GUIDE TO ENERGY ARBITRATIONS

FIFTH EDITION

General Editor
J William Rowley QC

Editors
Doak Bishop and Gordon E Kaiser

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This article was first published in July 2022
For further information please contact insight@globalarbitrationreview.com

Published in the United Kingdom
by Law Business Research Ltd, London
Meridian House, 34-35 Farringdon Street, London EC4A 4HL, UK

www.globalarbitrationreview.com

ISBN 978-1-83862-878-9

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

Acknowledgements

The publisher acknowledges and thanks the following for their learned assistance throughout the preparation of this book:

Bennett Jones LLP

Dentons

Doug Jones AO

Edison SpA

Energy Law Chambers

Haynes and Boone CDG LLP

K&L Gates LLP

King & Spalding

Squire Patton Boggs

Twenty Essex

Publisher's Note

Global Arbitration Review is delighted to publish *The Guide to Energy Arbitrations*.

For those unfamiliar with GAR, we are the online home for international arbitration specialists, telling them all they need to know about everything that matters.

Most know us for our daily news and analysis service, but we also provide much, much more – technical books and reviews, conferences and handy workflow tools, to name just a few, that go into more depth than the exigencies of journalism allow. (Do visit us at www.globalarbitrationreview.com to see our full range of output.)

The Guide to Energy Arbitrations, fifth edition, is one such volume.

Because GAR is so central to the international arbitration community, we regularly become aware of gaps in the literature. *The Guide to Energy Arbitrations* was the first example of identifying such a gap and we are delighted at the successful way in which it has been filled, with the help of so many leading firms and individuals, and the enduring appeal of this Guide.

If you find it useful, you may also like the other books in the GAR Guides series. They cover construction, mining, post-M&A disputes, IP, advocacy, damages, and the challenge and enforcement of awards in the same practical way. We also have a citation manual – UCIA (*Universal Citation in International Arbitration*).

On behalf of the whole GAR team, I'd like to thank our editors – Bill Rowley, Doak Bishop and Gordon Kaiser – for the energy they've put into the project, and my colleagues in production for the elan with which they've realised our collective idea.

David Samuels
July 2022
London

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Preface

Economic liberalisation and technological change in the past several decades have altered the global economy profoundly. Businesses, and particularly those involved in the energy sector, have responded to reduced trade barriers and advancement of technology through international expansion, cross-border investments, partnerships and joint ventures of every description.

The move to today's 'internationality' of business and trade patterns alone would have been sufficient to jet-propel the growth of international arbitration. But when coupled with the uncertainties and distrust of 'foreign' court systems and procedures, the stage was set for a move to processes and institutions more suited to the resolution of a new world of transborder disputes.

Not surprisingly, the concept and number of international commercial arbitrations have grown enormously during the past 25 years. Bolstered by the advantages of party autonomy (particularly over access to a neutral forum and the ability to choose expert arbitrators), confidentiality, relative speed and cost-effectiveness, as well as near worldwide enforceability of awards, the system is flourishing. And if a single industry sector can lay claim to parental responsibility for the present universality of international arbitration as the go-to choice for the resolution of commercial and investor-state disputes, it must be the energy business. It is the poster boy of arbitral globalisation.

Led by oil and gas, the energy sector is marked by enormously complex, capital-intensive international deals and projects, frequently involving prominent parties and state interests. Transactions and partnerships are often long-term and involve 'foreign' places and players. Political instability and different cultural backgrounds characterise many of the sector's investments. In short, the energy sector is a natural incubator for disputes best suited to resolution through international arbitrations. And despite recent international trade disputes, Russia's invasion of Ukraine and the appearance in 2019 of the novel coronavirus, all of which have

lead to a degree of restructuring of cross-border investments and supply chains, there is no sign that this will diminish the popularity of (and need for) international arbitration.

Indeed, in the past 50 years or so, following a rash of nationalisations in North Africa, the Gulf States and parts of Latin America, and the lessons learned in 'foreign courts', there is scarcely a major energy sector contract (whether oil, gas, electric, nuclear, wind or solar) that does not call for disputes to be resolved before an independent and neutral arbitral tribunal, seated, where possible, in a neutral, arbitration-friendly place.

The experience and statistics of the major arbitral institutions bear out the claim that the energy sector has driven, and continues to account for, major growth in international arbitration. ICSID is illustrative, where 42 per cent of its caseload in 2019 involved the energy sector. At the LCIA, case statistics for 2019 revealed that the energy and resources sector had the highest number of parties, both as claimants and respondents. Between 2014 and 2015, the Stockholm Chamber of Commerce Arbitration Institute saw a 100 per cent increase in the number of its energy-related cases.

Although much of the evidence of the energy sector's arbitral demand is anecdotal, those arbitrators who are known in the field report growing demand and a steady increase in enquiries as to availability. And having regard to the multi-faceted fallout from the oil price crash of earlier this year, a revival of resource nationalism (which exacerbates the natural tension between energy investors and host states), an ongoing war in Ukraine and a world in which sanctions, as well as the still present covid-19 pandemic, imperil contractual performance, the only realistic expectation is for further reliance on arbitrators and arbitral institutions coping with the disputes that are surfacing daily.

Another driver towards arbitration of energy disputes is the fact that the number of substantive players in the sector is relatively limited. These parties will invariably have multiple agreements, partnerships and joint ventures with each other at the same time, many of which are long-term. These dynamics call for disputes to be resolved by decision makers who are known to and trusted by all, and whose decisions are final. The simple fact about business is that the economic uncertainty associated with an unresolved dispute overhanging a long-term partnership is often considered to be more problematic than getting to its quick and definitive resolution, even if the resolution is unfavourable in the context of the particular deal.

Against this backdrop, when Gordon Kaiser raised the question with me in the summer of 2014 of producing a book that gathered together the thinking and recent experiences of some of the leading counsel in the sector, it resonated

immediately. Gordon was also more than pleased when I suggested that we might try to interest Doak Bishop as a partner in the project. With Doak's acceptance of the challenge, we have tried, in the first four editions of this guide, to produce coherent and comprehensive coverage of many of the most obvious, recurring or new issues that are now faced by those who do business in the energy sector and by their legal and expert advisers.

Before agreeing to take on the role of general editor and devoting serious time to the project, we needed to find a publisher. Because of my long-standing relationship with Law Business Research (LBR), the publisher of Global Arbitration Review (GAR), we decided that I should discuss the concept and structure of our proposed work with David Samuels, GAR's publisher, and Richard Davey, then managing director of LBR. To our delight, the shared view was that the work could prove to be a valuable addition to the resource material available. On the assumption that we could persuade a sufficient number of those we had provisionally identified as potential contributors, the project was under way.

Having taken on the task, my aim as general editor has been to achieve a substantive quality consistent with *The Guide to Energy Arbitrations* being seen as an essential desktop reference work in our field. To ensure the high quality of the content, I agreed to go forward only if we could attract as contributors colleagues who were some of the internationally recognised leaders in the field. The guide is now in its fifth edition, and Doak, Gordon and I feel blessed to have been able to enlist the support of such an extraordinarily capable list of contributors over the years.

The fifth edition of *The Guide to Energy Arbitrations* has been expanded with a new chapter on LNG arbitrations. The remaining chapters have all been updated to reflect developments since 2018.

In future editions, we hope to fill in important omissions, such as the changing dynamics of investment cases under the Energy Charter Treaty, including the consequences of the *Achmea* decision of the European Court of Justice; injunctions against and the setting aside of awards; bribery and corruption; sovereign immunity and enforcement issues; *force majeure* and contractual allocations; issues arising related to sanctions; and intellectual property and insurance disputes in the energy sector.

Without the tireless efforts of the GAR/LBR team, this work not would have been completed within the very tight schedule we allowed ourselves. David Samuels and I are greatly indebted to them. Finally, I am enormously grateful to Doris Hutton Smith (my long-suffering PA), who has managed endless correspondence with our contributors with skill, grace and patience.

I hope all my friends and colleagues who have helped with this project have saved us from error – but it is I alone who should be charged with the responsibility for such errors as may appear.

Although it should go without saying, this fifth edition will obviously benefit from the thoughts and suggestions of our readers, for which we will be extremely grateful, on how we might be able to improve the next edition.

J William Rowley QC
July 2022
London

CHAPTER 7

LNG Arbitrations

Ben Holland and Steven Sparling[1]

Liquefied natural gas (LNG) is one of the great connectors of world trade. It connects territories over vast distances. It connects companies with different cultures and economic interests. It has been commercialised for more than 50 years, and will flourish in coming decades, with substantial growth in its use predicted. It is also the most realistic transition source of energy between the circumstances today and a future where fossil fuels are less readily utilised, due to environmental reasons. It is also the most immediate source of relief from market disruptions brought about by conflict and other (sanctions-related) displacement. It is the best available means for overcoming turmoil in established pipeline gas transportation routes, in the context of global events arising from the position taken with respect to Ukraine by the Russian Federation, the world's largest exporter of pipeline natural gas.

