

## TIME CHARTER PARTIES IN THE LNG TRADE

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After years in the doldrums, LNG transportation is on the rise. LNG importers and exporters acted quickly in recent years to secure rights to the few remaining available LNG tankers. Although some LNG sellers and buyers elected to acquire ownership of LNG vessels, often companies in need of LNG transport chose to enter into long-term time charters with a shipowner (who is normally a third party but is occasionally a minority affiliate of the LNG seller/buyer). Shipowners have also preferred the security of long-term time charter income, as it has provided the necessary support to arrange financing on the most attractive terms. In fact, a recent report<sup>1</sup> indicated that well over 90% of the world's LNG ships are presently committed under long-term charter arrangements.

However, persons given the responsibility for negotiating LNG time charters have swiftly realized that the so-called "standard" marine time charter party used by the shipping world is inadequate for properly documenting the relationship between LNG shipowner and charterer. The long-term focus of the LNG trade, the absence of readily-available replacement LNG ships, and the unique inherent nature of LNG itself have necessitated numerous additions and changes to the standard forms developed for short-term crude oil and LPG trades.

This article will briefly highlight key issues that arise in a long-term LNG time charter, which may have a duration exceeding twenty-five years. Under the typical form of a time charter: (i) the shipowner places the ship's full transport capacity at the service of the charterer for a certain period of time; (ii) the shipowner operates the ship, with the charterer having freedom to determine voyages and cargo; and (iii) hire is paid by the charterer throughout the entire charter term unless the ship is considered unavailable for service of the charterer (i.e. "off-hire"), without regard to the number of voyages performed by the vessel. Although many issues arising in the "standard" crude oil/LPG time charter are common to the LNG vessel charter (e.g., delivery, registry, hire rate, speed and fuel consumption, off-hire, taxes, dispute resolution, and certain maritime clauses), this article will focus on several issues faced in long-term LNG charters that are not adequately addressed in such standard forms but for which proper documentation is critical.

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<sup>1</sup> "LNG tankers move into new role", by *Gabriel F Avgerinos , Roy L Nersesian , Jeffery Goetz , Fred Adamchak*, Oil & Gas Journal, Volume 98, Issue 51 (Dec 18, 2000). The article highlights the results of a recent study by Poten & Partners.

- **Existing Vessel Issues** – Given the resulting cost savings of chartering existing vessels, cargo owners often prefer chartering older vessels. However, many existing LNG ships were built during the 1960s and 1970s, so their suitability for long-term charter may be questioned. To address this issue, detailed provisions are often incorporated into the time charter of older ships which call for a “Ship Useful Life Study” to be carried out by an agreed expert. The LNG ship’s physical capabilities become increasingly at risk as the ship ages; performance warranties may also be modified by an agreed procedure in the event the age of the vessel is reasonably expected to adversely affect its performance. The parties pay particular attention to allocation of the risk of changes to government regulations and classification society rules which require expensive modifications to the vessel during the term of the charter; vessel owners may elect to retain a termination option if the cost of such changes exceeds an agreed threshold amount.
- **New Vessel Issues** – In light of the tight market for existing ships and the recent move of LNG suppliers (especially those from the Middle East) to twenty-five year sales contracts, often only a newly-built LNG tanker will be acceptable. The “standard” crude oil/LPG time charter does not contain the expansive vessel delivery provisions needed to address the parties’ rights in relation to construction of the vessel and the lender’s security in relation to financing of new-builds. The extent to which a shipbuilder force majeure or default will modify the shipowner’s obligations to deliver the vessel to the charterer on a certain date must be sufficiently dealt with, as well as the parties’ relative rights to cancel the charter as a result of such delays. Other matters in connection with newly-built vessels that should not be ignored include the charterer’s right to supervise or inspect the vessel during construction and gas trials and the charterer’s rights to alter the vessel during the construction period. Lastly, given that shipowners typically have limited recourse against a defaulting shipbuilder, the parties often agree to include liquidated damages in the event of non-delivery of the vessel as a result of failure on the part of the shipbuilder.
- **Extraordinary Situations Affecting the LNG Trade** - Although the charter of non-dedicated LNG vessels is not uncommon, frequently charterers are acquiring rights to a particular LNG vessel in connection with a certain trade to which the vessel will be committed, perhaps exclusively. Charterers are especially keen on addressing the circumstances under which hire may be reduced or the charter terminated if the underlying LNG trade is interrupted due to a sales contract force majeure. Rights of the charterer typically differ in relation to the length of the sales contract force majeure, with very short force majeure events (3-4 months) having little if any effects on the parties’ rights, longer events reducing the amount of hire, and lengthy circumstances allowing the charterer the right to terminate the charter upon the payment of a “permanent force majeure termination fee”. If the shipowner is unwilling or unable (due to financing restrictions) to grant the charterer such broad sales contract force majeure rights, at a minimum charterers insist on having the ability to reduce operating costs by placing the vessel in lay-up during extraordinary situations halting the underlying LNG trade. Alternatively, charterers who fear losing the chartered vessel (perhaps due to an off-hire event) often seek an exclusive

