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Force Majeure Provides Questionable Relief for LNG Buyers as Covid-19 Pandemic

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Buyers of liquefied natural gas with existing payment obligations for previously committed cargo shipments are increasingly looking for opportunities to relieve themselves of their obligations that were part of existing long-term contracts but are finding it difficult to prove that their inability to meet those obligations is due to an event that qualifies as force majeure, such as the lack of a market, rather than economic factors such as low prices, market participants have told Reorg. Economic factors would not qualify as force majeure events, the market participants added.

LNG spot prices in Asia for June delivery are trading at \$1.85/MMBtu, according to Eikon data, from recent highs of \$6.80/MMBtu seen last October amid the demand collapse, causing an excess of supply. A scramble among buyers to push back cargo deliveries, or cancel them altogether, has pushed LNG sellers to offload excess volumes through tenders, according to sources. A case in point is Royal Dutch Shell, which the sources said is offering four cargoes a year from 2021 onward, with an option for a five-year extension.

Given dampened demand for gas and low prices in the wake of Covid-19 lockdowns, LNG buyers across Europe and Asia, including Royal Dutch Shell and Total, have been able to cancel at least 20 U.S. LNG cargoes slated for delivery in June, with about half of those cancellations involving cargo shipments through their seller, Cheniere Energy's Corpus Christi and Sabine Pass LNG terminals, according to sources, but in other situations, canceling cargoes from the buyer's perspective could prove to be more difficult.

In February, China National Offshore Oil Corp., which operates nearly half of the LNG receiving terminals in China, issued force majeure letters, as a buyer, suspending LNG contracts with its suppliers. It has refused to purchase contracted LNG cargoes from at least three of its cargo suppliers, Total, Royal Dutch Shell and Australia's Woodside Petroleum, in addition to Qatargas, which sells the cargo to CNOOC, according to sources. In another instance, Brazilian oil company Petrobras notified its seller, GeoPark, that the Covid-19 pandemic could constitute a force majeure event by temporarily reducing its offtake commitments. However, GeoPark said that the coronavirus pandemic does not constitute a force majeure event under their take-or-pay contracts.

"We're seeing force majeure questions and issues surrounding what the market is going to look like for buyers to enter into long-term offtake agreements right now, as well as dealing with the pricing structure for new off-take contracts," Jim Wetwiska, a partner and trial attorney in the Houston office of Akin Gump, said in an interview with Reorg, pointing to concerns over multiple defaults from buyers as well as worries about liquidity, capital costs and getting new

projects off the ground. If force majeure is exercised, it's really meant to address a short-term bump in the road, and not a permanent solution,” he added.

Force majeure provisions, which are typically found in sale-and-purchase agreements, or SPAs, joint operating agreements, master service agreements, gas gathering and processing contracts and firm transportation contracts, are designed to excuse the performance of certain contractual obligations due to an unforeseeable and uncontrollable event - an “act of God” - that adversely affects one or more aspects of the asserting party’s ability to perform under the contract despite that party’s best efforts to mitigate the impact of such an event. However, the usefulness of a force majeure provision depends on the language of the contract in question, particularly the level of detail regarding what constitutes a force majeure event. Such language may be ambiguous, sources note.

Sources say that force majeure provisions in LNG contracts tend to provide greater insulation to LNG sellers than LNG buyers from certain natural events, such as floods, storms and earthquakes and/or pandemics. For instance, Kinder Morgan subsidiary Natural Gas Pipeline Company of America was compelled to send a notice to its customers on April 29, declaring force majeure due to nonavailability of transport services at the Sabine Pass delivery point in Louisiana after severe storms in the area caused damage to the pipeline. The force majeure was lifted the same day after the pipeline was repaired. Sources expect LNG developers that face a risk of losing buyers to seek force majeure relief against the backdrop of gas shut-ins, non-availability of gas necessary for LNG terminals and/or an inability on the part of facilities to produce LNG for sale, exacerbated by the risk of supply disruptions amid dampened prices.

“If you review the force majeure clauses in most contracts, they are primarily designed to protect the seller from problems at the plant,” Gilbert Porter, a partner in the New York office of Haynes and Boone said.

Buyer Difficulties Due to Take-or-Pay Contracts

Sources note that it is a heavy burden for buyers under take-or-pay contracts to demonstrate that governmental responses to the Covid-19 crisis have directly affected their ability to take an LNG commitment or pay for it.

The buyers’ rights are typically limited to actions such as reducing the amount of LNG they are obligated to take. A Haynes and Boone report released in April states that in many LNG SPAs, there are no termination rights available to buyers that declare force majeure for a prolonged period. However, the sellers have the right to terminate the purchase-and-sale agreement if they think the buyers are seeking to avail force majeure relief as an excuse for not performing.

While certain buyers that are unable unload their cargo at their intended destination(s) may be able to claim relief as a result of a supply glut, government shutdowns and/or quarantines, there exists uncertainty as to whether such events will be viewed as derailing the buyers’ ability to accept delivery of the LNG and pay for it, unless “the contract can be interpreted as expressly contemplating relief for such circumstances,” Haynes and Boone attorneys stated in the report. The report notes that although certain contracts do permit such relief for nearer-term shipments with clearly delineated destinations, those provisions are frequently limited in their impact and tend to exist separately from force majeure provisions. The attorneys also acknowledge that LNG SPAs expressing contemplating payment of tolling fees and/or similar payments for failing to

take the cargo may affect the buyers' ability to invoke a force majeure claim for being unable to accept the cargo delivery.

