

NAVIGATING THE COMPLEXITIES OF U.S. LNG EXPORT AGREEMENTS: A COMPREHENSIVE GUIDE

12 FEBRUARY 2024 • ARTICLE



With a decreased supply of liquefied natural gas (“LNG”) in Europe, many buyers are increasingly turning to U.S.-sourced LNG. The United States (“U.S.”) exported more LNG than any other country in the first half of 2023, according to data from CEDIGAZ.¹

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It is important to note that global market dynamics significantly influence LNG pricing, with supply-demand shifts, geopolitical events, and policy changes in major consuming countries contributing to price volatility. This underscores the importance of well-structured LNG export agreements.

Bulk LNG export transactions by vessels are typically governed by a master sale and purchase agreement (“MSPA”) between the buyer of the LNG and the LNG export terminal. This article outlines the fundamental components of an MSPA and other legal aspects of exporting LNG cargoes from the U.S.

CRITICAL MSPA CLAUSES, APPENDICES, AND CONSIDERATIONS

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quality and testing. Some of the more commodity-specific clauses, considerations, and appendices to the MSPA are examined below.

a. Confirmation

A crucial component of an MSPA is the “Confirmation” form. Each sale under the MSPA is documented in a separate Confirmation, incorporating the MSPA’s terms. Typically, a Confirmation form is included as an appendix to an MSPA.

The Confirmation form specifies details of each delivery under an MSPA, including the load port, quantity, sale price of the cargo, scheduled arrival period, demurrage rate for the loading vessel, and payment terms. Due to significant transaction values, sellers may require buyers to provide credit support, like a parent guarantee, letter of credit, or other security for each purchase.

For an LNG export facility, berth time is precious. The buyer must ensure that the nominated vessel for lifting the cargo provides pre-loading notices and issues a notice of readiness, indicating it is prepared to load by the scheduled period. The vessel must first dry and cool its cargo tanks, a process that can exceed twelve hours.

b. Price

LNG prices vary; thus, effective risk management strategies are crucial for both buyers and sellers in the LNG market. Buyers typically seek to mitigate the risk of price fluctuations, while sellers aim to manage risks associated with supply commitments. These strategies can include the use of various financial derivative instruments or contractual terms to balance the risks inherent in the LNG trade.

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Parties may opt for a fixed price in their MSPA, or they may choose a spot market price for each delivery. This spot market price often references indices like the Platts Japan Korea Marker ("JKM") or Henry Hub pricing. The JKM is widely recognized as the benchmark price assessment for spot physical LNG cargoes delivered into key Asian markets, including Japan, South Korea, China, and Taiwan. In contrast, Henry Hub, situated in Louisiana, serves as a delivery point for LNG and is a key spot price marker for natural gas primarily in the North American gas market. However, its influence extends globally due to its established position in the energy sector. Parties often prefer JKM for Asian market transactions due to its closer reflection of the supply-demand dynamics in these key LNG-consuming regions.

For buyers receiving cargo in North America and basing their purchases on the spot market, it's common to add a liquefaction fee on top of the spot price. Alternatively, they might agree on a fixed price per million British thermal units ("MMBtu"). Such fixed rate agreements are frequently employed and can extend over several years. In scenarios where the market-driven spot price exceeds the pre-agreed rate, sellers might find it more lucrative to sell LNG on the spot market instead of adhering to the lower fixed rate. To manage and mitigate these price risks, parties employ contractual clauses in the MSPA discussed below, and may also employ hedging strategies. These strategies are typically formulated under standard financial frameworks like the ISDA Master Agreement, which provide structured approaches to offset potential financial fluctuations arising from varying spot prices.

c. Seller's Shortfall or Failure to Deliver

Common in long-term, fixed price MSPAs, is the "Seller's Shortfall" which relates to the seller's failure to deliver the quantity agreed with the buyer, as might occur in a rising LNG price market.

Under each Confirmation, the seller commits to delivering a specified LNG quantity. The Seller's Shortfall clause generally specifies that if the seller fails to deliver the contractual required amount, absent a valid contractual excuse like force majeure, they are liable for any increased costs incurred by the buyer for sourcing alternative LNG, or, alternatively, the buyer may opt for liquidated damages, usually 30-50% of the shortfall multiplied by the contract price.

"Technological advancements in LNG transportation and storage are reshaping the landscape of LNG export contracts. "

d. Buyer's Failure to Take

Typically, a buyer's failure to take occurs when there are difficulties loading the LNG vessel, resulting in excess boil-off and the vessel failing to load a full cargo. To the extent possible, LNG buyers should assure that the vessel charter agreement requires the vessel to load the full amount agreed with the LNG seller or that the vessel interest compensates the LNG buyer for the resulting damages due to the shortfall in the loaded amount.