Liquefying natural gas (which involves cooling it to approximately -161°C) allows it to be transported by ship, which has enabled countries with large gas reserves not linked by pipelines to other markets to sell gas around the world. Terminals for receiving and regasifying LNG have been built in many parts of the world, and the market for LNG has grown. LNG plays different roles in different parts of the world. In some markets it is the primary source of gas supply; in others it helps make up for decreases in domestic production; in yet others it balances or complements other sources of gas. Constructing the facilities required to extract, liquefy and export gas such as LNG, including liquefaction trains,

1 Ben Holland and Steven Sparling are partners at K&L Gates. The authors gratefully acknowledge Steven P Finizio and his colleagues at WilmerHale, whose chapter on 'Destination Restrictions and Diversion Provisions in LNG Sale and Purchase Agreements', published in the third edition of this work, provided the framework for sections of this chapter.

requires substantial capital investment. Because of the need to finance these facilities, producers have historically sought to enter into long-term contracts. However, LNG is also increasingly sold through short-term or 'spot' agreements (e.g., a single cargo may be sold) or medium-term agreements (e.g., a number of cargoes or a certain volume of LNG sold over the course of a number of months or several years). In some instances, LNG supplied under a long-term contract may be sold and delivered to customers in different destinations. Companies may also enter into swap agreements to create efficiencies, including through savings on shipping costs.

Historically, most LNG supply contracts have been in the form of long-term sale and purchase agreements (SPAs) with a contract term of 20 years or more, and an option to extend or renew. As noted above, the capital costs for building the facilities and equipment required to extract gas and then liquefy, transport and distribute LNG can be many billions of dollars. At least in part to obtain financing for such projects, producers wanted to contract with buyers who would commit to purchasing substantial volumes over a long time period and who would provide regular revenues.[2] As the long-term contract evolves, disputes arise, particularly as LNG SPAs are often signed many years before first deliveries. A 20-year SPA may be negotiated 25 years before the term of the contract will expire, and it is not realistic to expect that every future circumstance over this extended time period can be foreseen and governed adequately by the drafting. Today, there is far greater reliance on shorter-term contracts, with contracts of five, seven or 10 years becoming reasonably common. LNG is increasingly being sold through even shorter-term contracts and on a spot contract basis. Many new LNG projects are projected to be brought into operation due to world events, and may be pushed forwards in some territories, further increasing the risk of disputes. This chapter considers many of the most repeated sources of tension within these large-scale contractual relationships and their related operations, and how they may lead to arbitration.

Disputes relating to failures to deliver LNG

This section addresses disputes that may arise because the seller is unable, or unwilling, to deliver LNG that it has committed to sell. In particular:

- if a seller misses cargo deliveries, or fails to deliver the agreed volume, including when it has done so in order to obtain a higher price elsewhere;

2 Ben Holland and Phillip Spencer Ashley 'Natural Gas Price Reviews: Past, Present and Future', *Journal of Energy & Natural Resources Law*, Vol 30, No.1, p. 29 (2012).

- disputes arising from a buyer's right to upwards flexibility over the volumes of LNG that it wishes to accept over a given time period, which the seller declines to deliver under;
- reliance by sellers on hardship provisions to decline to deliver LNG; and
- other failures to deliver LNG.

Missed cargoes

In times of high market prices, there is an incentive for LNG sellers to reduce deliveries under long-term and mid-term LNG contracts if the prices under them are cheaper than those available in alternative markets. If so, it has become common for sellers to consider diverting cargoes from long-term supply obligations in order to seek a profit by selling those volumes on the higher-price, often short term, markets. Other disputes have arisen where:

- lower than agreed volumes (short cargo deliveries) are supplied;
- sellers have exercised downward flexibility outside of the agreed operational tolerances; and
- operators of new facilities have delayed the declaration of terminal readiness, with early cargos being sold on a short-term basis at higher prices.

If an LNG cargo, scheduled to be delivered under a long-term contract, is missed and undelivered (or under-delivered) without good cause, a contractual shortfall amount is paid to the buyer to cover the loss that will result from the short delivery. If included, these shortfall (or short delivery) clauses operate, in effect, as a liquidated damages provision. They can be helpful to buyers to the extent that they obviate the need to prove that the buyer has actually suffered any loss at all, or that it has sought to mitigate its loss. If the buyer has not onward-sold the cargo, or has the right to cancel the cargo, then there may be no damages, only the shortfall amount. Without them, the normal starting point is that damages for breach of contract are awarded so as to compensate the innocent party for any loss that it suffers. This claim for damages would be supported by expert evidence based on the replacement cargo value and associated costs and losses. In circumstances where the buyer could mitigate its loss by acquiring substitute LNG to replace those missed cargoes under the SPA, arbitral tribunals will usually expect to see evidence of meaningful attempts to do so. However, these contractually agreed shortfall amounts may not always cover the entirety of the loss faced by the buyer. Shortfall amounts may be based on a percentage of the cargo value, established by reference to the contract price. If the contract price is not sufficiently high, this shortfall amount, when calculated, may fall below the cost of replacement LNG that the buyer may be obliged to source in the open (short-term) market. This

has two effects: the seller can wager that it could find an alternative market for the cargo, pay the shortfall amount arising from the missed cargo and still profit, selling at the current higher market price instead; and the buyer may pay more to replace the expected cargo than the amount it can recover from the seller for its shortfall.

If this is the case, the parties will wish to know whether the shortfall amount is the buyer's sole remedy or exclusive remedy under the SPA, or if other losses of the buyer can also be claimed. This is an area that has given rise to arbitration, as the amounts in dispute will likely be significant, carrying a threat of a heavy damages claim for loss arising from all the original missed cargoes. Likewise, there may be a reasonable uncertainty as to the outcome. This uncertainty is because the language of the SPA may appear to clearly specify that the sole remedy excludes actual losses faced by the buyer, yet principles of the law governing the SPA may operate in a way that fails to exonerate the seller for certain, particularly intentional, breaches. If the seller, in making its decision to miss a cargo, has acted solely or predominantly with the aim of making a profit, in the face of its obligations to the buyer, arguments arise as to whether such conduct forms the basis for wilful default or gross negligence under the SPA. Such provisions often void any caps or other exclusions on remedies, such as the sole remedy provision, and also provisions that operate to exclude indirect loss and/or all loss of income and profits of the buyer. Depending on the language used, wilful default or gross negligence provisions can be challenging to activate, as they act as carve-outs to otherwise excluded losses, and can require evidence that a senior manager or representative has disregarded intentionally, alternatively consciously or recklessly, that party's duty under the SPA. This would require proof of recklessness or knowledge that the missed cargo was a breach of contract, which would likely need to be justified by documents sought during a dispute through disclosure in the arbitration.

Alternatively, a refusal to deliver without good case, or without a valid declaration of *force majeure*, may arguably lead a reasonable buyer to conclude that the seller no longer intended to be bound by the provisions of the SPA, and, consequently, to amount to a breach allowing the buyer to terminate the SPA (under English law, a repudiatory breach). Such a course of conduct may likely be seen on its proper construction as not being covered by the shortfall clause containing the sole remedy restriction, as a missed cargo arguably refers to a situation of short-term unavailability due to various specific physical or related reasons, and does not extend to a situation where the seller has available LNG to deliver and commits a repudiatory breach, or renounces the SPA, or both. Depending on the governing

law, there may also be evidence that a decision to miss a cargo amounts to a failure to employ good faith, or similar duty, under the long-term SPA, which may not protect any seller that has deliberately sought a profit at the buyer's expense.

Regardless of what the buyer's remedies may be, this is one of the many areas within a long-term SPA where the buyer must be wary of seeking a self-help remedy, for example withholding payment on other cargoes, in reaction to the seller's conduct. Even if the seller has caused the commercial disruption in the contractual relationship, this will not likely grant the buyer a right to breach the SPA itself. Doing so, even if the buyer feels that it is taking a contractual step to mitigate its loss arising from the seller's prior failure to deliver, in a way that feels like being a purely reasonable commercial or legal reaction to the earlier breach of the SPA by the seller, may allow the seller to rely on the buyer's default, and to terminate the SPA itself.

Upwards flexibility

Upwards flexibility rights entitle a buyer to take increased quantities of LNG during a particular period. Buyers will be interested in maximising deliveries during times of higher than expected demand (in particular, many Asian buyers periodically seek to achieve this as part of building reserves of LNG for their winter schedule, when demand spikes occur). Some buyers also seek to schedule more LNG supply at times where the contract price under the SPA is favourable to the price of other sources of supply in the market. This is done to build reserves of stored LNG when the price is favourable, or with the aim to on-sell any excess to other markets at a profit. These buyers can face blocks to getting their expected deliveries from sellers. This is because the same market conditions that incentivise buyers to increase deliveries will induce sellers to have the opposite objective. Periods of high demand and high market prices will likely incentivise sellers to seek to maximise spot sales, seeking the highest available price for all produced LNG in preference to their delivery obligations under long-term contracts.

