

Client Alert

November 2012

Impact of U.S. Shale Gas on Existing LNG SPAs

Current top concern to Asia's LNG buyers and sellers

The main issue exercising the minds of Asia's LNG sellers and buyers is what will happen to their current LNG sale and purchase agreements (SPAs), which are priced based upon the Japan Crude Cocktail (JCC), as cheaper (Henry Hub-linked) shale gas imports start to flow into the region from North America.

Buyers will be under pressure to "close the gap." At the same time sellers are concerned to maintain the prices based on which they made the decision to develop their LNG projects.

SPAs differ, depending upon the LNG SPA model preferred by the seller - in effect the operator of the project. However, most SPAs contain two provisions of relevance to the current issue.

Price review clauses

The existing Asian SPAs are usually for terms of between 10 and 20 years. While prices are invariably linked to the JCC, the contracts often reduce price volatility by building floors and caps (or "s-curves") into the pricing mechanism.

The contracts also usually (but not inevitably¹) contain a price review provision, which may consist of several elements.

Where the buyer is a foundation buyer, the review clause will often contain a "most favored customer clause" such as:

The price paid by the buyer shall not be materially higher than that paid by other buyers from the project.

Such a clause is often accompanied by a most favored supplier clause:

The price paid by the buyer shall not be materially less than the price paid by the buyer's other suppliers.

These clauses would not give relief to the buyer when cheaper North American shale cargoes become available.

Of more relevance is the market parity clause, which seeks to ensure that the price will not be out of line with a particular market.

¹ Giving up on the right to review is sometimes part of the bargaining process on the pricing mechanism - e.g. there is an increased discount of the JCC in consideration of no price reviews.

The price shall be based on the pricing of similar sales [into Japan][into the North Asian market].

Sometimes the comparison is made against current imports into Asia/Japan, sometimes against new long-term contracts into Asia/Japan and sometimes both tests are applied.

The SPA usually provides that the review takes place at specified intervals (e.g. every five years) but in some cases it occurs when requested by one of the parties. Often the test includes a materiality threshold, e.g. requiring that the party seeking to reopen the price establish that it is materially worse off.

Questions which arise in practice include: whether the trigger to bring the clause into operation has been met², whether only the discount factor to JCC or the whole pricing mechanism is to be reviewed³, and what happens if the parties do not agree.

The answer to the latter point depends upon the wording of the contract. Some contracts provide the matter will be decided by arbitration. Some make it clear that if no agreement is reached there will be no change. Often, however, the review clause is such a sensitive matter in negotiations that the parties, consciously or unconsciously, leave the question open. In this case the wording of the disputes clause becomes key. For example does it cover disputes only or also failure to agree?

Asian SPAs are almost always governed by either English or New York law. English courts in particular tend towards interpreting contracts literally and avoiding allowing the court to fill the gaps, and arbitral tribunals are supposed to apply the governing law. On the other hand, courts and tribunals also tend to take account of the fact that in entering the contract one party may have relied upon a particular set of circumstances that were known to both parties. It will be interesting to see how these factors play out in the Asian LNG SPA context.

Hardship clauses

Most long-term SPAs also contain some kind of hardship clause. Hardship clauses differ from review clauses in a number of respects.

Rather than being triggered at a specific point in time, as is often the case with price review clauses, hardship clauses can be triggered at any time if a specific test is met, such as:

Upon a substantial change in circumstances resulting in one party suffering substantial hardship.

² The court in *Esso Exploration & Production UK Ltd v Electricity Supply Board* [2004] 1 All ER (Comm) 926, found that such a threshold had not been met because no comparable market was available at the time.

³ In *Gas Natural Aprovevisionamientos, SDG, S.A. v. Atl. LNG Co. of Trinidad and Tobago*, 2008 US Dist. LEXIS 69632 (S.D.N.Y. Sept. 16, 2008), the court upheld the rights of the arbitral tribunal to substitute a completely new pricing mechanism.

The clause usually provides for a review of all provisions of the contract causing hardship, not just the price.⁴

Some contracts make it clear that the obligation is to discuss only; if no agreement is reached the matter is not subject to arbitration. Other contracts are ambiguous on the point, consciously or unconsciously.

What is likely to happen in the market?

While the parties to the Asian LNG SPAs will no doubt attempt to resolve the price gap problem through commercial negotiation, the issue is of such importance that the negotiations will inevitably take place against the backdrop of the parties' views of their legal rights.

It is hard to see how cheaper imports of LNG from North America would fall within the most favored customer clause. Such imports should, at least at first sight, trigger the market parity clause, but this depends upon the actual wording of the clause. If for example the clause requires a comparison with "similar sales" the seller may argue that only sales from e.g. Australia are "similar". Another issue will be timing - at what point will lower priced imports be sufficient to have in effect changed the market?

If the market parity clause does not apply, or the SPA does not have such a provision, the buyer will need to try and seek relief through the hardship clause. One way he may be able to do this is by showing that the regulator has reduced retail power or city gas prices because of the availability of such imports.

As for new contracts, there is a move away from pricing mechanisms based solely upon the JCC and the media reports that buyers are predicting the end of oil based pricing (as we noted in our [August 2012 Client Alert](#), two Japanese utility companies signed deals with Freeport LNG which reportedly use Henry Hub as the main pricing benchmark). Price review clauses are also likely to change, with the realization that they have not met the needs of the changing market.

Latest non-FTA applications

Three projects in the U.S. recently filed applications with the DOE for approval to export LNG to non-FTA countries, including Japan, which brings the total number of pending non-FTA applications to fifteen. This indicates continued interest in projects to export natural gas produced from shale gas ahead of the U.S. presidential election this month.

- On September 21, 2012, CE FLNG, LLC, an affiliate of privately-held Cambridge Energy Group Limited, applied for authorization to export up to 8 mtpa from its proposed floating terminal to be located in nearshore Plaquemines Parish, Louisiana.
- On October 5, 2012, Excelerate Liquefaction Solutions I, LLC, an affiliate of privately-held LNG importer and marketer Excelerate Energy, LLC, applied for authorization to export up to 10 mtpa from its proposed terminal to be located in Calhoun County, Texas.

⁴ In fact some contracts provide that the hardship provision will not apply to price.

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- On October 26, 2012, Golden Pass Products (GPP), a venture between Exxon Mobil (NYSE: XOM) and Qatar Petroleum, applied for authorization to export up to 15.6 mtpa from a proposed facility to be located next to its existing import terminal in Sabine Pass, Texas. As we reported in our [September Client Alert](#), GPP previously announced its intent to submit this non-FTA application when it submitted its FTA application on August 17, 2012.

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