LNG MARKET ENTRANTS, RECENT MARKET AND CONTRACTUAL DEVELOPMENTS

CRISTINA F. LUDENA

Introduction

World LNG trade had a record growth of 22% in 2010 by reaching 298 bcm due to very strong economic recovery in Asia, increased production capacity from Qatar and emerging market such us Latin America or Middle East. As spot volumes increase and LNG market becomes more liquid, there are new players entering the LNG market, such as oil traders or financial institutions, both with an appetite for contract standardisation, for various reasons but ultimately, in order to facilitate trading and cargoes changing hands. Traditional buyers welcome standardisation as it typically implies more balanced contractual positions for seller and buyer. The next step in the commoditising process of LNG is the access by new entrants to mid-term LNG contracts, explained by sellers need to use intermediaries to be able to expand market reach and buyers search of more flexible hybrid contractual and pricing structures.

Objectives

This paper aims to address the main drivers and trends that have contributed to the development of the spot/short term LNG market, in particular, the appearance of new entrants and contract standardisation. The article will provide an overview of changes to contracting practises from long-term sale and purchase agreements to spot master agreements, with a special focus on recent released industry standard spot master agreements and show how these can dramatically assist market participants increase liquidity and trading. We will then conclude identifying some trends in mid-term LNG markets like the incipient entrance of new market participants and development of new hybrid contractual structures.

Spot market developments

The market share of spot trade in LNG accounted for 17% in 2010. Nevertheless, the 20 - 25year long-term contracts still comprises a majority of the LNG market. The main factors driving the continued growth of the LNG spot market include, 1) the share of “liquid markets” in the overall LNG market mix increases, 2) the need for flexibility increases as a result of the liberalization process, 3) the margins derived from opportunistic spot transactions increase, 4) the acceptability of spot LNG risk for LNG producers (and lenders) increases, 5) midstream and downstream investments will offer room for spot, 6) new supply coming on-stream to the market (eg, Qatar, Peru, Australia, Angola, Yemen etc).

LNG has some common characteristics with the oil market, including netback pricing and a growing spot market. However, there are structural differences since oil price differentials are much smaller than for LNG because of the lower cost of shipping oil and the greater number of points of oil supply and offtake. There is also a trend to hedge against volatility in LNG prices through storage, spot trading, contract-indexation mechanisms and financial instruments which will lead towards greater standardisation in pricing and facilitate trading.

However, building liquefaction and regasification capacity is capital-intensive making the limited volume of production and import capacity an obstacle to the development of the spot market. Consequently, in the long-term point-to-point contracts will remain the norm for the producers.

New entrants in the market include intermediaries such as banks and trading houses and new buyers in markets where importing monopolies have disappeared, for example, India, South Korea or Greece.

Global International Gas Trade (2010)

(Gas Imports By Region)

BCM	Pipeline:	LNG:	Total:	% LNG Share: Imports:	% LNG Share: Global:
North America	123	20	143	*14%*	*7%*
S/C America	12	10	22	*45%*	*3%*
Europe	363	87	450	*19%*	*29%*
FSU	88	-	88	-	-
Africa	6	-	6	-	-
Middle East	31	3	34	*9%*	*1%*
Asia	24	178	202	*88%*	*60%*
Total	**647**	**298**	**945**	***32%***	***100%***

Global International LNG Trade (2010)

(Gas Imports By Region & Contract Type)

BCM	LNG:	Spot*:	Term:	% Share Spot:	% Share Term:
North America	20	4	16	*20%*	*80%*
S/C America	10	7	3	*70%*	*30%*
Europe	87	12	75	*14%*	*86%*
FSU	-	-	-	-	
Africa	-	-	-	-	-
Middle East	3	0	3	*0%*	*100%*
Asia	178	28	150	*16%*	*84%*
Total	**298**	**51**	**247**	***17%***	***83%***

**Spot Includes Short-Term Contract Deliveries*

Reaching the negotiation stage for spot LNG transaction requires at the very least a supplier with uncommitted capacity, a potential buyer with available import capacity and a vessel that is vetted and can meet the requirement of loading and unloading terminals. In addition, contact negotiations for purchase and sale agreements can be very time and resource intensive (just as arranging for a term trade).

To address this, the industry has moved to put in place standard master agreements (FOB and/or DES deliveries), where the majority of terms and conditions are established in advance and individual confirmations are executed as cargoes become available.

Spot market industry master agreements

The first standardisation effort came in 2004 by Groupe International des Importateurs de Gas Natural Liquéfié (GIIGNL) issuing a 25 page Master Ex-Ship LNG Sales Agreement. Then the Association of International Petroleum Negotiators (AIPN) in 2009 published a 90 page DES Master LNG Sale and Purchase Agreement subject to New York law. None of the two models have really picked up in practise, the former for allegedly being too succinct and the later for being seller oriented and overly complex with too many choices. As a result, in 2010, the European Federation of Energy Traders (EFET) published a Master DES LNG Sale and Purchase Agreement subject to English law. Companies in the EFET LNG legal task force included sellers, buyers, traders such as BP, Centrica, Dong, EGL, Eon Energy Trading, Essent Trading, Gaselys, Morgan Stanley, RWE Trading, Total, Shell and Vitol.

