Mitigating Risk In US Liquefied Natural Gas Contracts

By **C. Thomas Kruse** (August 14, 2023)

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Liquefied natural gas, or LNG, continues to be globally prized as a fuel and feedstock in the energy, petrochemical and other industries, including as a basis for hydrogen production.

Given its many potential applications, LNG is viewed as a key component even in plans for a transition to green energy in the U.S. and abroad — including in Europe and Asia, the largest expected consumers of LNG.

For years, Asia was expected to be the largest consumer of new LNG as markets grew; suddenly, Europe also joined as a major target for sales of LNG and a scramble has begun to meet demands on several continents.

In February 2022, the sudden conflict in Ukraine starkly reminded the world that natural gas is also a strategic commodity. The International Energy Agency declared in October 2022 that the reduction in natural gas supplies, including LNG, became the world's first truly global energy crisis,[1] as demands for gas would now arise in Europe and Asia simultaneously.

Despite projected demand increases coming out of COVID-19, the markets for LNG became even more volatile in 2022 with effects from political events, economic shifts and government policymaking.

European sanctions against Russia also forced many buyers in the last year to seek out new ways to import LNG as an alternate source of natural gas at the same time demand has been rising for imports of LNG into Asia.

This dual increase in demand, both in the East and West, will present challenges for suppliers, including logistical, economic and most critically, on the legal front.

These will include navigating a minefield of supply, demand and price fluctuation challenges through supply, storage and transportation contracts broad enough to mitigate risks for buyers and sellers. Increasingly, this is a U.S. legal problem.

By the beginning of 2023, the U.S. became the world's largest LNG producer by installed capacity due to increased investments and government approvals of new terminals.[2]

Investors are flocking to the LNG supply and sales market, with even Berkshire Hathaway Inc., led by Warren Buffet, buying a majority interest in an LNG export facility on the East Coast in July.[3]

Permits from the Federal Energy Regulatory Commission and other agencies have increased and many have gone through litigation challenging the opening of export facilities, such as a major project in Alaska for LNG export in May.[4]

Based on the increased activity, this article focuses on the legal implications for U.S. suppliers and buyers in the global LNG market; on key legal issues such as contract negotiations, disputes from failed supply or purchase obligations; and on possible implications of failure or rerouting of deliveries from the contracted destinations.

Recent Volatility

As a direct consequence of the supply squeeze named the new global energy crisis by the IEA, there were immediate shifts to contracting patterns such as length of commitment, pricing terms and remedies for delayed startup or other interruptions in the LNG markets.

LNG buyers signed more long-term contracts than ever before, while companies and even countries that supply LNG rushed to increase their output. While some of the contract terms are novel, many are a return to long-term, locked-in 10-20 year supply contracts in forms such as tolling agreements or take-or-pay arrangements, natural gas sales arrangements that have been present in the industry since the late 1970s.

Also noted by the IEA, these cataclysmic shocks to the market in 2022 and contract patterns were tangible, "with long-term contracts (over 10 years) accounting for around 74% of newly signed LNG contract volumes in 2020 and 84% in 2021, up from an average of 60% in 2015-2019."[5]

The key question: How to mitigate the risks of being locked into these long-terms contracts, or on the flip side, how not to be exposed to sudden price hikes if dealing only in short-term agreements?

Long-Term Contracts

Since production of LNG requires processing, removal of impurities and freezing a gas to a liquid, the costs at LNG export and import facilities renders its price higher than unprocessed natural gas.

As a result, the capital required to set up export terminals and import facilities along with shipping carriers demand long-term financial commitments. These longer-terms agreements, known in the industry as tolling agreements, usually fix a long-term price for the feed gas and the costs of processing and liquefaction for export either on a fixed or variable costs basis.

Usually the U.S. markets peg the prices at an index based on the Henry Hub delivery point in Louisiana.[6] Despite longer contract terms, including tolling agreements or take-or-pay arrangements, an increasingly volatile supply and price environment will likely subject LNG buyers and sellers to increased possibilities of contractual or legal disputes.

Supplies may tighten causing sellers to abandon LNG delivery obligations on long-term contracts in favor of higher-priced spot market sales, a practice that became frequent in COVID-19.

Price volatility may affect the economic feasibility of contracts. Also, government policies, including regulatory focus on decarbonization may affect the timing of export or import facilities coming online and delay deliveries.

To address those legal issues and risk-mitigation strategies facing U.S. buyers and sellers, especially those exporting LNG for use abroad in Asia and Europe, new and older, tested contract provisions can mitigate risk.

A risk mitigation strategy is critical for future contracts since LNG sales are still expected to increase in volume, with projections of U.S. exports alone increasing 152% between 2022 and 2050, per the U.S. Energy Information Administration.[7]

How does a buyer or a seller mitigate against risk in long-term supply contracts? For a long time, including during recent supply interruptions such as COVID-19, contracting parties have relied on legal doctrines such as force majeure clauses, legal impossibility, or damage waivers or limitations in trading and shipping contracts.

The use of these contract clauses can shift risks to buyers or sellers depending upon the negotiated terms, or in fact these clauses can completely waive damages or even allow termination on short term notice if the contracts become economically unfeasible.

However, as the world experienced in COVID-19, major events causing unforeseen price fluctuations can occur quickly and heavily affect contracts. In the U.S., LNG prices at the Henry Hub in Louisiana have moved over the past 52 weeks ending in June, from $14.36/mcf in 2022 to the current $7.33/mcf.[8]

LNG always commands a higher price than natural gas since the cleaning and processing of raw gas into transportable LNG requires processing, cleaning and refrigeration at special facilities. Thus, contractors cope with such rapid price change and the risks involved usually by locking in prices for longer terms.