A buyer's shortfall damages payable to the seller are usually calculated by multiplying the un-lifted MMBtus by the difference between the contract and spot rates.

e. Load Time

LNG cargoes are highly valuable and dock space at facilities is limited. Vessels are typically allotted 24-48 hours at the dock, depending on the facility and vessel size. Loading involves a complex procedure to cool the tanks and cargo lines gradually, avoiding thermal shock and metal failure. If a vessel cannot maintain optimal temperature, it may load less LNG than expected. If the required amount isn't loaded in the allotted time due to non-vessel deficiencies, the seller compensates the buyer for extra time at the dock, usually at a rate of US\$50,000-100,000 per day, prorated.

f. Export Controls and Indemnity

The U.S. Department of Energy ("DOE") oversees LNG exports from the U.S. Historically, exporting to non-Free Trade Agreements ("FTA") countries was prohibited and involved stringent requirements, including tracking LNG to its end use. This was revised in 2015 with DOE Order No. 4322[2], which simplified reporting requirements to focus on the destination countries of the exported LNG, rather than the end use.

LNG MSPAs require that the LNG buyer correctly identify to the U.S. exporter where the LNG was delivered under DOE export regulations. Because a seller's export authorization could be revoked if delivered to a non-FTA country, sellers generally require a report from buyer as to the countries where the LNG is delivered and an indemnity for any damages caused by a faulty or incomplete report.

g. Marine Terminal Liability Agreement

Another key appendix in an MSPA is the Marine Terminal Liability Agreement (“MTL Agreement”), executed by the LNG vessel owner (on behalf of the buyer) and the seller/terminal interest for each cargo. The MTL Agreement apportions risk among the LNG export facility and the LNG carrying vessel. It also covers legal matters, including compliance with regulations, insurance, and vessel and crew suitability.

Liability in the MTL Agreement is allocated based on each party’s fault, with indemnities provided by both sides. Liability for direct or indemnity claims is generally capped (except in cases of gross negligence or wilful misconduct), typically between US\$100-200m.

Claims exceeding the liability limits are managed on a “knock for knock” basis, where each party covers its own employees’ claims (generally for personal injury), regardless of fault. It is essential for parties to validate these clauses with their insurers to ensure coverage remains intact and subrogation against the other party is waived.

h. Technological Advancements & ESG

Technological advancements in LNG transportation and storage are reshaping the landscape of LNG export contracts. Innovations in vessel design, increased efficiency in liquefaction processes, and developments in floating LNG technology are influencing key contractual terms such as load time, delivery schedules, and terminal use.

ESG considerations are becoming increasingly important in LNG contracts. These include factors such as the environmental impact of LNG operations, social responsibility in sourcing and transportation, and governance practices of involved parties. Integrating these factors aligns with regulatory pressures and market expectations.

One example of how technological advances have greatly decreased the carbon footprint of LNG is Carbon Capture and Storage (CCS). CCS is a means of capturing carbon emitted during the production, vessel loading and combustion of LNG. Cryogenic CCS advances this technology by capturing carbon and freezing it in a solid form, making storage and disposal more efficient and secure.

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i. Derivative Contracts

While a detailed discussion of derivative contracts used for hedging LNG prices is outside the scope of this article, it is important to note that agreements for purchasing bulk commodities in the future, like LNG MSPAs, are typically classified as “Forward Contracts.”² Forward Contracts and derivatives used as hedges to mitigate price fluctuations of the underlying commodity, receive favorable treatment under the bankruptcy code.

The derivative for Forward Contracts are generally based on the standard ISDA 2002 Master Agreement and Schedule. The ISDA Schedule usually specifies that hedged transactions under the MSPA are collectively treated as a “Forward Contract” and qualify for the Forward Contract “safe harbor” in bankruptcy.

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More specifically, Forward Contract payments are not subject to be classified as preferences and clawed back into a bankruptcy proceeding. A Forward Contract's automatic termination clause remains valid in bankruptcy and Forward Contracts may not be unilaterally assumed or assigned by the debtor.

The favorable treatment of Forward Contracts lends stability to the parties' expectations and minimizes the risk of widespread disruptions in derivative markets.

CONCLUSION

The dynamic nature of the global LNG market, shaped by regulatory changes, market fluctuations, and technological advancements, requires an understanding of the technical and legal landscape in order to be strategically navigated.

Watson Farley & Williams specializes in providing legal guidance in the energy and shipping sectors. Our team of experienced professionals is equipped to assist you in understanding and navigating the legal landscape of LNG trade.

FOOTNOTES

[1] See The United States exported more LNG than any other country in the first half of 2023, U.S. Energy Information Administration (EIA) (Sept. 12, 2023), <https://www.eia.gov/todayinenergy/detail.php?id=60361>.

[2] Notably, however, the U.S. bankruptcy code provision exempting such contracts from the usual treatment for executory contracts is not applicable to LNG or other commodity futures traded on an exchange or regulated by a clearing organization. Instead, bulk purchases and sales of LNG for delivery are called "Forward Contracts" which are exempt from the standard rules of the bankruptcy code.

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