It can be necessary to overcome arguments from sellers that the buyer's upwards quantity tolerance (UQT) rights, which allow it to increase deliveries under the SPA, are inflexible. A buyer may be required to provide a fixed period of notice before being able to receive increased quantities. Schedules may be set far in advance and prove hard to alter without agreement by the seller, which restricts the buyer's ability to respond to sudden demand shocks. Sellers routinely challenge the notifications provided, in particular whether these requests are made in time, or with sufficient clarity, or whether there are any restrictions on the use of UQT that apply. Buyers that have used downwards volume rights in recent years to reduce deliveries over past time periods, and which are later trying

to exercise 'make good' LNG deliveries, can face further restrictions. If the buyer is in deficit from previous years, it will normally be encouraged to use its rights to increase deliveries in order to catch up, but the contractual framework to do so may be restrictive. There may be a lack of precision as to what is required of both parties under the SPA. All of these issues have given rise to disputes.

Hardship for sellers

If the seller is unable to produce and deliver LNG because a structural market change or upheaval has reduced its ability to produce and deliver the LNG called for under the SPA, and if this change is enduring (or irreversible), then the seller may begin to satisfy the necessary requirements to rely on any provisions in the SPA dealing with hardship, or extra contractual arguments under some governing laws such as fundamental change in circumstances or frustration of purpose. These provisions are not always included in LNG SPAs, or part of applicable governing law. Where they are present, they allow the seller to ask for a discussion with the buyer about what reductions or changes to the seller's obligations will release it from its claimed situation of hardship. Hardship provisions operate to preserve the core of the party's contractual relationship – useful in a long-term contract – by allocating the risk of an event of financial hardship, if economic consequences impact on the parties' obligations. Applying the doctrine of *pacta sunt servanda*, national legal systems usually respect and enforce express provisions dealing with changed circumstances that parties have agreed to include in their contracts, particularly if the provision contains parameters or a methodology on which to base the contractual revision. [3]

Such provisions, if included, will set out the triggering event; for example, many clauses will ask for evidence to be presented of a lasting, substantial change of circumstances. These changes are required to be beyond the control of the parties, as neither party wants to take the risk that it will bear the economic consequences of actions taken by or events controlled by the other party. Other provisions may add a requirement that the triggering event was not predicted or predictable (or foreseen or foreseeable) at the time of contracting. In the case of a seller, it has been argued that this would include an unexpected reduction in the realisable gas reserves needed to produce the LNG, or a technological change (such as the growth of a new source of energy) that adversely impacts on the financial position that the seller is facing. The inclusion of a dramatic increase in the seller's costs of

3 George von Mehren and Ben Holland 'Beyond Price Reviews: Adjudicating Claims of Financial Hardship', *Leading Practitioners' Guide to Oil & Gas Arbitrations*, JM Gatis ed.

production, or a decrease in the value achieved under the SPA compared to the costs of production, has also been argued. It is likely that these changes will be harder to portray as being unforeseeable, given the regular price cycles that are well understood within the LNG industry. Often, a variety of separate factors have changed, each interacting with the others, to produce economic effects that impact on the contractually agreed obligations of both parties.

It is also commonplace to require that the party affected is enduring a loss, a significant loss or a loss of expected reward, depending on the language used or the stipulations of the governing law. Many disputes turn on whether hardship requires the seller to be in a loss-making situation under the SPA. While this may seem obvious, on the basis that the seller will not face hard times if it is still making money under the contract, some provisions go further, and allow a limited examination of lost opportunities. Depending on the facts and the substantive law of the contract, such hardship may involve an elimination or reduction in margins of a party, and may also involve other harmful effects on one or both or the parties' businesses, such as a loss of market share. Hardship may also involve circumstances that prevent a party from performing under the contract, or even under other contracts.

In the absence of an express provision governing hardship, there is, however, a wide and fundamental distinction in approach among legal systems. Many legal systems do not permit a court or arbitral tribunal to adjust a contract for financial hardship under any circumstance. Other legal systems provide a legal basis for doing so, one example being Article 107 of the Algerian Civil Code, which addresses exceptional and unforeseeable changed circumstances threatening an excessive burden.[4]

Other failures to deliver

The seller may have an obligation to use reasonable endeavours to source alternative supplies, if it is unable to deliver itself, and to schedule delivery at a time agreed with the buyer. It is rare for this duty to be any stricter than this. If this provision required the seller to use best endeavours, then English law, which governs a reasonable cross-section of LNG SPAs globally, would require the seller to have to source alternative LNG by exhausting all of a number of reasonable courses of action that could be taken to meet its duties. If the seller had to use all commercially reasonable endeavours, then the seller would have to source

4 Article 107(3) of the Algerian Civil Code: '*d'evenements exceptionels, imprévisibles*' and '*l'obligation deveune excessive*'.

alternative LNG by exhausting all of a number of reasonable courses of action, taking into account its commercial interests when doing so, alongside those of the buyer. It would not, however, have to proceed if it would disproportionately lose money doing so. In contrast, reasonable endeavours would mean that the seller would have to adopt and pursue one reasonable course of action to meet its duties, bearing in mind its own commercial interests and the likelihood of success: a lesser obligation than the other types of obligation above.

Disputes relating to oversupply of LNG

This section addresses disputes that may arise because the buyer is unable, or unwilling, to take LNG that it has committed to purchase. In particular:

- the argument that the buyer's obligation to take-or-pay for LNG is not enforceable against it;
- disputes arising from a buyer's right to downwards flexibility over the volumes of LNG that it wishes to accept over a given time period;
- reliance by buyers on hardship provisions; and
- other failures to take delivery.

Take-or-pay as an unenforceable penalty?

Because sellers want buyers that will commit to purchasing substantial volumes over a long time period and provide regular revenues, long-term LNG SPAs will often require the buyer to take a substantial annual quantity and include a take-or-pay provision, which requires the buyer to pay for a certain amount of the annual contract quantity (sometimes 100 per cent, but often a percentage of that quantity, e.g., 85 or 90 per cent), whether or not the buyer takes that quantity. For this reason, take-or-pay provisions are a very familiar feature in LNG sales contracts, and provide an option for the buyer to take supply of LNG, or to pay for it anyway. Some take-or-pay provisions can provide for the seller to be paid by a buyer that has decided not to take the LNG, but then also allow the seller the additional right to sell the surplus LNG to any other interested customer at market prices, in effect receiving payment twice for the same molecules of LNG.

In many legal systems, this outcome would be seen as a straightforward risk allocation, agreed in advance with transparency between an experienced buyer and an experienced seller. However, under English law, an anomalous principle known as the 'rule against penalties' has given rise to disputes as to whether take-or-pay provisions can be considered to be unenforceable in certain circumstances. The English law rule against penalties prevents the enforcement of clauses that operate as a penalty against the party in default. For example, where a contract stipulates that a specified sum is payable upon breach of an obligation by a party

to that contract, but the sum stipulated is not a genuine pre-estimate of loss suffered due to that breach (because it is too high), historically the clause will not be enforceable. The rule against penalties is something of an anomaly within the English law of contract, as English law generally allows commercial parties the freedom to contract at will. For this reason, English law is predisposed to enforce clauses that parties have agreed, and only rarely finds that they are a penalty. This predisposition is particularly strong in commercial contracts freely entered into between commercial parties of comparable bargaining power, as will be the case in any LNG SPA. English law has rationalised the test as to whether a term is an unenforceable penalty over recent years, in a way that makes it difficult to maintain an argument that a take-or-pay provision operates as a penalty under English law.[5] When disputes arise, the following factors operate to resolve the issue one way or the other.

There are two separate obligations in most take-or-pay contracts. First, there is the obligation on the seller to make the LNG available to the buyer. Secondly, there is the obligation on the buyer to pay for the LNG that has been made available (either as well as, or instead of, taking up the LNG). Both of these obligations create a benefit for the other party. This being so, take-or-pay payments will be considered by English law to be an amount due to the seller as a debt for having made the LNG available, and not as damages for breach of contract by reason of a failure on the other party to take the LNG. This is because the seller is providing the service of making LNG available to the buyer, in accordance with the SPA, which will create a debt owing to the seller for that service. On this basis, the rule on penalties should not apply at all, because this rule has a limited application: it only applies (in this context) to stipulations for the payment of a sum of money in the event of breach of contract (for example, damages for a breach of the SPA).[6] There will be no breach if the SPA is drafted so that it provides the buyer with an option whether or not to take the LNG. A buyer with an option to purchase ought never to be considered in breach of contract for deciding not to do so.[7] If there is no breach, then the penalty doctrine cannot be engaged.

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5 *Cavendish Square Holdings BV and Another v. Talal El Makdessi* [2015] UKSC 67.

6 English law sees a 'primary obligation' as being a duty to perform an action agreed under a contract, and a 'secondary obligation' as being a duty to pay damages upon default of that primary obligation. The rule on penalties only applies to secondary obligations.

7 Ben Holland 'Enforceability of take-or-pay provisions in English law contracts – resolved', *Journal of Energy & Natural Resources Law*, Vol 34, No.4, p.443–453 (2016).