This incentivizes exporters to accept the risk of investment in LNG facilities both in the U.S. and abroad that are expensive and take long lead times to build — on the import and export side.

In the middle of the European crisis in 2022, Germany even began to build temporary offloading LNG import facilities in its harbors to facilitate the flow of LNG supplies; to justify long-term capital investments, the companies' engineers notably stated that the terminals could also be used later for hydrogen imports to achieve decarbonization goals.[9]

Whether negotiated terms will solve price volatility to achieve resolution in contracts can be best analyzed in light of COVID-19 shutdowns that began in March 2020.

During COVID-19, buyers and sellers of LNG were subject to many events that required or resulted in issuance of force majeure notifications of the inability to deliver or to receive LNG, supply chain shutdowns and even an inability to transport on LNG tankers.

The frequency of litigation and arbitration disputes over force majeure claims on contracts became well-known and caused significant legal expense from 2020-2022.[10]

In future contracting, the experience of the last few years since the COVID-19 shutdowns, combined with the new demand for LNG in the East and West will undoubtedly influence contract habits to lessen the frequency and severity of supply related disputes.

It will also drastically affect choice of venue, form selection and other provisions that may change a party's options on the availability of legal or contractual defenses in the event of an unexpected disruption in LNG supply.

These trends will continue, and as exports increase from the U.S. and overseas markets in the Middle East and Australia, new contracting strategies may evolve, especially with respect to long-term supply contracts.

Short-Term Contracts

Some European buyers are relying on short-term or spot market supplies rather than longer commitments. The IEA, however, warned this summer that a temporary downswing in European demand due to the mild winter in early 2023 "is no guarantee against future volatility and should not be a distraction from measures to mitigate potential risks."[11]

Parties must expressly negotiate those events that constitute force majeure, termination or call for invocation of the impossibility doctrine. Otherwise, parties will face uncertainty and enormous losses if disputes arise, whether in court or in arbitration, on the application of law to the contract.

In the U.S., any claim of a force majeure claim or contract impossibility must be proven by the party claiming an event occurred. That means documentation of shut down events caused by uncontrollable forces, such as regulatory rulings, court-ordered injunctions or other forces that may delay operation or even initial start-up of an LNG export facility.

Yet, the party opposing a force majeure event may have the unlucky choice of choosing long protracted litigation or a quick settlement to keep supplies flowing.

In addition, parties need to be proactive in including limitations or waivers of damages, including liquidated amounts, direct or consequential losses, or other costs, in contracts to mitigate losses.

For example, a lost delivery may cost a buyer ten or even hundreds of millions of dollars to find make up quantities in the international market. Sellers may find themselves in a tempting position to make quick spot market sales at a profit despite a contractual obligation to deliver.

It was not uncommon in COVID-19 for sellers of LNG, and other fuels, to simply issue notices of force majeure or contract termination, in order to resell contracted-for deliveries at far higher spot market prices.

As a result, even under long-term contracts, adequate measures must be taken to mitigate potential damages, or to at least expressly set a range of appropriate damages in the event of an inability to consummate a sale.

Conclusion

These issues will dominate legal work on LNG contracts, potential disputes and even contracted-for forums, such as courts or international arbitration bodies over the next several decades.

With the critical nature of LNG as a fuel, a feedstock and even a next stop in some green technologies to achieve decarbonization, the goal of national policy in the U.S. should be a focus on secure and uninterrupted supply.

Otherwise, investors in exports of LNG or purchasers may simply take their business to other nations that are entering the game as fast as possible to ship LNG to East and West to overcome the new global supply crisis.

C. Thomas Kruse is a partner at Arnold & Porter.

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[2] Reuters, US LNG project approvals on track for record new volumes, June 23, 2023, at https://www.reuters.com/business/energy/us-lng-project-approvals-track-record-new-volumes-2023-06-23/.

[3] Berkshire Hathaway takes control of LNG facility as Buffett ups bet on energy infrastructure, CNBC Markets, July 11. 2023, at http://www.cnbc.com/2023/07/11/berkshire-hathaway-takes-control-of-lng-facility-as-buffett-ups-bet-on-energy-infrastructure.html.

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[5] International Energy Agency, Gas Market Report, Q4-2022, at https://www.iea.org/reports/gas-market-report-q4-2022/.

[6] Breaking down US LNG contract value, June 14, 2021, at http://timera-energy.com/breaking-down-us-lng-contract-value/.

[7] US Energy Information Administration, US Natural Gas production and LNG exports will likely grow through 2050 in AEO2023, April 27, 2023, at https://www.eia.gov/todayinenergy/detail.php?id=56320.

[8] US Energy Information Administration, Price of Liquefied US Natural Gas Exports, reviewed August 3, 2023, at https://www.eia.gov/dnav/ng/hist/n9133us3M.htm.

[9] Germany Announces New L.N.G. Facility, Calling It a Green Move From Russian Energy, NY Times, Sept. 1, 2022, at https://www.nytimes.com/2022/09/01/business/germany-lng-russia-green-energy.html/.

[10] See, e.g., Litigation Trendspotter: In COVID-19, Force Majeure Disputes, Appeals Courts Focus on Cause and Effect, May 31, 2022, at www.law.com/2022/05/31/law-com-litigation-trendspotter-in-covid-19-force-majeure-disputes-appeals-courts-focus-on-cause-and-effect/?slreturn=20230703131946.

[11] International Energy Agency, Gas Market Report, Q2-2023, at https://www.iea.org/reports/gas-market-report-q2-2023.