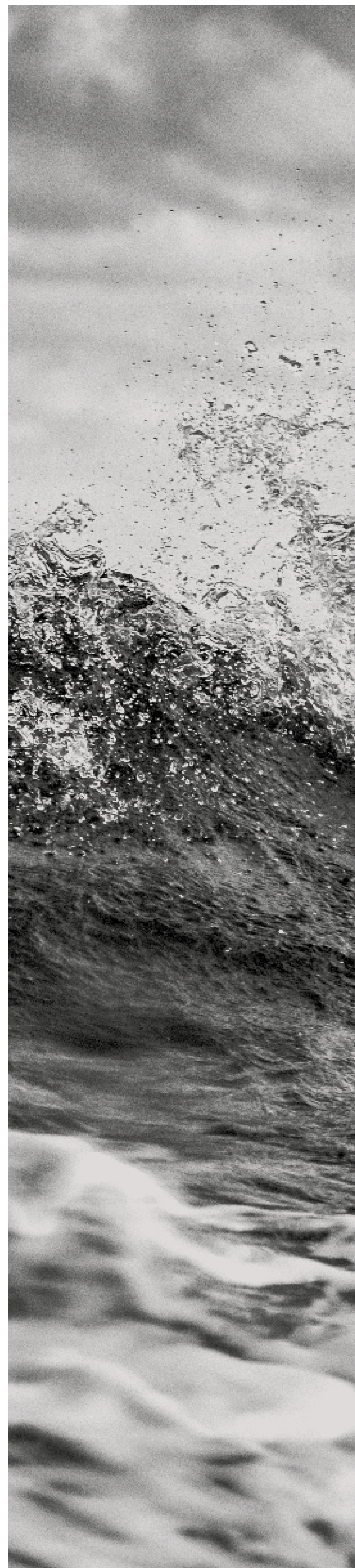
Footnotes:

1 [2022] EWHC 1615 (Comm)
2 [2022] EWCA Civ 1406



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REGULATORY DEVELOPMENTS IN RESPONSE TO RAPID GROWTH OF LNG SECTOR IN THE US

The US Pipeline and Hazardous Materials Safety Administration ("PHMSA") is the lead regulator tasked with protecting people and the environment by ensuring the safe transportation of energy products. The PHMSA has an internal Liquified Natural Gas Research and Development ("R&D") Group that addresses developments in the LNG industry and any "research gaps" that may occur as technology continues to evolve.

On November 15 and 16, 2022 the PHMSA LNG R&D Group sponsored a meeting and forum to encourage discussion about public concerns relative to the rapid expansion of natural gas production and LNG operations in the US. The stated intent of this forum was to share the *"PHMSA's goal of advancing knowledge and technology in pursuit of improved LNG facility safety."* The scope of this program includes performance-based risk assessment during determination of site location, design, construction, operations, maintenance and fire protection, as well as methane mitigation.

The PHMSA acknowledges that its regulatory oversight will have to adapt to the increase in US LNG export capacity from less than 1 Bcf per day in 2015 to 10.78 Bcf per day at the end of 2020 and up to 11.2 Bcf per day in the first half of 2022. In 2015 total US LNG exports were approximately 28 Bcf to seven countries. In 2021, the US LNG exports were approximately 3,561 Bcf to 45 countries, amounting to 54% of the total US natural gas exports. The US became the world's largest exporter of LNG during the first half of 2022, with an increase in exports of 12% compared with the second half of 2021. According to the US Energy Information Administration, this growth has been driven by three factors: increased LNG export capacity, increased international natural gas and LNG prices and increased global demand, particularly in Europe, as a result of Russia's invasion of Ukraine.[1]

The PHMSA also acknowledges that the transition from diesel to LNG for marine transportation will likely increase the demand for LNG production in the US.

This rapid expansion in US LNG activity has created safety challenges that the industry, and its regulators, must address in a proactive manner. The PHMSA is currently focused on revising certain provisions in the US Code of Federal Regulations (CFR) to make sure that industry advances in the generation and export of LNG is matched by the appropriate safety and regulatory requirements.

The PHMSA is considering industry and public comment concerning the following areas of LNG production and transportation:

- LNG facility design and construction
- LNG facility siting and possible industrial gaps relative to safety
- LNG facility fire and gas detection, emergency shutdown procedures and hazard controls
- LNG operation and maintenance, including best practices, safe work practices, human factors, incident investigation, inspection and testing – with a focus on fugitive and vented methane emissions and controls.

In the last four years, HFW USA has been involved in construction, transportation, logistics and regulatory/contractual risk allocation matters involving various new LNG facilities in Louisiana.