This leaves other provisions, which can be described as take-and-pay clauses (rather than take-or-pay clauses), where there is an obligation on the buyer to take a minimum quantity of LNG. Although this will also normally create a primary obligation (debt) as a result of the seller making LNG available, the existence of a breach by the buyer if it does not take the minimum volume demanded by the SPA makes the distinction less clear-cut. Although take-and-pay provisions govern the price to be paid to the seller, the occasion for their operation is also a breach of contract due to the buyer's failure to take the LNG. Of assistance to the seller, English law has rejected the argument that a parallel breach by the buyer should entitle the buyer to rely on the rule against penalties. Further, even if the rule on penalties does apply, the restated test applied by English law emphasises that to be unenforceable the payment for breach has to be 'exorbitant or unconscionable' when viewed against the seller's interest in the performance of the contract.[8] Given the significant investment by the seller in its LNG facilities, and its interest in the secure revenue stream that the payments provide, this test is more helpful for the seller to meet than the previous test, and such provisions will usually reflect a legitimate interest in covering the seller's up-front costs. This is made even more certain if a 'make-up' provision is included in the SPA alongside the take-and-pay provision. If so, the buyer's payment under a take-and-pay provision comes with an entitlement to benefit in future by taking make-up LNG at a later date. Within this sort of contractual payment structure, the buyer is simply making a payment in advance for the future performance of an obligation, such that it is difficult to construe the sum paid as damages upon breach, rather than debt. Again, if there is no breach, then the penalty doctrine cannot be engaged.

Downwards flexibility

A full cargo of LNG on a conventional LNG tanker is a significant quantity of gas (more than sufficient to supply a small city for a year, for example). It takes time to load, transport and unload a cargo. As a result, gas volumes delivered as LNG may not closely match the demands of the buyer's customers throughout the year (which can vary substantially depending on a number of factors, including the season), and there may be limited storage capacity available for the buyer to store excess gas. Downward flexibility rights entitle a buyer to take reduced quantities of LNG during a particular period. During the covid pandemic, these provisions,

8 *Cavendish Square Holdings BV and Another v. Talal El Makdessi* [2015] UKSC 67 at [255] (Lord Hodge).

also known as 'downwards quantity tolerance' (DQT), were commonly operated by buyers. They were used to full effect to mitigate many buyers' short-term fall in demand from its own customers, as demand collapsed with reduced industrial activity.

However, long-term SPAs often constrain the exercise of these rights, and disputes arise in relation to their operation. As with UQT rights, considered above, the buyer may be required to provide a fixed period of notice before being able to receive reduced quantities. Schedules may be set far in advance, and prove hard to alter without agreement by the seller, which restricts the buyer's ability to respond to sudden market shocks. Sellers routinely challenge the notifications provided, in particular challenging whether these requests are made in time, or with sufficient clarity. The exercise of DQT can also involve a series of checks and balances whereby, depending on the SPA, the seller's commercial interests and logistical factors can be raised as a reason to reject the buyer's DQT request. Ambiguity and subjectivity can be introduced by sellers wishing to curtail the exercise of the buyer's rights. All of these issues have given rise to disputes. If DQT rights are successfully exercised, SPAs often contain additional checks and balances that store up disputes for the future. There is often a parallel obligation for the buyer to take increased 'make-up' quantities in later periods. There also may be maximum amounts allowed for cumulative downward flexibility. If the buyer has relied on DQT rights in the past, its ability to do so in future may be restricted. This is not an inexhaustible remedy for the buyer. This serves to limit the usefulness of the DQT rights.

Hardship for buyers

Oversupply situations occur when buyers who prioritise advance planning and security of supply enter into long-term commitments, yet unexpected events intervene in a way that reduces the volume of LNG that they later need. The result is that the buyer has too much LNG. This is a cyclical difficulty. It is particularly hard to balance in liberalising markets, where customer demand unexpectedly fluctuates. Most recently, it has been a feature for several buyers in Asia, where the unexpectedly fast deployment of renewables has reduced the forecast need for power generated from LNG. In particular, market liberalisation in Japan has unsettled customer demand, leading to a surplus of LNG for some buyers, as has the resumption of nuclear power production following the Fukushima incident.

If the buyer is unable to take LNG because a structural market change has reduced the volume of LNG that it needs, and if this change is enduring (or irreversible) then the buyer may begin to satisfy the necessary requirements in order to rely on any provisions in the SPA dealing with hardship, or extra contractual

arguments under some governing laws such as fundamental change in circumstances or frustration of purpose. As set out above, such provisions, if included, can apply where there has been lasting, substantial change beyond the control of the parties, and an enduring loss. In these circumstances, hardship provisions are relied on to contend for reduced volumes under long-term SPAs if the buyer's own customers demand less gas. Liberalisation may have opened up an unexpected ability of a buyer's customers to switch supplier, leaving the buyer with an unexpectedly reduced demand that is outside its control. In these circumstances, the buyer will likely be facing a long-term, structural over-supply situation, where it will be making enduring losses under the SPA. The market may be such that the buyer cannot reasonably divert, reload or otherwise offset its surplus commitment to take LNG under the SPA. This will make for disputes where the parties do not agree on whether the necessary factors set out in any hardship provision are present one way or another.

Other failures to take delivery

The starting point is that the buyer will be in breach and the seller will be entitled to damages. These damages will normally reflect the difference between the contract price of the LNG that should have been taken by the buyer and the market price at the time when delivery was due. The question will be whether the seller is able to enter into a short-term supply contract with an alternative contracting party. This damages assessment exercise, which may be supported by expert testimony, will determine the extent to which there is a reasonably available supply of LNG necessary to fulfil the contract quantities such as to amount to an 'available market'. There may be LNG purchasers available on the spot market, but there are often real questions as to whether those spot contracts will be comparable such as to amount to an available market. The prices they pay will not likely be comparable to the SPA, as the terms and duration are different. To establish an available market, a substitute buyer of LNG needs to be temporally and geographically available and accessible to the seller. In the event that there is no available market, then regard may be had to the loss actually suffered by the seller, and arbitral tribunals may decide to displace the prima facie market value measure of loss (the difference between the contract price and market value) and look instead to the loss down the contractual chain, when evaluating the extent of the loss actually suffered by the seller.

Disputes relating to force majeure

This section addresses force majeure in the context of LNG sale and supply. In particular, two scenarios are discussed. The first concerns a delay to deliveries of LNG under a long-term SPA due to a disruption in the production, loading, transportation or unloading of LNG. The second concerns a delay to the construction of LNG facilities that disturbs the planned sale and purchase of LNG that has been contracted for in advance of the commissioning of the LNG facility.

It is necessary to introduce this topic with the precursor that a one size fits all analysis is not available. To rely on *force majeure* where an LNG SPA is governed by common law (for example English or Singaporean law), a *force majeure* clause must be included in the contract. *Force majeure* is not a term of art under English law or Singapore law and many other common laws. It is also radically different from civil law conceptions of *force majeure* and *rebus sic stantibus*. The definition and scope of *force majeure* will be determined by the specific wording of each individual contract. What happens when a *force majeure* clause is engaged will depend on pre-agreed contractual mechanisms, with the further result that it is necessary to generalise the language and concepts that are regularly included in LNG SPAs.

Force majeure for delayed deliveries

It is for the party claiming *force majeure* to prove the facts bringing the circumstances or events within the *force majeure* clause. For example, depending on the language of the clause, that party would typically need to prove the occurrence of one of the events referred to in the clause, and that it had been prevented, impeded or delayed (as the case may be) from performing the contract by reason of that event. The party would ordinarily need to further prove that the non-performance was due to circumstances beyond its control and that there were no reasonable steps that it could have taken to avoid or mitigate the event or its consequences. There are a number of factors specific to LNG SPAs that can make it hard to maintain a claim to *force majeure* in the context of a delay to deliveries or acceptances of LNG.

Specific notification

Under many SPAs, the party claiming *force majeure* is required to give notice of the event or circumstances (or combination of events or circumstances) causing the failure to perform or delay in performing and said to constitute *force majeure*. Disputes arise when it is claimed that notifications contain unspecific references, or are lacking in detail in a way that fails to satisfy the requirement to give specific notice of the event or circumstances relied upon. In the context of LNG SPAs, it is common to require the parties to keep each other informed of circumstances

that could reasonably result in a disruption to the sale and purchase obligations under the SPA. This obligation can arise before the event itself materialises, by way of a need to notify of issues that may develop into *force majeure* events. When a *force majeure* event arises, it is common to require prompt notification of the event. These provisions can be detailed and unyielding. It is common for *force majeure* clauses to provide, in effect, that a party cannot rely on *force majeure* where it fails to comply with these notification obligations, and any circumstance that may have originally amounted to *force majeure* shall cease to do so. Following a number of *force majeure* claims made during the covid pandemic, there has been an increase in the use of *force majeure* clauses under which *force majeure* arises automatically, even when the trigger event is clear only in retrospect. These provisions therefore do not require the same degree of timely or specific notification.