The difficulty facing LNG buyers is figuring out whether their force majeure declarations are driven by price declines between their time of purchase and the arrival of the tankers at the intended destinations and/or the absence of a need for regasified gas due to a situation of no-demand, lawyers said.

"If it's simply an economic issue [such as low prices], the force majeure and take-or-pay provisions in LNG contracts will likely not prevent the buyer from paying for the shipment due to force majeure," said Willie Wood, an energy litigation and arbitration specialist at McKool Smith PC, citing an expectation of litigation and arbitration over this issue in the coming months.

"It's more difficult [for the buyers] because of these take-or-pay provisions in many LNG contracts that mandate them to pay for their shipment, even if they are not able to take the shipment as they would in routine circumstances," he added, pointing to an attitude among the complaining buyers of switching the take-or-pay model to a "make me pay" position and resorting to defending their position in arbitration or in court.

Differences in LNG contract terms also create a sense of disparity among different LNG buyers who have entered into contracts with the same seller but do not necessarily have the same provisions. Cheniere's 20-year LNG sale-and-purchase agreement with BG Group, which was among Cheniere's earliest customers, and its parent Royal Dutch Shell, which acquired BG Gulf Coast LNG's 20-year SPA with Cheniere, requires BG and Shell to pay a monthly sales charge for gas liquefaction, starting from \$2/MMBtu, if they are to declare a force majeure event. In contrast, some of Cheniere's other buyers, such as Total and Centrica, do not have that construct in their SPAs, meaning they are not required to pay a liquefaction charge in the event of a force majeure declaration.

Additionally, many LNG contracts, such as those involving Cheniere and Freeport LNG, have provisions that warrant an extended force majeure, meaning that some of their buyers looking to withdraw from their agreements will have to wait for a period of about two years before they can exercise their termination rights, sources said.

"FOB buyers are likely going to have a difficult time getting out of their obligations," Gabriel Procaccini, an energy-focused partner in the Houston office of Akin Gump, said in an interview with

Reorg, pointing to the tendency for many of the first wave of U.S. LNG SPAs to be more favorable for sellers, especially given that those contracts were signed at a time when the market was more favorable for sellers.

Growing Concerns

Hedge funds are contacting law firms to develop a better understanding of the intricacies of force majeure and related provisions in LNG-specific SPAs so that they can determine how to price LNG-related securities and model out risks associated with potential nonpayment for six months or longer, according to sources.

During ExxonMobil's first-quarter earnings call on May 1, CEO Darren Woods pointed to the possibility of a shift in the schedules and time frames of LNG projects, some of which have slowed down or been canceled upon getting sanctioned. The coronavirus outbreak has triggered the deferral of a final investment decision for ExxonMobil's Rovuma LNG project in Mozambique, slated for later in 2020, to at least 2021 after the company announced a 30% capex cut in April. On the earnings call, Woods said that the first two phases of development in Guyana, which is another critical area of offshore focus for the company, remain on schedule, but the third phase of development may again be delayed by as much as a year due to a slowdown in government approvals amid the ongoing election process and uncertainty about the next administration.

Exxon had shut its \$19 billion LNG plant in Papua New Guinea and declared force majeure on its exports from the facility in March 2018, citing an earthquake and expected damage to gas field infrastructure and its gas pipeline.

Some sources say that attempts to invoke force majeure are not outside of the realm of possibilities this year and could have immediate impacts. "Many LNG projects are relatively highly levered, every balance sheet is being stress-tested and those projects that have higher cost structures than their peers are at greater risk today," Procaccini said.

Alternatives for Buyers

Decision-makers have the opportunity to decide whether to invoke contract clauses that could result in an aggressive, escalated polarization in positions, Wood of McKool Smith noted.

"What buyers will do is have a dialogue with their counterparties to negotiate for value if they believe the counterparties are not complying with the contracts and vice versa. So, they may grant price relief or get price relief on the shipments and make up for the deliveries at a later time," he said. "They're all looking for price relief and/or logistics relief to get the LNG to the most attractive market."

If a buyer declares force majeure, the seller may find a new buyer to offload the LNG at a lower price than that set in the original contract and charge the price differential to the original defaulting buyer, Wood explained.

Lawyers say that parties to agreements that do not have specific force majeure provisions may still be able to look to the Uniform Commercial Code for suspension of performance. Alternatives to declaring a force majeure event include invoking a material adverse change clause and/or the covenant of good faith and fair dealings that is implied as a matter of law in most contracts. Although the details may differ significantly between contracts, material adverse change clauses are intended to permit a party to exit from the contract or excuse performance if certain negative events that would be considered "material" changes occur relative to the parties' original expectations. The implied covenant of good faith and fair dealings holds that asserting parties that do have rights must exercise them in a reasonable fashion rather than "ghosting" or cutting off the other party in the event of an intent to invoke a material adverse change clause, for instance.