

While energy markets are designed to sustain periods of volatility and uncertainty, the past 24 months have sought to test their elasticity and durability. Even though markets evolve and react to bouts of uncertainty over time, the Russia-Ukraine conflict has impacted not only the European gas market, but has also caused significant upheaval in the Asian gas market. Indeed, its effects are being felt in all major import markets around the world as market players assess their portfolio volumes and contractual flexibility and prices in an effort to develop commercial and legal strategies to best confront the multiple issues arising out of the conflict.

While the spotlight has primarily focused on events in European gas markets,¹ serious issues have also arisen for importers in Asia on the back of the conflict in Europe. The impact of the conflict is enhanced by the fact that it arises directly on the heels of the COVID-19 pandemic. Taken together, the following issues can be seen in the Asia Pacific gas markets:

1. Upstream project operators extricating themselves from certain Russian LNG export facilities;²
2. Certain Asian banks and financial institutions imposing restrictions on US dollar-denominated payments being made to Russian or Russia-linked banks/companies in connection with currency conversions made through US financial institutions to protect their reputational positions in the market;³
3. Uncertainty as to whether Russia's Decree No. 172 regarding payment for gas by importers from "unfriendly" countries (to be made in roubles rather than US dollars) will, in fact, be imposed on Asian importers purchasing gas under US dollar-denominated SPAs;⁴
4. Spot market prices becoming a source of attractive arbitrage opportunity for sellers who, as a result of the demand spike, tendered limited available excess short-term volumes for lucrative spot trades in preference to requests from long-term customers for additional JCC/Brent price linked cargoes;
5. Market price spikes prompting missed cargo shipments or partial loads from sellers that are then not subsequently rescheduled;
6. Concern about the sanctions regime against Russia causing operators to avoid using Russian DES⁵ vessels, used to supply LNG cargoes to local Asian buyer markets;⁶ and

7. Russia levelling sanctions against certain of its own former affiliates involved in supplying and shipping gas in Asia.⁷

While these arguably constitute the most recent events impacting the Asian gas market, they represent the sequel to a steadily evolving market landscape in Asia in the past few years, which has witnessed cultural shifts in the approach to dispute resolution, a decline in long-term LNG prices since 2012, market liberalisation and a global pandemic impacting demand. As a consequence, there has been a crucial behavioural change among buyers in the Asian market. In order to grapple with the changing market horizon, buyers are increasingly considering what contractual tools they have at their disposal to confront these issues. An ever-increasing number of contractual negotiations has enhanced the understanding of how valuable certain contractual provisions can be, and, by consequence, has removed any hesitation in seeking to invoke them. One resulting example has been a sharp rise in the number of price review negotiations and arbitrations in the region.

In each of the major JKTC markets, buyers under long-term, take-or-pay contracts are now moving forward with price review negotiations and arbitrations in an effort to secure contract prices that better reflect prevailing market prices to provide some financial security moving forward in these highly changeable times. Equally, buyers have taken to their contracts to commence negotiations with sellers regarding key non-price terms, seeking amendments to volume and destination flexibility provisions to accommodate supply/demand stresses and tensions in the market.

This piece briefly examines the practical impact of certain of these various market events and explores some potential contractual mitigation steps to strategically combat these issues.

1 See "Gas payment issues in Europe: what are the next steps?" in Global Arbitration Review, dated 11 May 2022.

2 See, e.g., "Shell intends to exit equity partnerships held with Gazprom entities," dated 28 February 2022, at <https://www.shell.com/media/news-and-media-releases/2022/shell-intends-to-exit-equity-partnerships-held-with-gazprom-entities.html> (announcing Shell's intention to exit from its stake in the Sakhalin II LNG facility).