LNG market economics

An argument based on rising costs to justify the discharge of duties through *force majeure* will very likely fail. Economic hardship or unprofitability will seldom amount to an event or failure that prevents the performance of a party's obligations under an SPA, as the alleged uneconomic nature of the remaining performance does not prevent those uneconomic steps to be taken. Under English law, in the context of a gas supply agreement, the position that commercial impossibility due to changed prices could found an argument in *force majeure* has been rejected.[9] This is made more certain if the list of examples of *force majeure* that may be set out in the clause each involve a physical, external event or action of a third party, rather than internal economic circumstances. Indeed, many SPAs explicitly list economic hardship as an exclusion from *force majeure*. If so, it will be necessary to prove that something more than adverse economic circumstances has impacted on the contractual bargain, for example that market forces have changed to the point of inversion, with LNG terminal use flipping from import to export, or similar circumstances. Several leading awards in the energy sector and leading commentary on arbitral practice confirm this: 'Although *force majeure* clauses are often invoked in energy contracts, claims based on such clauses in arbitration proceedings rarely succeed as their application is subject to strict conditions [. . .] arbitral tribunals have ruled that neither increases nor decreases in oil prices, no matter how large or unexpected, can be considered to constitute *force majeure*.'[10]

9 *Thames Valley Power Ltd v. Total Gas and Power Ltd* [2005] EWHC 2208 (Comm) at para. [50].

10 ICC International Court of Arbitration Bulletin Vol. 20 No. 2, p. 51.

Obviously, if there was no evidence that the party was in fact incurring significant losses, the claim for *force majeure* would likely also fail on that ground alone. This can often require an analysis of increased costs and, if so, even if the party's costs did increase overall, it is often necessary to consider whether it is still making profits when isolating only the transaction set out in the SPA, leaving aside any impact on it from losses from wider activities (including under other contracts). For all these reasons, it is commonplace for economic issues to be addressed expressly in LNG SPAs through price review provisions or hardship provisions, but not through *force majeure* provisions.

Scheduling

Although referred to by different terms, it is overwhelmingly common for LNG deliveries to be fixed in advance by an annual delivery plan, or a delivery schedule. There is often a complex mechanism of notice and counter-notice leading to the establishment of this delivery schedule in advance of each contract year. As a result, the parties will be required to specify a wide series of issues in good time prior to delivery. These include the volumes, dates, source of supply, LNG vessel for the cargo, loading port for the cargo, receiving terminal and other issues. This approach restricts the operation of *force majeure*, as it narrows down the facilities (including terminals, ports, vessels) that are involved for any particular delivery. In turn, this makes it harder for a party to seek relief from its obligations unless the vessel, terminal and other specified facilities needed for that specific delivery are impacted by the *force majeure*.

Delay in any event

The party claiming *force majeure* can also face the challenge that the event of *force majeure* did not cause all of the delay or disruption alleged. If so, these other reasons will be argued to have been responsible for losses in any event. In particular, there may be grounds to suggest that the delivery or acceptance would have been late or disrupted notwithstanding the purported *force majeure*, even if *force majeure* is validly asserted. If so, disputes can arise as to whether or not the party claiming *force majeure* is still responsible for the losses suffered in respect of delayed or missed cargos. It can be necessary to examine carefully the 'arrival window' applicable for the scheduled cargo that has been impacted by *force majeure*, and see if this was already impacted by other means prior to any event of *force majeure*. If it can be demonstrated that, at the time of the *force majeure*, there was still a possibility that the cargo could have been delivered within the scheduled 'arrival window', it likely would be open to the other party to suggest that there was no factual basis to maintain a claim for *force majeure*.

Currency

Topical for buyers of LNG from the Russian Federation, such as from the Sakhalin LNG project, Yamal LNG, and Novatek's Arctic LNG development, is the issue of whether sanctions that render payment for LNG in the agreed contractual currency unlawful will give rise to *force majeure*. English law has held that a request to make payment in an alternative currency is not functionally equivalent to a payment that was agreed to be made in the contractual currency, and that the request that a different currency must be paid instead is an impermissible request for noncontractual performance. It has been held that a party does not have to perform the contract other than in accordance with the contract in order to avoid a *force majeure* event.[11] Accordingly, if the contractual currency becomes unlawful, this may be considered to be a valid *force majeure* event. It would be different if the paying party had a contractual option to pay in the alternative currency.

Control

In circumstances where the *force majeure* clause requires a party to show that the event of *force majeure* was beyond its control, a further hurdle is often faced where the party cannot rely on events that it could have avoided acting reasonably or, as is often seen, acting as a 'reasonable and prudent operator'. This hurdle impacts even circumstances that superficially have little connection to the parties to the SPA, for example, if costs increase because of an increase in oil prices and associated costs, or the weakening of the contract currency, or due to the failure of a component, or because a contractor or affiliate has been poorly selected or poorly monitored. While these events were essentially outside of the party's control, if their impact can be shown to have been foreseeable, it will be necessary to prove whether these impacts were within their power to insulate against in some reasonable way. Many participants in the LNG industry are state-owned, and if actions of the state contributed to the event of *force majeure*, this will open up an analysis as to whether the event was entirely extraneous, or whether it was contributed to by the state's actions or inactions.

Sources of supply

The effects of *force majeure* on the seller's relevant production facility are further limited if the seller is a large integrated concern, which owns and operates other production facilities or sources of supply, or both. An area of considerable dispute concerns whether the complete inability of a relevant terminal to produce or to

11 *MUR Shipping BV v. RTI Ltd* [2022] EWHC 467 (Comm).

receive LNG, or the complete inability of an LNG vessel from loading and delivering a cargo that has been scheduled for delivery, can found a claim for *force majeure*, where the seller has available alternatives. Under certain SPAs, cargoes are contracted to be delivered from the seller's LNG supply pool, or similar terminology. In other SPAs, where the seller aggregates supplies from a mix of sources, including third-party sources, there is an alternative formulation similar to 'seller shall obtain all Cargoes to be delivered under this Agreement from a specified pool of suppliers'.[12] If there is an event of *force majeure* at one facility, the non-affected party will often assert that it is not aware of any reason why a cargo could not have been delivered from elsewhere within the LNG supply pool, meaning that there is no relief for *force majeure*.

The counter to this argument would likely be that this provision imposes an obligation on a seller to obtain the cargoes it supplies to the buyer from a specific source, i.e., the LNG supply pool, so that this source can be checked and approved in advance by or for the buyer. On this basis, it would be argued by the seller that this provision does not impose an obligation on the seller to supply cargoes from the LNG supply pool if there has been a *force majeure* event affecting its chosen supply or supplier in respect of a specific cargo. The source of the seller's supply might be at its discretion, giving rise to the argument that it was either not an obligation, or alternatively not possible, to secure any alternative source for the cargo. Any other LNG that might be available to the seller from the LNG supply pool or otherwise is relevant only to the extent that potential mitigation efforts are possible, as discussed further below.

Mitigation

If a *force majeure* event has occurred, the impacted party may very likely be under a market-standard obligation to use reasonable endeavours to mitigate the effect thereof under the SPA, and to proceed with due diligence to take such steps as would be taken by a reasonable and prudent operator to remedy the failure as soon as possible and to resume normal performance. Connected with the point above, this might be argued to involve steps such as, for example and without limitation, the supply of replacement cargoes from any LNG supply pool referred to in the SPA. If so, even if the seller was not obliged to deliver from any LNG supply pool referred to in the SPA, the argument identified above often resurfaces, that is, that the seller may still have a duty in any event to do so by way of mitigation. The seller might argue that it has discharged this duty to mitigate by

12 Sample clause used for illustration only.

approaching other affiliate companies, terminals and users of the facilities to assess the feasibility of obtaining replacement cargoes from them. If these efforts were not successful, it is likely that the buyer would argue that they had been insufficient, and require that the seller obtain replacement cargoes from the market to supply to the buyer under the SPA. This is a position that the seller may not agree with, as it can often appear that obtaining replacement cargoes in this manner would likely result in the seller making a substantial loss. This may be particularly the case in high-priced market conditions (which can be made worse if there has been as assertion of *force majeure* events by other suppliers at the same time). If so, it may be argued that the seller's obligation only extends to a duty to use reasonable endeavours to mitigate the event of *force majeure*, such that this obligation does not require the seller to go to the market to source replacement LNG, if doing so would subordinate its own financial interests. This obligation would likely require the seller to see whether it could meet the delivery obligation from another reasonably available source.

Force majeure for delayed facilities

LNG facilities are often constructed in territories that are at higher risk of weather-related or political instability. For example, there may be a severe deterioration of the security situation in the region in which the LNG facility is to be constructed and made operational. If so, there may be a long intervening period during which no significant steps towards the construction of the planned LNG facility can be conducted. For project financing reasons, LNG SPAs are often signed in advance of the facility being available for use. After an agreed period of delay due to *force majeure*, it is common to include a provision allowing the non-affected party a right, in its sole discretion, to terminate the LNG SPA on notice for prolonged *force majeure*. There are a number of factors specific to LNG SPAs where disputes relating to such provisions can arise.

Long-stop dates

The long-stop dates that give a right to terminate the SPA, if included, are often set conservatively, so the delay to commissioning often has to be very significant before any right to terminate for prolonged *force majeure* arises. In the meantime, market conditions may change, giving rise to doubts about the original project economics. It may prove tempting for the developer to rely on *force majeure* to mask a wish to defer capital expenditure on the project during a cycle of low prices or other unfavourable events. If so, the other party will have many months

to assess the ongoing validity of the claim for *force majeure* relief that has been asserted. As matters become clearer over time, it may decide to challenge whether *force majeure* has been validly asserted.