option to charter any LNG vessel in the owner's fleet that is uncommitted at the time of such loss; such a protection may have considerable value if the dearth of LNG tankers at hand on the "spot" market continues.

- **Condition of the Vessel.** Shipowners and charterers often disagree on the standard to apply to the owner's post-delivery obligation regarding condition of the vessel, with charterers arguing for an absolute warranty of condition and shipowners arguing for only an obligation to exercise "due diligence". In addition to the usual and customary representations and warranties of a tight, staunch, strong and otherwise seaworthy vessel, typical condition-related provisions added to "standard" charters include warranties that at delivery and throughout the term of the charter the vessel will (i) be fitted in every way for the safe loading, discharging, handling and carrying of LNG in bulk at atmospheric pressure, and (ii) have cargo handling and storage systems necessary for the safe loading, discharging, handling, carrying and measuring of LNG.
- **Performance Warranties** – The hire rate under a long-term LNG time charter is agreed assuming that the vessel will at all times be capable of achieving a minimum level of performance with regard to speed, fuel consumption, boil-off and LNG loading and unloading. In the event such thresholds are exceeded, the charter provides certain reductions in the amount of hire; no increase in hire is generally available for performance exceeding such lower limits. Verification of such performance is typically on an annual basis (or for periods between dry-docks) but in some instances (such as speed) is carried out on a voyage-by-voyage basis. In this regard, the shipowner warranties may be conditioned on certain operating conditions, such as (i) the absence of extremely adverse weather conditions which affect the vessel's speed, and (ii) the existence of suitable gas return lines at LNG shore installations to permit loading or unloading at the minimum rate.
- **Actual Operating Cost Hire Rate** – In long-term time charters, many shipowners are uncomfortable with taking the risk of increases in operating costs (such as insurance, manning, maintenance and repair, spare parts and drydocking). If so, a portion of the hire rate may be based on the actual operating costs incurred by the shipowner, with monthly hire payments established within an agreed estimate and an annual reconciliation (with interest) between the parties after audit of the shipowner's actual costs. Obviously, if the charterer is to bear the risk of increases in operating costs, the charterer will insist on certain approval rights (such as the frequency and place of dry-docking; crew composition; insurance levels and types; and capital expenditures near the end of the charter term) to avoid unnecessary expenses and "gold plating" of the vessel. It is not unusual for a conflict to occur between the shipowner's desire to ensure that the vessel is maintained and manned to the highest standards and the charterer's need to obtain LNG transportation at the lowest possible rate. A requirement of planning by the parties of significant costs (such as a rolling five-year approved plan for vessel maintenance and repair) assists in reducing such divergent views on annual operating costs.

- **Compatibility and Documentation** – Most LNG time charters allow the charterer to engage in worldwide trading, subject to certain British or other Institute Warranty Limits and to certain ice-related limitations. Despite such freedom of trading, LNG time charters do not require the shipowner to warrant that the ship will at all times be compatible with every LNG terminal or that the ship will always have on board valid documentation to enable the ship to enter every port to which the charterer might direct the ship. Instead, it is not unusual for the parties to agree to certain named ports for which the shipowner will have the responsibility for ensuring that compatibility and documentation requirements are met, regardless of the cost thereof. In a related issue, LNG charters frequently contain a more detailed treatment of safe port/berth issues than do traditional short-term charters.
  
