HERBERT SMITH FREEHILLS

TAKE OR PAY, BUT AT WHAT PRICE AND WHEN?

09 December 2020 | Global
Legal Briefings – By **Rachel Lidgate and James Robson**

PODCAST

Herbert Smith Freehills Podcasts · Navigating the low oil price environment: EP8

In many ways, the LNG market is particularly susceptible to the unfavourable market conditions which underpin the low oil price environment. The LNG market is less liquid than the oil market, and LNG is more difficult to store than oil, meaning large reserves of LNG cannot be stockpiled at a time of low demand.

In addition, LNG, unlike oil, is often sold under long term ex ship "take or pay" contracts with large volumes of LNG committed to be purchased and restrictions on where the LNG can be delivered.

This article focusses on the impact of a low oil price environment on those specific contracts: long-term LNG sale and purchase agreements (**"SPA"**).

The article first analyses the immediate issues faced by participants in the industry in March, April and May arising out of declining oil prices and the wider pandemic. It then focuses on the take or pay clauses which are common in such contracts. It goes on to consider whether the low oil price environment may lead to an increase in price review activity, and it concludes by considering what the future might hold in light of the low oil price environment.

THE IMMEDIATE REACTION TO COVID-19

The immediate response to the unfavourable market conditions earlier this year was characterised by participants in the industry scrutinising their contracts to identify the potential options available to them.

This mainly involved considering whether committed cargoes could be diverted to different markets, both from an operational and contractual perspective; reviewing whether cargoes could be reduced by cancellation, deferral or the exercise of downwards flex rights; and, of course, force majeure.

We have written at length about the operation of force majeure clauses, including in the specific context of long term LNG contracts. See, for example, our briefing here.

So rather than focus on force majeure, this article next considers the take or pay clause. Like force majeure, this clause is common to almost all long-term LNG contracts – but it has received considerably less scrutiny in the last few months.

THE TAKE OR PAY CLAUSE

A take or pay provision requires the buyer to take and pay for a quantity of LNG in a contract year, or otherwise pay an agreed price for any LNG not taken. Take or pay clauses are seen as essential in order to finance large greenfield LNG developments: the mechanism essentially guarantees a certain level of revenues for the duration of the contract.

However, for sellers and buyers scrutinising the take or pay provisions in their contracts, a number of questions are likely to arise. For example:

- **When does the take or pay liability accrue – is it on a cargo-by-cargo basis, or is there a reconciliation at the end of the Contract Year?** This question is particularly relevant in the current market environment, where cash flow is a particular concern. A take or pay liability which accrues on a cargo-by-cargo basis is unlikely to ease cash flow problems, whereas a liability occurring six or twelve months into the future may be more helpful to a buyer.

- **If a buyer 'pays' rather than 'takes', is there an entitlement to make up LNG?** This is usually the case. However, we have seen contracts where there is no such entitlement. In a contract where a buyer obtains nothing in return for its take or pay payment, paying but not taking is likely to be an option of absolute last resort.

- **Are there stipulations on when the make-up LNG can be taken, and at what price?** If a large make up balance accrues under an SPA with 15 years still to run, that is quite different to a balance accrued under an SPA with only one or two years left to run. The shorter the duration of the contact remaining, the greater the likelihood that there could be an outstanding balance at the end of the contract. If that happens, we often see provisions whereby a period of time is added onto the end of the contract in which the

buyer can take the outstanding make up LNG balance – but even then, there remains a possibility that the balance might still not be zero by the end of that additional period.

The answers to these questions will ultimately depend on the wording of any individual take or pay clause. Many long term LNG contacts are governed by English law, where the language of clause will be key. However, the questions illustrate some of the complexities inherent in how the take of pay mechanism might work in practice, and may explain, at least in part, why notwithstanding the ubiquity of take or pay clauses in long-term SPAs, they are in our experience seldom invoked (in the sense that a buyer will rarely pay and not take).