The EFET Master is a robust and well balanced document for DES spot deliveries of single cargoes or a string of cargoes over a more extended period of time. Commercial terms are included in a confirmation notice to the Master Agreement (eg, volume, price, arrival period, Delivery period, LNG specifications, designation of loading/discharge port). It is open for use by anyone and can be downloaded for free from http://www.efet.org/Standardisation/LNG_6941.aspx#23735?urlID2r=15. Traders and new buyers coming onto the market (not only in Europe, but also Middle East and Asia) have quickly embraced the document as reliable and easy to execute as there are no choices to be made.

The main highlights and differences between a long-term sale and purchase agreement (SPA) and the EFET spot Master Agreement are as follows:

1) Failure to Deliver / Take

As opposed to the standard “take or pay” and make-up remedy for buyers failure to take and no express remedy or just a percentage (10% to 25%) of the contract price for seller’s failure to deliver, the EFET Master Agreement includes a symmetrical replacement cost remedy for failure to deliver / take. The remedy in both cases being the difference between the contract price and the replacement cost of LNG or natural gas plus incremental transportation and other direct costs, and capped to 100% of the contract price.

2) Off-spec gas

Specifications typically reflect the composition of the domestic pipeline gas. Buyer and seller are to cooperate in dealing with off-spec LNG, and Seller is to reimburse buyer for the cost of treating the LNG to bring it into the desired specification range, up to 20% of the contract price. However if Buyer unknowingly accepts off-spec LNG, seller is to indemnify buyer up to

100% of the contact price. In term SPAs seller's liability is more limited and capped to 10% or 15% of the contract price.

3) Force Majeure

Contrary to very broad and asymmetrical provisions in SPAs, under the EFET Master Agreement, ""Force Majeure" means any circumstance whatsoever occurring after the date of execution of the relevant Confirmation Notice which is beyond the reasonable control of the Party affected ("Claiming Party"), acting as a Reasonable and Prudent Operator, that prevents or delays such Party's performance under this Agreement and such Confirmation Notice". Provided that events meet this test, serious damage to liquefaction and loading facilities (production area as well, if agreed in the confirmation notice) and import terminal facilities (including trunkline) are included. There is no coverage of reservoir depletion or downstream customer facilities as delivery is DES unloading port. If force majeure continues for 7 days and parties are prevented from delivering/receiving the LNG cargo, then either party may cancel the cargo without liability. In SPAs buyer may have restoration rights in respect of affected force majeure volumes and carry over such volumes until the end of the contract term.

4) Title Transfer

Title transfer can be on unloading or alternatively, outside territorial waters of discharge port since the EFET master agreement can be used for deliveries worldwide. SPAs are generally constrained by destination restrictions.

5) Credit Support

Credit Support is an important element in LNG spot trading. Typically a cargo will be sold open credit or subject to letter of credit (documentary or stand-by). In addition, either party may request performance assurance if the creditworthiness of the other is materially impaired. For SPAs, there are additional credit requirements since the creditworthiness of the buyer will have to meet minimum lender requirements (eg, minimum rating).

6) Applicable Law and Disputes

English law is the governing law of the EFET Master Agreement and disputes can either be submitted to London High Court or arbitration in London in accordance with Arbitration Act 1996, as elected by the parties in the master agreement. SPAs governing law and jurisdiction may vary depending on the producer but the majority will be subject to arbitration.

Spot LNG influencing Mid-term LNG market development?

As spot market develops and new entrants consolidate their share, mid-term markets start to become also accessible to new players, particularly intermediaries. For sellers these new entrants may help expand their reach to other markets where they cannot supply directly for various reasons, including logistics, geopolitics or inability to accept certain contractual or credit risks. As a result, new entrants can offer novel and more flexible contractual and pricing structures for mid-term supplies than traditional producers as they are not constrained by any project finance or long-term precedents. Some of these new mid-term structures incorporate elements from spot contracts which are very attractive for buyers compared to the more strict take or pay term contracts and continue rolling-over of volumes over the term of the contract.

Conclusion

Spot LNG market continues to grow and provide increased liquidity. Standardisation achieved in the contractual side is relevant to facilitate trading negotiations and cargoes changing hands. New entrants, particularly intermediaries, have an important role to play to bring together suppliers and buyers worldwide. As liquidity increases and intermediaries consolidate their position in spot markets, mid-term markets will open more and more and benefit from the contractual standardisation and pricing structures achieved on spot markets.