Challenging validity

The longer the period of *force majeure*, the harder it may be, in practice, to maintain that *force majeure* has impeded all activity on the path to development of the LNG facility. Developers are often sophisticated and experienced oil and gas industry companies used to operating in areas of complexity or tension. Disputes can arise where the non-affected party challenges the event of *force majeure*, and challenges whether the event relied on truly falls under the ambit of the definition of *force majeure* under the SPA. English law, in an oil and gas context, has confirmed that it is necessary for a party relying on *force majeure* to show that the *force majeure* was the only cause of delay, rather than having other, possibly commercial, motives to delay performance.[13] Disputes can also arise over whether there are additional measures that could have been taken by the developer or operator to continue work at the site of the LNG facility. If there is an insurgency, for example, could additional measures have been taken to enable work to continue work at the site despite the insurgency?

Not waiting for the long-stop date

As time passes, with limited development towards commissioning, the non-affected party may jump the gun, and (without waiting for the long-stop date to arrive) attempt to terminate the SPA. It may become transparent prior to the long-stop date that progress on the LNG facility, and the needed activity in advance of this date, have been so delayed that it is impracticable for the developer to be in a position to be ready at the long-stop date. It may likely prove possible for specialist delay consultancies to map out the needed steps on a critical path analysis and reach the conclusion that the long-stop date cannot be met, as a result of facts available to them about the (lack of) progress as at a date well in advance of the long-stop date itself. It can also be possible to rely on pessimistic public announcements made about progress at the facility to demonstrate that it cannot be ready in time.

13 *Seadrill Ghana Operations Ltd v. Tullow Ghana Ltd* [2018] EWHC 1640 (Comm).

Other provisions

Some LNG contracts may also contain material adverse effect clauses, for example language such as: 'Since the date of this Agreement there shall not have been any Material Adverse Effect and no event, change, development, state of facts or effect shall have occurred that would reasonably be expected to have a Material Adverse Effect'.[14] These provisions can provide a further remedy to avoid performance due to changes since the project was conceived. Sometimes these provisions are qualified by requiring that performance under the contract will have had to be made especially onerous, over and above any wider disruption that occurs to the wider industry.

Finally, the applicable law may provide additional relief, even where no provision has been included by the parties when contracting. For example, the common law principle of frustration applies by the automatic operation of law. Frustration generally terminates a contract where an extraneous event beyond the control of the affected party, which could not reasonably have been foreseen when contracting, renders performance impossible or radically different than what the parties contemplated. If an LNG SPA incorporates a *force majeure* clause (as will likely be the case) and that clause already caters for the event complained of, English law will hold that protection granted by the law of frustration will not be available. The risk of the event occurring will be taken to have been allocated by the parties in advance, through the language of any *force majeure* provision. Depending on the circumstances, this can make reliance on frustration in many English law LNG SPAs extremely challenging.

Disputes relating to rescheduling, diversions and destination restrictions

This section addresses rescheduling disputes in the context of LNG sale and supply, including disputes concerning the diversion of cargoes from the primary or original receiving terminal to an alternative or secondary receiving terminal. It includes disputes concerning:

- the right to reschedule LNG cargoes from time to time;
- the right to ask for diversions to different receiving terminals;
- destination restrictions in LNG SPAs; and
- the impact of cargo reloadings.

14 Sample clause used for illustration only.

Rescheduling

As set out above, although referred to by different terms, it is overwhelmingly the case that LNG deliveries are fixed in advance by an annual delivery plan, or a delivery schedule, set by agreement in advance of each contract year. Once the delivery schedule is set, cargo rescheduling options may be available under many SPAs. Parties may be permitted to reschedule cargoes to later in an existing annual programme, or to move a cargo from the current delivery schedule into a subsequent delivery schedule. Reasons why any rescheduling should take place are routinely required. These may include reasons of an operational nature declared by either of the parties, including events such as planned maintenance. Wider reasons may include unplanned maintenance, or any other situation where a party, acting as a reasonable and prudent operator, needs to make changes to the delivery schedule. Further operational reasons may include insufficient LNG storage tank space, if a delay to the delivery schedule is requested, or a shortfall that impacts on the security of supply, if an acceleration to the delivery schedule is requested. There may also be far wider reasons allowed, including those that allow rescheduling solely for commercial, non-operational reasons.

Rescheduling is an obvious way of managing demand fluctuations from time to time, but normally requires the agreement of both parties. A request for a change to the delivery schedule often imposes a duty on the other party not to unreasonably withhold its consent to the requested change. A host of logistical and practical counter-arguments are often witnessed in order to resist a rescheduling, commonly including difficulties with shipping times and shipping distances, the need to make multiple unloadings at different terminals (restricting the ability to change deliveries at one location without prejudicing those elsewhere), or unavailability of vessels at the time the rescheduling is sought. These counter-arguments are more compelling if the request for a rescheduling is made late in the day, so there is little time for either party to plan for the change requested. For this reason, many SPAs set out a different framework for agreeing a change to a cargo that is due in the near future, as opposed to one that is due in several months' time.

For notifications given far in advance, there may be joint reasonable endeavour obligations for both the buyer and seller to refix the delivery date by agreement or to revise the volumes or delivery date, or both, by agreement. This would impose a duty to work together to try avenues to allow a rescheduling. For more imminent notifications, the framework may be more restrictive, and there may be an obligation not to unreasonably withhold consent, which would allow the party receiving the request to present reasonable objections to the request to reschedule. In both cases, there may also be an express duty of good faith in considering such requests. During the months of peak demand, or towards the end of the relevant contract

year (if the SPA restricts rescheduling to moving cargoes within the same annual programme), similar strict restrictions can also apply. All of this may make the accommodation of a request to change the agreed delivery schedule contentious. The views of the buyer and the seller may differ as to whether the reasons relied on, for example future shipping capability, are limited or not. The wording of the SPA will set out the constraints on rescheduling, and whether a request to do so triggers any duty to consider the request, or requires just the goodwill and co-operation of the other party.

Diversion restrictions in LNG SPAs

Diversion rights allow a buyer to take delivery of a cargo at a different receiving terminal. The option to sell LNG cargoes in alternative destinations may be an opportunity to create additional value for the buyer and the seller. In addition to obtaining a higher price, sending a cargo to a new destination may result in substantial savings in shipping costs. Because of this, parties often cooperate in identifying and sharing the benefits from diversion opportunities even if there is no provision in their SPA requiring that they do so. However, sellers and buyers can have different views as to whether diversions should be permitted as a right in an SPA and, if so, under what circumstances a buyer should be permitted to divert cargoes to other destinations.

LNG SPAs will include a provision identifying the delivery point and shipping terms that stipulate that title, custody and risk transfer from the seller to the buyer at that point; both title and shipping terms are relevant to determining how much destination flexibility a buyer has. The allocation of costs and risk between the seller and buyer is usually specified by reference to the Incoterms shipping rules published by the ICC. The most commonly used delivery terms in LNG SPAs are delivery free on board (FOB) and delivered at terminal (DAT) or delivery at place (DAP), which replaced delivery ex ship (DES) in more recent agreements. If LNG is delivered FOB, title and risk will shift to the buyer when the LNG is loaded on to the ship, and the buyer is responsible for arranging the vessel. Accordingly, unless there are other contractual provisions that purport to limit the buyer's ability to resell or send the LNG to whatever destination it chooses, under an FOB contract, the buyer may have almost complete destination freedom (subject to shipping and other commercial constraints). By contrast, if LNG is delivered DAT or DAP, the seller retains title and risk until the LNG is unloaded at its destination, and the seller is responsible for shipping costs. In such a case, the SPA will identify a specific delivery port (often in the buyer's home market)

and the buyer may have no destination freedom at all, unless the parties have added provisions providing that the buyer may request delivery to other destinations, often referred to as diversions (or deviations), which are discussed below.

Provisions addressing the possibility of diverting cargoes in LNG SPAs help parties structure diversion rights to accommodate their competing commercial interests. The Association of International Petroleum Negotiators (AIPN) issued an updated version of its Model Contract Master LNG Sale and Purchase Agreement in 2012, which contains an optional diversion provision.[15] Some diversion provisions are very brief, while others are very detailed. There is a wide range of approaches to such provisions, including:

- permitting the buyer a certain number of diversions (and some also permit the seller to divert);
- setting out circumstances in which the buyer may request diversions and the seller must agree; and
- providing that either the buyer or the seller may propose diversions, and the parties will discuss such proposals in good faith.

Many SPAs provide for a combination of these options.

Diversions can be operated where the primary receiving terminal is unable to operate, but where an alternative terminal is available. Diversions also occur if it makes sense to try to supply an area experiencing increased demand. Diversion provisions may also include limitations or conditions, such as:

- limiting the volume of cargoes that a purchaser may send to alternate markets;
- constraining the number of diversions to which a party is entitled; and
- limiting the particular destinations to which cargoes may be diverted.

