The Changing Geography of LNG Disputes

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Liquefied natural gas ("LNG") provides a means of moving stranded gas supplies to market, or to markets were more favorable economics. The process involves cooling gas to a temperature of approximately minus 260 degrees Fahrenheit, shrinking it to 1/600th of its original volume. In this liquid state, the LNG is loaded onto vessels and transported to the receiving port. There, the LNG is off-loaded to storage tanks, re-gasified into its original form, and placed into the pipeline system. Global transformation in gas supplies and consumption is changing the face of future LNG disputes.

I. The changing global market will affect where disputes arise and how they are resolved.

a. The global LNG market has seen the entry of new importers and exporters.

While global LNG production has held steady, the LNG has found homes in new markets. In 2011, total global LNG trade totaled 330 billion cubic meters (Bcm) of LNG. That year, the United States imported 349 billion cubic feet (Bcf) of LNG from seven different exporting countries, with the largest being Trinidad and Tobago. While total global LNG production held steady in 2012, European LNG imports dropped by 23.6%, while North American imports fell 33.1%, in large part the result of the shale gas boom. In contrast, South American imports rose 34.5%, and Asia Pacific imports increased by 9.6%.

Not only is the demand market moving geographically, but over the last 25 years, new exporters have risen to dominance. In 1995, Indonesia, Algeria, Malaysia and Australia accounted for over 80% of the world's LNG production. By 2009, Qatar accounted for 20% of the global LNG exports, with Malaysia, Australia and Indonesia together providing another 33%.

Meanwhile, The North American shale gas boom has brought new reserves into play for potential export. In the United States, natural gas production in 2012 totaled 681 Bcf, against consumption of 722 Bcf. Canada produced another 141 Bcf of gas, exceeding consumption of 91 Bcf. As of December 2012, the United States Federal Energy Regulatory Commission identified

ten North American LNG export terminal projects that have been proposed, with one under construction.

b. The effect of new market entrants on the nature and location of dispute resolution.

In the United States, unlike most of the world's LNG production, natural gas production is performed by private companies who own exploration rights under privately granted leases. Government involvement is either regulatory or, to the extent that natural gas is produced from government-owned lands, the government owns a share of production. It does not, however, own the export and liquefaction facilities.

It remains to be seen whether the entry of new exporters, such as the United States, Canada and Iran, will impact the underlying law governing LNG disputes. In the United States, there is no federal common law, so that the choice of United States law will ultimately require the adoption of the law of one of the states. Depending on the identity of the purchaser and seller, as well as the terms and conditions of the contract, selecting the law of one of the United States as the governing law could result in the contract's being governed, at least in part, by the 1980 United Nations Convention on Contracts for the International Sale of Goods (CISG).

c. Increasing use of short-term or "spot" pricing

The International Group of Liquefied Natural Gas Importers reports that in 2000, fewer than 5% of supply agreements were entered into on a spot or short-term basis. By 2012, that amount had increased to 25%, driven in large part by purchases from the UK and Asian countries, such as Japan, Korea and China. With increasing reliance on the spot market, fewer traditional pricing disputes will occur, but commoditized, "form" contracts" will likely include a dispute resolution provision about which the parties should be aware when entering into the contract.

II. Price Re-Openers

In 2011, world liquefaction capacity totaled 37.09 TCF, with another 49.59 TCF of non-U.S. projects proposed or under construction. The United States had another 28.67 TCF of proposed liquefaction projects. Together, all of these projects would bring global liquefaction capacity to 126 TCF, competing for the projected global LNG demand of 50-65 TCF from 2020- 2025. That gap between liquefaction capacity and LNG demand, while giving importers market strength, will also drive the desire for exporters to lock in long-term contracts, or "anchor" contracts, guaranteeing sufficient returns to justify billions of dollars of project costs. Parties know, however, that markets and pricing structures vary over time, and may well trend strongly in favor of one party or the other. For that reason, parties also desire to build flexibility into their contracts to allow for price adjustments. Those price adjustment clause typically fall into one of three categories: those designed to alleviate one party's short-term hardship, those that reflect economic trends and changes, and those that allow the parties to periodically adjust their price to account for the passage of time