3 See, e.g., "Major Japanese banks to halt dollar transactions with Russia's Sberbank," Kyodo News, dated 26 March 2022.

4 See "Asian gas buyers puzzle over Putin's demand for payment in roubles," Reuters, dated 24 March 2022.

5 Meaning delivery "ex-ship," i.e., the seller provides the shipping.

6 See "Shell idles LNG ships owned by Russia to avoid sanctions risk," Bloomberg, dated 7 April 2022.

7 See "Russia allows gas flows to Gazprom Marketing & Trading for 90 days," The Business Times, dated 26 May 2022.

Practical Impacts

In late February 2022, the G7 developed a range of economic sanctions against Russia and Russian banks. At that time, the market considered how SWIFT sanctions could meaningfully impact the operation of certain LNG contracts, including restricting the access of Russia's major banks to the SWIFT financial network, making it difficult for Russian companies to make and receive payments.

As a G7 member, Japan signalled its support for these sanctions and announced that it would limit the ability to carry out transactions with Russia's central bank. That announcement prompted questions from Japanese LNG buyers – purchasing LNG from various Russian LNG projects, such as Sakhalin II – regarding the potential impact these sanctions may have on their ability to make payments for LNG cargoes under their contracts with Russian sellers. More specifically, genuine concerns emerged regarding (i) a buyer's ability to "take," but potentially not "pay" for LNG cargoes; and (ii) the certainty of future long-term supplies from those projects that could impact a buyer's wider supply portfolio.

When a Buyer Can "Take" LNG Without the Corresponding Certainty as to Whether Its Payment Will Be Effected

As sanctions were levelled against various Russian entities, the question increasingly arose for Asian buyers as to how to comply with their take-or-pay obligations under their long-term contracts. Many buyers were ready to make payment to fulfil their contractual obligations, but, depending on the terms of their SPAs, it was not clear how their payments could be effected.

Many of the Russian-Asian LNG SPAs are denominated in US dollars. As a preliminary matter, Russia's President Vladimir Putin announced at the end of March 2022 that Russia would continue exporting gas under previously concluded contracts, but that gas exports to "unfriendly" countries would change their payment currency to Russian roubles. The Russian government had previously identified Japan as an "unfriendly" country. On 31 March 2022, Russia issued Decree No. 172, which outlined a new payment procedure for gas importers from "unfriendly" countries and involved a multistep mechanism through specialised Gazprombank accounts.⁸ News reports immediately appeared that Gazprom had asked its European counterparties to change the mechanism by which gas was paid for under those contracts. Asian buyers, however, waited to see whether the same would happen for their US dollar-denominated contracts. Thus far, to our knowledge, Gazprom has made no such demands of its Asian counterparties.

Nevertheless, once gas was taken under these US dollar-denominated Asian LNG contracts, the gas still needed to be paid for to avoid a breach event. Even where certain Russian banks were not specifically subject to sanctions by Japan, many of the US dollar-denominated cargoes were paid for via Japanese banks that undertook their currency conversions through third-party US banking partners. Certain of the major financial institutions began imposing restrictions on payments being made to Russian or Russia-linked banks/companies to avoid coming close to breaching restrictive measures and/or to protect their reputational position in the market. As the situation was rapidly unfolding, it was not clear whether any of the several banks in this chain of financial transactions would actually process the money transfer. Thus, depending on the language of their SPAs, many Asian buyers were in the unappealing situation of having a take-or-pay obligation for cargoes that they were able and willing to take, and having money with which to effect payment for these cargoes, but without knowing whether they would actually be able to effect the payment.

In such event, could a buyer's payment obligation be excused on grounds of *force majeure*? If not, was the buyer potentially in breach of the take-or-pay obligation in the contract? The rapid onset of these events prompted various players to actively consider exercising *force majeure* over scheduled LNG cargoes. However, questions of *force majeure* are rarely straightforward and their meaning and effect will, of course, depend on the contractual language in issue and the applicable governing law of the contract. What, then, should parties to a long-term LNG or natural gas contract do in response to these financial sanctions? The answer is to carefully study the terms of the contract and consult with legal counsel regarding the precise scope of the application of restrictive measures.

