

In the last decade, buyers across Japan, Korea, Taiwan and China (the JKTC region) contracted to purchase significant volumes of liquefied natural gas (LNG) on long-term contracts. In certain jurisdictions, recent improvements in energy efficiency coupled with a growth and uptake in renewable energy have prompted a reduction in electric power demand, leaving certain buyers facing an oversupply issue across their portfolios.

Conversely, elsewhere in the region, robust post-COVID-19 recovery has led to gas demand increasing (sometimes rapidly), leaving other buyers in need of more supply than their contractual entitlement under existing LNG SPAs.

Whether a party is oversupplied or undersupplied, market players in Asia need to ensure their market competitiveness. This may involve seeking to rebalance their portfolios through securing reduced or increased contractual volumes and prices as the case may be. With that aim in mind, the engagement of price and volume rebalancing clauses is fast becoming standard market practice in the Asian LNG market. The commercial reality is that volume and destination flexibility represent a fundamental aspect of long-term, take-or-pay contracts for the sale of LNG into markets without a reliable, transparent and traded gas price based on supply and demand fundamentals.

It is also particularly important in circumstances where the traditional risk allocation dynamic within long-term gas and LNG take-or-pay contracts may not be adequate to solve an oversupply issue, or where a contract has very limited contractual rights available to a party in need of changes to the pricing or supply terms. For example, a periodic price review may be limited to specific intervals set by the contract. This may mean that a party is unable to take advantage of that right until later in the contractual term. In these cases, parties may be forced to consider other contractual avenues (to the extent they are available). However, again, their ability to introduce meaningful change or secure relief is dependent on the terms of the contract. It follows that market participants are well advised to familiarise themselves closely with their contracts in order to gain a better understanding of how they can provide solutions to address periods of difficulty.

- *First*, does the contract afford a buyer sufficient downward quantity tolerance? Downward quantity tolerance levels may be limited in the contract to 5% to 10% of the ACQ, which may not go far enough to alleviate the problems at hand. Furthermore, downward flexibility may not be an inexhaustible remedy – if a party has relied on it in the past, its ability to do so again may be restricted.
- *Second*, does the contract allow for cargoes to be diverted to be sold in other Asian markets? Will the diverting party need the consent of the seller to sell on its excess LNG and will a profit-sharing mechanism with the seller be required?
- *Third*, is make good LNG available under the contract in order to fill in gaps when there previously was an undersupply?
- *Finally*, for those affected Japanese buyers, can the 2017 Japan Fair Trade Commission Report on ensuring fair competition in the LNG market come to a buyer's aid? For example, does the relevant contract contain destination restrictions and profit share clauses that may be viewed to have "foreclosure effects," and as a result are, in principle, in violation of Japanese competition law?

If of no immediate use, or where changes need to go beyond those available from the avenues described above, an affected party may look to other routes to secure relief. In Asian LNG SPAs, leverage can sometimes be exercised through a Change of Circumstances or a Material Adverse Change clause. These clauses typically allow – or in some instances, oblige – parties to meet and seek to agree on modifications to the terms of a contract in circumstances, for example, where unforeseen events have occurred that have fundamentally altered the equilibrium of a contract and the existing commercial bargain, resulting in an excessive burden or hardship being placed on the affected party. Of course, the scope and effect of these provisions is dependent on the wording of the contract and its governing law.

Therefore, depending on the wording and structure of the particular clause, these provisions may provide an avenue to open negotiations with the possibility of reaching a mutual agreement on contractual amendments or, in some cases, lead to more formal dispute resolution in the event the parties cannot agree on any suitable amendment(s).

Other factors can also impact the requirement for parties to improve, rebalance or even renegotiate their contracts. The last 12 months have seen exceptional volatility in the JKM price index. These market price movements have shone a spotlight on the importance of having sufficient contractual volume and destination flexibility in a long-term contract.

By way of reminder, JKM prices soared to US\$33/MMBtu in the January 2021 winter peak, fell back to a more typical and expected figure of US\$7/MMBtu during the summer months, before shooting up once again during the autumn, entering a remarkable rally that witnessed prices increase to as high as US\$56/MMBtu in October 2021. This volatility presented a number of issues, but also opportunities, for market participants, for example (i) sellers contracted to supply at lower longer-term prices across their portfolios with limited production flexibility were restricted from capitalising on large and lucrative windfall spot trades; and (ii) buyers with take-or-pay oversupply issues were at the mercy of their destination flexibility provisions and sellers' consent to divert to other markets in an effort to mitigate issues with their demand position downstream.

For parties about to commence, or participating in, contractual price reviews, coupled with those negotiating new long-term LNG contracts, the issue of adopting JKM (instead of JCC or Brent), including as part of a hybrid contractual price formula, has become an interesting and frequently debated topic. Unsurprisingly, market players are considering the impact of adopting price formulations to include JKM. While the JKM index has undergone dramatic growth in both liquidity and volume of trades, only time will tell whether hub or hybrid indices will become more frequently adopted within price formulas in the region, replacing the more traditional JCC and Brent price proxies. Nonetheless, the recent price movements make it clear that buyers should seriously consider the impact of extreme volatility and their own risk profile before any such decisions are reached.

This price spike has also raised issues with regard to missed cargo shipments or partial loads that are then not subsequently rescheduled in the full cargo lot. Often, long-term contracts contain liquidated damages provisions to compensate a buyer in the event that a seller has been unable to properly perform its supply obligation, for example, in a *force majeure* scenario where performance has been prevented or hindered by a qualifying disruptive event. Missed cargoes are often "crimes of opportunity" since spot cargoes are, at their heart, opportunity driven. This is especially true in the current LNG market where European and Asian spot prices remain artificially high. Mechanical or production issues at an upstream facility, together with bouts of inclement weather forcing loading port closures, can, of course, impact a party's performance and in such cases, the contract can and often will cater for such events and the remedial aftermath, such as *force majeure* restoration quantities. It follows that affected parties should keep a watchful eye on the purported basis for any non-deliveries while this price spike endures to ascertain the objective basis (or otherwise) behind the supply failure and the avenues of redress available to it under their contract.

A strong understanding of the contract and its legal context is the best foundation for dialogue in the case of supply disruptions and difficulties around price or volume, and can be a good source of leverage in the discussions that follow. The contractual and legal mechanisms mentioned above can be a solution to securing more flexible LNG within long-term contracts under the present circumstances and beyond. A solid understanding of the available options is vital in times when the sands in the Asian LNG market are constantly shifting.

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