Some long-term agreements combine two or more of these enumerated price renegotiation conditions. For example, in Esso Exploration & Production UK Limited v Electricity Supply Board [2004] EWHC 723 (Comm), the parties' contract called for price readjustment every six months based upon four factors: (i) the price of gasoil, (ii) the price of low sulphur fuel oil, (iii) the price of natural gas and (iv) the rate of inflation in Ireland as reflected in the industrial wholesale price index. The agreement also allowed the seller to require a price review if "... it is reasonably satisfied in good faith that the Energy Charge . . . is at the time of giving such Price Review Notice eighty five per cent (85%) or less than the market price for natural gas."

a. Index/economic drivers

The industry has seen a marked increase in the number of LNG price arbitrations, driven in large part by reduced regulation in indexed gas markets and by rapidly increasing oil prices during 2007 and 2008. Pricing in European and Asian LNG contracts is typically linked to oil

and oil products, so price volatility in the oil market significantly impacted pricing structures in indexed LNG contracts. As an index experienced rapid fluctuation, the fluctuation could cause the contracts to frequently hit price dispute trigger points.

Oil prices provided the traditional linkage to LNG pricing, because LNG was displacing oil for end consumers. With the prospect of numerous U.S. and Candian export adding North American shale gas to global liquefaction volumes, contracts will likely be indexed to new commodities prices. Purchasers of U.S. exports should expect to receive LNG indexed to Henry Hub gas prices, because the suppliers will purchase their gas supply through the U.S. supply system that is tied to the Henry Hub index. That access to Henry Hub-priced supplies has spurred buyers to seek gas-indexed prices in their new purchase contracts, displacing traditional oil-indexed prices. Moreover, some buyers who seek to access Canadian supplies through British Columbia export projects, are pushing to use that same Henry Hub gas price as the index for LNG.

Not only has the contemplated emergence of North American LNG caused a restructuring of pricing mechanisms in supply contracts, but in recent years, gas prices and oil prices have diverged: oil prices soared, while technological developments and increased gas production drove gas prices down. Consequently, while Asia is most typically an oil-linked market, Europe has become a mixed oil-linked and gas market. The UK and U.S. have developed gas-on-gas market pricing mechanisms (National Balancing Point and Henry Hub). This emergence of gas-driven and gas-coupled indicators has caused Asian customers, and in particular customers in Japan who purchase enormous quantities of LNG, to seek to reduce their fuel costs by de-coupling from oil pricing.

b. Jurisdictional concerns

One particular concern for parties is whether the tribunal has jurisdiction under the price renegotiation clause. In Esso Exploration & Production UK Limited v Electricity Supply Board, for example, the parties were required to base their renegotiated prices upon long-term contracts.

One party demanded renegotiation based upon twelve month contracts, and the respondent opposed arbitration on the basis that the twelve month contracts were not "long term." On an application to the English High Court, the court concluded that without reliance upon the proper long-term contracts, the arbitration tribunal lacked jurisdiction.

c. Drafting advice

Two basic tips will aide parties in avoiding unexpected consequences in their arbitration. First, to ensure that there is a right to renegotiate and the arbitral authority has jurisdiction to act, parties should identify clear triggers for price renegotiation clauses, and they should be prepared to present the minimum requisite evidence that the triggering event occurred. Second, the parties should clearly identify any limits on the tribunal's authority, such as a "baseball" or "last best offer" provision that prevents the panel from selecting pricing other than what a party proposes. They could also consider clauses that prevent the tribunal from introducing new concepts into the pricing formula or contract, and clauses designating the evidence upon which the panel may rely.