THE MEDIUM AND LONG TERM RESPONSE TO LOW OIL PRICES

We explained above that the short-term response to the unfavourable market conditions was characterised by contractual, or extra-contractual, 'quick fixes'. We will next consider what the medium or long-term response might be.

Why are oil prices relevant to long-term LNG contracts?

The first question is why low oil prices are relevant to long-term LNG supply contracts at all.

The answer lies in the fact that the Contract Price (the price of LNG sold under the agreement) will often be directly linked (to some extent) to oil or oil product prices (usually Brent or Japanese Crude Cocktail), typically on a three or six month average. Low oil prices will usually lead to lower Contract Prices – but with some lag time.

Price review clauses: a tool allowing either party to mitigate the differential between spot prices and Contract Price?

If there have been significant market changes which mean the Contract Price no longer reflects the bargain originally struck between the parties, a price review clause can be a valuable mechanism for either party to use to seek a change to the price.

However, whether low oil prices will increase price review activity depends on a number of factors.

First, from a timing perspective, contracts usually provide that price reviews can only be started after certain fixed intervals of time have passed. European LNG import contracts usually allow for a review to be available every three or five years, whilst Asian LNG import contracts (to the extent they provide for price reviews at all) tend to allow for five or even ten year intervals. Provided the set period of time has passed, and there has been a significant change in the relevant market since the last price review which is beyond the parties' control, a party will usually be able to trigger a price review.

A party may be also able to trigger a ‘special’ price review outside the regular window, provided certain conditions are met. The availability of such ‘special’ reviews varies greatly across contracts and – in our experience – is more common in European LNG import contracts rather than Asian LNG import contracts.

Second, the conditions for a price review specified in the contract must have been met by the relevant circumstances.

The underlying purpose of a price review clause is to provide parties with flexibility to deal with unforeseen changes. There is therefore often ambiguity in the drafting of the clause. However, contracts will usually set out the circumstances allowing a party to trigger a price review, and the methodology to be used when determining the revised price. Usually, it is based on the value of the gas (or regasified LNG) sold in the relevant market.

Contracts may stipulate that the assessment of the change in value be conducted by reference to changes in the prices paid by end consumers and the costs of serving them. Alternatively, the assessment may be conducted by comparing the Contract Price to comparable contracts, sometimes defined as contracts from/to a specific market (e.g. from Indonesia to Japan) or from/to a broader geographic area (e.g. the Asia-Pacific region).

WHAT THE FUTURE MIGHT HOLD

The extent to which low oil prices will be important in the context of a price review will depend on the specific contract and clause being considered.

But it is clear that the low oil price – and the broader pressure on prices – has created an incentive for buyers and sellers to re-open contract prices in long-term contracts. And that includes re-opening the very basis on which such prices are formulated.

As discussed above, low oil prices are relevant to long-term LNG SPAs through the pricing formula, which is often linked to oil products to some extent.

The move away from oil-indexed prices in such contracts has been ‘just around the corner’ for some time. However, we await with interest to see whether, in existing SPAs which are subject to price reviews, and in any new medium or long-term LNG SPAs that might be negotiated in the next few years, the low oil prices, the increasing dislocation from the spot market for LNG, and the wider reverberations from the pandemic, mean parties will move away from this approach, and negotiate formulae based on spot or hub-based prices instead.

Navigating the low price oil environment

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

RACHEL LIDGATE
PARTNER, LONDON

+44 20 7466 2418
Rachel.Lidgate@hsf.com

JAMES ROBSON
SENIOR ASSOCIATE, LONDON

+44 207 466 2641
James.Robson@hsf.com

LEGAL NOTICE

The contents of this publication are for reference purposes only and may not be current as at the date of accessing this publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

© Herbert Smith Freehills 2021

SUBSCRIBE TO STAY UP-TO-DATE WITH LATEST THINKING, BLOGS, EVENTS, AND MORE
Close

© HERBERT SMITH FREEHILLS LLP 2021