The parties may also agree on other conditions as to when diversions may be permitted or refused. For example, the parties may stipulate that the buyer may not be entitled to divert cargoes to alternate markets unless the market price for gas in the designated market falls below the contract price. More commonly, the parties may stipulate that the buyer may not have a right to divert a cargo unless the diversion will not increase the shipping distance or costs, or impair the seller's vessel from returning to the loading port in time to make its next

15 The Association of International Petroleum Negotiators' Model Contract Master LNG Sale and Purchase Agreement (2012).

scheduled delivery. The parties may also stipulate that the buyer is obligated to pay for any additional costs that the seller incurs in order to deliver LNG to an alternate destination.

There are different approaches to pricing or sharing the economic benefit from diverted cargoes. For example:

- the parties may have an agreed profit-sharing mechanism for diverted cargoes;
- the parties may need to agree on a price (or a profit-sharing mechanism) each time a cargo is diverted; or
- where the parties have identified permitted diversion destinations in the SPA, they may also include pricing provisions for cargoes delivered to specified markets (and these price formulae can be very different from the contract price for non-diverted LNG).

These pricing provisions may also be subject to revision in the event of a change in the diversion market (and the price review provision for the diversion markets may have different standards).

As the LNG market has grown, and as short-term changes in demand and supply have created more opportunities for price arbitrage by sending LNG to other markets, there have been an increasing number of price disputes relating to deliveries to other destinations and diversions. In some instances, sellers have argued that a buyer's use of diversions justifies revising the SPA's price formula. In these cases, the seller may argue that the contract price was negotiated in light of the parties' mutual understanding that the gas sourced from the LNG supplied under the contract would be sold only in a particular market, such that a destination restriction effectively constitutes an implied element of the parties' bargain. The seller may therefore contend that the diversion of cargoes to other markets alters the bargain reached by the parties. Parties also have sought adjustments to the price formulae used in some SPAs to price LNG delivered to alternate destinations (often on the same or similar grounds as in other pricing disputes, including that formulae based on competing sources of energy should be revised to include gas market prices in the new market). There have been a range of other disputes, including as to whether the seller has the right to refuse a diversion proposal and whether (and how) the parties have agreed to share profits on cargoes delivered to other destinations.

In the dispute concerning diversions between a Trinidad producer, Atlantic LNG, and a Spanish buyer, Gas Natural, which was made public as part of court proceedings in the US, the parties had negotiated their contract price 'on the assumption that the LNG would be delivered to and sold in Spain', including by

modelling the contract price on various aspects of the Spanish energy market.[16] The SPA nevertheless permitted Gas Natural to divert some or all of the LNG cargoes to New England in the US, but it did not provide for any change to the contract price if Gas Natural did so. When a price difference made selling to the US sufficiently attractive, Gas Natural elected to divert cargoes to New England. Atlantic LNG claimed that these diversions entitled it to a price review under the terms of the SPA (which referred, without specifying which market, to the question of whether the contract price 'reflected the value of Natural Gas in the end user market') because the contract price reflected the Spanish market and not the New England market. The tribunal agreed and imposed a revised price formula that was intended to 'be adaptable depending on the Buyer's end user market at the time'. The revised price formula required Gas Natural to pay a New England-based price in the event that it elected to divert a specified percentage of cargoes to the New England market. This reflects some of the issues that can arise concerning diversions, particularly where the parties have not included detailed diversion provisions.

Destination restrictions in LNG SPAs

In addition to designating the delivery point, historically, many long-term LNG SPAs contained destination restriction clauses. Such provisions restricted the buyer from reselling the LNG outside of a designated geographic market (usually, the buyer's home market). A seller may want to prevent a buyer from being able to deliver cargoes to other destinations because the seller does not want the buyer to compete with it in other markets or to compete with its other buyers. A seller may also be concerned about the costs of delivering to alternate destinations and the potential disruption to its transportation logistics and schedule, or that delivery to a different market than the one designated in the contract may violate trade restrictions or the terms of the seller's financing. In contrast, a buyer may view the right to deliver LNG cargoes to different destinations as essential to mitigating the take-or-pay risk created by its volume commitment (because it may not have sufficient customer demand in the designated delivery market to sell gas there at a profit or to avoid a take-or-pay liability). A buyer may also have obligations to supply customers or its own facilities in different locations (for example, a buyer may own facilities such as combined cycle gas turbines in other places) and it therefore may want to have the contractual right to deliver to multiple

16 See *Gas Natural Aprovisionamientos SDG, SA v. Atlantic LNG Co of Trinidad and Tobago*, No. 08 Civ. 1109, 2008 WL 4344525, (SDNY 16 September 2008).

destinations. More generally, a buyer may want destination flexibility to manage its overall portfolio (which may include different sources of supply with different pricing and other terms) and to pursue arbitrage opportunities.

Destination restrictions have become less common in LNG SPAs. They are less common in shorter-term contracts. The European Commission has also said that such provisions are not permitted in contracts for the sale of LNG to EU buyers. During a number of investigations (involving both LNG and pipeline gas contracts) the European Commission has said that 'territorial restriction clauses (re-export prohibitions) and mechanisms having similar effects', including the effect of reducing the opportunity for the buyer to pursue arbitrage sales, constitute a 'severe restriction' on competition.[17] The European Commission has made clear that it considers such provisions in contracts that impact on trade within the EU to constitute a serious breach of European competition law because they prevent cross-border trade and undermine the goal of a single integrated gas market in Europe, because they limit the number of potential sources of supply within each country, and act to divide up rather than harmonise the single European market. The European Commission has entered into a number of settlements requiring gas and LNG producers to change the terms of their supply contracts. In 2017, the European position was reaffirmed in the European Commission's Follow-up Study to the LNG and Storage Strategy, as follows: 'Destination clauses are contrary to EU internal market and competition rules, and are contrary to the Treaty establishing the EU. Destination clauses are therefore banned in pipeline gas and LNG contracts for all supplies to any EEA country.'[18]

The European Commission has also stated that profit-sharing mechanisms where 'the buyer/ importer [has] to share a certain part of the profit with the supplier/producer if the gas is sold on by the importer to a customer outside the agreed territory' have been used as an alternative to territorial restriction clauses[19] and may restrict competition by dissuading purchasers from selling cargoes outside a designated market, even if such provisions do not expressly prohibit

17 European Commission press release, 'Commission settles investigation into territorial sales restrictions with Nigerian gas company NLNG,' dated 12 December 2002, IP/02/1869.

18 https://ec.europa.eu/energy/sites/ener/files/documents/follow_up_study_lng_storage_final_01.pdf.

19 See European Commission press release, 'Commission and Algeria reach agreement on territorial restrictions and alternatives clauses in gas supply contracts,' dated 11 July 2007, IP/07/1074.

such sales.[20] The impact of the buyer having to share part of the profit obtained from the diversion is seen by the European Commission to have an anticompetitive effect, if it removes or reduces the importer's incentive to attempt the diversion. This would act to maintain low prices in the original market and high prices in the proposed diversion market by hampering the connection between the two. The European Commission has stated that profit-sharing mechanisms are not permissible for LNG sold on a FOB basis. The Commission has indicated, however, that the use of profit-sharing mechanisms may be permitted where an SPA provides for delivery on a DAT or DAP (previously DES) basis and 'title of the gas remains with the seller until the ship is unloaded'.[21] Destination restrictions are thus generally not included in LNG SPAs with European buyers, and diversion provisions requiring profit sharing are generally understood to only be permissible while the seller retains title of the LNG.[22]

The Japan Fair Trade Commission has also indicated that destination restrictions combined with FOB provisions likely violated Japan's antitrust laws[23] and Japan has also signed a Memorandum of Cooperation on the Global LNG market with the European Union with its objectives including 'accelerating efforts in facilitating more flexible LNG contracts in terms of destination – aiming at avoiding

20 In doing so, the Commission specifically referred to clauses that restrict LNG buyers from selling LNG 'into terminals located in a different member state'. See European Commission press release, 'Commission secures changes to gas supply contracts between E.ON Ruhrgas and Gazprom', dated 10 June 2005, IP/05/710.

21 See European Commission press release, 'Commission and Algeria reach agreement on territorial restrictions and alternative clauses in gas supply contracts,' dated 11 July 2007, IP/07/1074. See also E Wäktare, 'Territorial restrictions and profit sharing mechanisms in the gas sector: the Algerian case', 3 Comp Pol Newsletter 19, 20 dated 2007.

22 In 2018, the EU Commission opened an investigation into restrictions to the free flow of gas sold by Qatar Petroleum in Europe. See European Commission press release, 'Antitrust: Commission opens investigation into restrictions to the free flow of gas sold by Qatar Petroleum in Europe,' dated 21 June 2018, IP/18/4239. Access: http://europa.eu/rapid/press-release_IP-18-4239_en.htm. The investigation was subsequently closed in 2022 after a 'thorough analysis of all relevant evidence'.