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Footnotes:

1 https://www.eia.gov/todayinenergy/detail.php?id=53159

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ENERGY CRISIS: EU EMERGENCY REGULATION TO TACKLE HIGH GAS PRICES AND VOLATILITY

The European Commission ("EC") has proposed exceptional and temporary measures aimed at addressing high gas prices and ensuring energy security this winter and next. Part of this package includes the development of a new benchmark, which may require traders of liquefied natural gas ("LNG") to comply with reporting obligations.

Background

On 18 October 2022, the EC adopted a proposal for a Council Regulation to enhance solidarity through the better coordination of gas purchases, exchanges of gas across borders and reliable price benchmarks (the "Regulation"). The European Council is currently working towards formal adoption of the Regulation[1]. However, it is not entirely clear whether (and if so, precisely when) the Regulation will come into force since its progress appears to be linked to the agreement of a gas price cap by EU energy ministers and this has only just been announced[2].

The Regulation contains a wide-ranging package of measures, which primarily relate to: (i) joint purchasing and the efficient operation of gas infrastructure; (ii) security of supply; (iii) action on gas price levels; and (iv) reducing price volatility.

One key aspect of the Regulation involves the development of a new benchmark for LNG imports into the EU, an underlying objective being to increase price transparency. In Europe, many gas contracts are indexed to the Dutch Title Transfer Facility, a virtual gas trading platform. Hub indexed pricing continues to be highly influenced, however, by infrastructure bottlenecks and pipeline supplies, including supplies from the Russian Federation in particular. In light of this, there has been recent doubt as to the representativeness of market indices.

LNG price assessment and benchmarking

Under the draft Regulation:

- The European Agency for the Cooperation of Energy Regulators ("ACER") has been tasked with producing an objective price assessment tool in respect of the EU's LNG imports. This would broadly involve ACER collecting and processing real-time information on all daily transactions relating to LNG deliveries in the EU.
- ACER will be given powers to collect transaction data for the purposes of establishing a comprehensive and representative price assessment of LNG deliveries. This represents an expansion of ACER's pre-existing responsibilities and powers under the Regulation on Wholesale Energy Market Integrity and Transparency ("REMIT") regime.[3]
- ACER is to produce and publish a daily LNG benchmark. This will be based on the spread between the daily LNG price assessment and the daily settlement price for the Title Transfer Facility Gas Futures front-month contract published by ICE.
- The benchmark will rely on the same day reporting of LNG trades, which is expected to cover, in general, bids, offers or transactions: (i) that specify delivery in the EU; (ii) that result in delivery in the EU; and (iii) in which one counterparty re-gasifies at an EU terminal ("LNG trading"). The Regulation shall apply to any legal or natural person who engages in LNG trading, irrespective of where that person is incorporated or domiciled (an "LNG market participant").

In comparison, REMIT applies, broadly speaking, to any person that is entering into transactions for wholesale energy products[4] (a "market participant"), where delivery is in the EU, and irrespective of whether the person is an EU entity. The definition of an LNG market participant under the draft Regulation therefore appears to be wider than the definition

of a market participant under REMIT. By way of illustration:

- In relation to REMIT, LNG transactions with an EU delivery point are wholesale energy products. Transactions on DES terms (or other terms where physical delivery occurs at an EU port of destination) are within scope of REMIT, whereas those on FOB terms (with delivery and risk transferring at the port of shipment) are outside scope.
- In relation to the draft Regulation however, it appears, at least on the face of it, that FOB transactions may constitute LNG trading which is subject to reporting obligations.

In the context of the price assessment and benchmarking provisions in the draft Regulation, the main obligations that LNG market participants will have will involve reporting a broad range of specified transaction data to ACER on a daily basis and in specified formats. Such LNG market data is to include, for example, information relating to contractual quantities and values, transaction prices, delivery terms and timings.

Why is this significant?

When the Regulation comes into force, ACER will be obliged to publish a daily LNG price assessment from no later than 2 weeks after the Regulation comes into force. ACER will also be required to publish a daily LNG benchmark by 31 March 2023 at the latest.

With that in mind, LNG market stakeholders who may potentially fall within scope of the Regulation should monitor its progress and consider their contractual and commercial arrangements as appropriate:

- to understand whether they are likely to be subject to the reporting obligations imposed by the Regulation; and, if so,
- to determine what steps will need to be taken in order to ensure regulatory compliance.

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Footnotes:

1. https://eur-lex.europa.eu/procedure/EN/2022_339.
2. Emergency measures for energy crisis in limbo after pressure for price cap – EURACTIV.com
3. Regulation (EU) No 1227/2011 and Commission Implementing Regulation (EU) No 1348/2014.
4. “Wholesale energy products” includes related derivatives.

HFW has over 600 lawyers working in offices across the Americas, Europe, the Middle East and Asia Pacific. For further information about our commodities capabilities, please visit hfw.com/Commodities.

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