In the first instance, it is important to look at the specific contractual terms and determine what a particular contract contemplates as properly constituting a *force majeure* event and whether it can be applied to the present payment and/or shipping sanction situation. If so, what other requirements under the contract and applicable law will need to be met to make a valid declaration? For example, a party may be required to notify the counterparty of a *force majeure* event within a particular timeframe, or to take specific steps to mitigate the event and its consequences. In this regard, it is important to consider what other provisions the parties included in the contract to address periods of difficulty. For example, diversion rights to unaffected terminals or other markets, downward flexibility options and adjustments to cargo delivery schedules (e.g. moving volumes to later in the same or next contract year) are all common contractual mechanisms that a court or tribunal may expect a party to have explored before declaring *force majeure*. This is particularly the case where a party has a duty to mitigate under the contract and governing law.

⁸ "Gas payment issues in Europe: what are the next steps?" in Global Arbitration Review, dated 11 May 2022.

Using Flexibility Rights to Acquire LNG Cargoes Now

With regard to current and future supply security, broader commercial strategies may be required. Uncertainty regarding the reliability and availability of Russian LNG exports has become a topical discussion point in Asian markets – both in the short and longer term. The withdrawal of operators Exxon Mobil and Shell from the Russian LNG export facilities at Sakhalin I and II prompted a wave of uncertainty concerning the future operation and reliability of those projects. More recently, the sanctions regime has created operational doubts on the usage of particular Russian DES vessels, used to supply LNG cargoes to the JKTC markets, and a consequential impact on production at affected facilities. Put simply, if production continues but ships are unable to arrive and load cargoes, the facility will hit “tank-tops” and production may cease. Equally, as the sanctions may impact Russian-owned oil and condensate vessels, the production of oil and condensate might also cease, prompting associated gas production to also stop, thereby impacting LNG deliveries.

Many power utilities and gas companies in Japan and South Korea purchase LNG from these facilities. The scale of the potential issues now, and in due course, will naturally vary from buyer to buyer. However, the extent of the disruption may be influenced by the size of annual take-or-pay volumes, the prescribed delivery mode, the availability of alternative shipping arrangements (and the associated cost), the frequency and timing of deliveries and the volume of Russian supply in the relevant buyer’s portfolio. The applicability of these issues will undoubtedly have a material bearing on the strategic response, both commercially and contractually.

As one would expect, a good comprehension of the contract is the key foundation block for commencing dialogue between the parties on how best to address the present crisis, including a possible discussion regarding delivery mode changes, deferring volumes (if applicable) and other commercial options to help ease the impact of these problems. Does a buyer have the right under its contract to accelerate any deferred volumes? Does it have UQT rights that it can exercise? If so, what does the contract require in terms of timing for the exercise of these rights?

Must a buyer exercise such rights during the development of the Annual Programme or can it do so at a later time? If at a later time, is there a prescribed lead time for such additional nominations under the contract? Does the contractual language provide a firm right to additional volumes or only the ability to ask for them and for the counterparty to use “reasonable endeavours” to provide them? The bottom line for Asian market participants facing Russian supply insecurity is to utilise available contractual flexibility to acquire additional cargoes at prices below JKM and to maximise pipeline nominations as much as possible where applicable.

However, as for seeking to secure as much supply as possible outside of long-term contract pricing, in light of the sharp volatility of supply in the market, it may be more prudent to wait and see how the situation ultimately develops. Likewise, sellers in the midst of price review negotiations are likely to use the current volatility regarding supply as a factor to reach early resolution of price review negotiations or better commercial terms, and LNG buyers should evaluate the impact of such an approach, factoring it into their price review negotiation strategy to avoid harmful concessions early on in the negotiation window. However, in Asia, in particular, where buyers can secure supply within the framework of long-term contract pricing, it makes economic sense to do so. Further efforts to secure supply should be used with caution when considering the specifics of a buyer’s contractual entitlements, the economics of a contract and the leverage that sellers may bring to the negotiation table.

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