23 The JFTC stated that companies should not include competition-restraining clauses when negotiating new contracts and should review existing contracts for 'competition-restraining business practices which lead to restrictions of resale'. See Survey on LNG Trades of Japan Fair Trade Commission, Survey, June 2017, available at: https://www.jftc.go.jp/en/pressreleases/yearly-2017/June/170628_files/170628-2.pdf.

related restrictions – and of re-selling, duration, price setting and review'.[24] It is not clear whether destination restrictions or profit-sharing mechanisms in FOB contracts violate antitrust or competition laws in other jurisdictions.

LNG arbitrations involving markets within the EU increasingly include submissions on EU law. These submissions are made in support of positions taken by the parties about the proper interpretation of the SPA. If there is ambiguity as to how the language of an SPA requires a party to operate a right to divert a cargo, submissions as to EU law would focus on the need for any delays or restrictions not to act as a restraint of trade within the EU. The arbitrators would be asked to consider whether a particular contract provision violated antitrust or competition laws, in which case it should be considered void, releasing the disputed restriction. Alternatively, if there are two available interpretations as to the legal effect of the offending provision, submissions would be made that it should be interpreted in a manner that made it lawful (a limited application), rather than unlawful (a wide application).

Disputes relating to reloading of LNG

If diversions are not permitted, or not desirable, the alternative means to access an alternative market is through a reloading. LNG terminals are often capable of both unloading and loading LNG. The LNG is delivered and unloaded as required by the SPA. The buyer then reloads some of the LNG onto another vessel. The buyer makes arrangements to sell and deliver this LNG to another market. In order to export LNG, the buyer may be able to make a ship-to-ship transfer (usually to smaller vessels). LNG also may be unloaded and sent to storage facilities at the LNG terminal, where it is commingled with LNG in the storage tanks. A buyer may then use the commingled LNG from several deliveries (or purchase LNG from other importers) to load a cargo onto a vessel or vessels to sell to another destination. Reloading is less efficient than diversions. Unlike a diversion, where it may be possible to reduce shipping costs, loading LNG typically involves incurring additional shipping costs and unloading costs (because the LNG is delivered twice). Due to the 'boil-off' of LNG while it is transported, unloaded and stored, there will often not be sufficient LNG from one cargo to load a full cargo onto another LNG tanker. There are also the costs of storing and loading the LNG, which can be substantial. In addition, there can be other logistical constraints that limit a buyer's ability to export LNG (including having sufficient

24 https://www.eumonitor.nl/9353000/1/j4nvgs5kjg27kof_j9vvik7m1c3gyxp/vkfh7btvr4wg/f=/10534_17.pdf.

LNG, timely access to the LNG terminal and available shipping capacity). The result is that reloadings occur only when there are substantial price differences between markets, allowing for enough uplift to cover the costs involved.

Where the SPA does not permit diversions or limits their availability, a seller may argue that reloading LNG is inconsistent with the parties' expectations or an attempt to evade contractual limitations. However, in many SPAs, there are no limits on what the buyer may do after it takes title to the LNG. Moreover, the rationale for sharing the benefit gained when parties agree to divert a cargo does not apply when LNG is loaded by the buyer after title has shifted to it, and the buyer bears all the costs and risks of the loading and subsequent sale: the LNG has been sold to the buyer, and the buyer has discharged its obligations to the seller. Whether it uses the LNG at the unloading port, or sells it elsewhere, it is likely to argue that this is its LNG, to do with as it pleases.

Disputes relating to terminal capacity and use

This section addresses disputes relating to the use of terminals by parties to an LNG sale and purchase transaction and the division of liabilities for doing so, including liability of the buyer and the seller to the operator of the terminal for any damage to the terminal caused by the vessel.

In terms of delivery of LNG to a receiving terminal, it is standard for the buyer (as the party that enters into the contract with the terminal) to be liable to the terminal for any loss or damage caused by either the buyer or the vessel, even though it is more likely that any damage done will be caused by the vessel (or the pilot) rather than the buyer itself. For this reason, terminal access rules regularly provide for either an uncapped indemnity or unlimited liability on the part of the buyer (as capacity holder) for loss or damage caused to the receiving terminal.

This indemnity cover also often addresses whether consequential or indirect losses by the receiving terminal (such as loss of profits) are covered or not, which may put such arrangements at odds with the division of risks under LNG SPAs, which very regularly do not allow for claims for consequential losses in any circumstances. In most cases, the receiving terminal will also require the vessel to sign a terminal operating procedures document, access code, or conditions of use, which gives the LNG terminal a direct contractual right against the vessel in the event of damage to the receiving terminal. This will likely be entered into between the receiving terminal and the vessel, and will address items such as insurance, safety, pollution prevention and remediation, public health or similar requirements. It will also regularly address the liability and remedies for any claims, liabilities, losses, costs and expenses (including in respect of pollution), in each case, in connection with the use by the vessel of the receiving terminal.

It will be appropriate to ensure that adequate insurance cover and creditworthiness are established in the case of an incident. The SPA will often provide that the seller (if it is the vessel owner) has insurance cover, including environmental cover. It may be necessary to negotiate a higher level of insurance cover, either in relation to all cargoes or in relation to specific cargoes, if there are concerns about a particular vessel or voyage. In extreme circumstances, if the receiving terminal imposes liability for third-party claims, and there are concerns about insurance, the seller or the buyer would need to be asked to accept liability for third-party claims, or claims from the receiving terminal, and build this into the division of risks in the SPA.

Disputes relating to the price of LNG

This final section introduces disputes relating to the price of LNG as agreed by parties to an LNG sale and purchase transaction. These issues are separately considered in Chapter 9 (Gas Price Review Arbitrations) of this work. In many markets, buyers are considering entering into discussions to sign new mid-term or long-term LNG volumes. This is in light of market developments, to balance portfolios or to mitigate against disruptions in pipeline gas supplies from the Russian Federation. These new LNG supply arrangements are being signed in order to replace expiring long-term supplies, or to provide an alternative source of supply to increase security of supply or to replace pipeline gas from Russia.

Many of these buyers are considering taking supplies of LNG from the US, which has been rapidly increasing LNG exports and which is one of the territories with surplus LNG available for commitment. Pricing under US LNG supply contracts is typically different to many other sources of supply. The price is routinely linked to the US gas hub price, with a commercial adjustment, and with a provision for transportation costs. As US LNG exports increase, these cargoes of hub-priced LNG are disrupting price patterns in some existing markets, particularly where these markets have no hub price of their own, that can adapt instantly to the introduction of LNG brought in at a different price, to smooth over the variances. In markets without existing hubs, the price of US cargoes may provide an additional price marker that may be used as a benchmark for seeking to vary the price under existing long-term supplies. US LNG prices are more transparent than other supplies, lifting a shadow from the evaluation of the impact of these deliveries that can be present where the price formation methods are less clear and less publicly available. US exports also introduce to new markets a different governing law of the SPA, as standard-form US export contracts are often governed by the law of one of the states of the US, such as New York law or Texas law. These governing laws incorporate the US's Uniform Commercial

Code (UCC), which applies to the sale of natural gas.[25] US exporters, who are themselves in contract with other US parties to secure the feedstock gas needed to produce the LNG for export, are resistant to efforts to disrupt these back-to-back arrangements by agreeing to non-US law as the law of the SPA.

Modern price review and hardship provisions, which have significantly evolved through the experience learned from the previous waves of price review arbitrations, allow parties to build into their adjustment provisions everything that has been learned from these past disputes, when allocating the risks of future changes. With currently unbalanced prices, sellers are now also considering seeking upwards price reviews under long-term contracts. After years of paying more than market price, which was the reality when buying on a Brent-based LNG price or on a hybrid price rather than a hub price, long-term buyers are resisting any price rise. A number of buyers are now responding to sellers' upwards price review requests, seemingly heralding the latest wave of LNG and gas price review arbitrations.

25 Uniform Commercial Code, Article 2.

APPENDIX 1

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Ben Holland is a partner at K&L Gates LLP, London. Described as a 'true energy disputes lawyer', and 'excellent for tricky, high-value disputes' (*Chambers UK*), Ben Holland handles multijurisdictional large-scale dispute resolution for energy sector clients around the world. Ben works exclusively on energy-related disputes, with a particular emphasis on LNG and natural gas. The American Lawyer's Arbitration Scorecard has recognised three of Ben's LNG/gas-sector arbitrations as among the largest in the world. Ben is experienced in hydrocarbon supply and pricing disputes under long-term international LNG, gas, oil and coal sale agreements, and the impact of economic and regulatory change on the commercial balance under them. He has authored a number of texts on LNG arbitrations, including on take-or-pay, hardship, *force majeure*, sanctions and a wide array of articles on gas and LNG price review arbitrations. Ben also focuses on disputes arising out of fluctuations in demand for energy and the price of crude oil and the consequential impact on the price of LNG, natural gas, oil products, coal and other commodities. Based on his experience in the resolution of international energy disputes, Ben consults on project advisory, risk avoidance and dispute strategy at a senior executive level.

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The energy industry nurtured and shaped what we now know as international arbitration, and, for a host of reasons – resource nationalism, oil price drops, geopolitics, climate change, sanctions and pandemics among them – it has remained one of the discipline's biggest clients.

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ISBN 978-1-83862-878-9