- **Default Rights** – To ensure the presence of reliable LNG transportation, charterers are apt to demand the capability to correct an owner's repeated failures to perform voyages, loadings or discharges by having the right to either (i) replace the manager of the vessel, or (ii) convert the charter into a bareboat charter for the remainder of the term. Moreover, to reduce the risk that a shipowner default will adversely affect availability of the vessel to the charterer throughout the charter term, most charters place strict limitations on the shipowner's power to place or permit any mortgage, lien, claim, or encumbrance on the vessel, its earnings or insurance without the prior written consent of the charterer. Such permission as to permitted encumbrances is normally conditioned on the lender's/third party's execution of documents expressly recognizing the charterer's rights in the vessel pursuant to the time charter. Conversely, in exchange for confirming a charterer's quiet enjoyment of the vessel under the charter, the vessel owner's lenders expect comfort from a charterer that it will refrain from exercising certain charter termination rights in order to allow such lenders sufficient time to replace a defaulting shipowner with another LNG operator whose participation would enable full continuation of the charter.
  
- **Shipowner Reorganization and Financial Security** – Relationships with financially secure and reliable parties are critical in the LNG business. As is typical in shipping, the shipowner is often a special purpose corporation whose only asset is the ship (or in some cases the demise charter of the ship). The payment and/or performance obligations of the shipowner (and sometimes the charterer) are backed by guarantees issued by the parent company or by standby letters of credit. Charterers are keen to exercise reasonable control over the direct and indirect ownership of the shipowner through limitations on the shipowner's right to merge with another entity or to transfer the shipowner's rights in the vessel to a third party. Likewise, shipowners wish to restrain the charterer's right to assign the time charter to unrelated entities.
  
- **Other LNG Issues** – Other issues of commercial significance in long-term LNG charters that are not addressed in standard time charter party forms include the following:
  - Vessel owner's representations and warranties as to key vessel specifications, such as cargo tank capacity at cryogenic temperature and atmospheric pressure;

- ❑ When liabilities for damage to the vessel and/or terminals and related personal injuries will be subject to port risk allocation agreements or conditions of use, and the approval of such agreements by P&I Clubs and other vessel insurers;
- ❑ When is a vessel considered “hot”, as well as valuation and compensation for LNG required for purging and cooling after regularly scheduled dry-docking, unscheduled dry-docking or lay-up;
- ❑ Off-hire treatment for time spent inerting, purging and gas-freeing the vessel in connection with dry-docking and repair procedures;
- ❑ An agreed ratio of LNG to fuel oil in order to arrive at the vessel’s total fuel usage;
- ❑ Use of non-negotiable bills of lading for LNG cargoes;
- ❑ Charterer’s right to attend LNG measuring procedures and its obligation to bear the cost of testing and recalibration of measuring devices; and
- ❑ Shipowner’s obligations regarding storage of LNG samples during the voyage and their delivery to LNG customers at the completion of each laden voyage.

In conclusion, it is acknowledged that there is currently a trend for LNG companies to move away from the tradition of ordering ships only after long-term LNG sales have been contracted; in the last two years several orders for new ships were placed without the owner first firmly employing the ship in a long-term LNG trade. Although the growing short-term market for LNG and escalating hire rates for uncommitted LNG ships will have an increasing impact, the long-term oriented LNG business shows little sign of disappearing in the near future. In both ex-ship and FOB trades, negotiators and draftsmen will need to continue to closely tie the obligations in an LNG sales contract with the availability of LNG transportation (e.g., LNG plant start-up; delivery of new vessels; force majeure; capacity of vessels; and dry-docking and other vessel unavailability). When modified to address specific LNG issues such as those mentioned above, the conventional time charter party has proven to be an excellent contractual means of arranging reliable, safe and cost-efficient long-term marine transportation of LNG.

### **Biography**

Philip R. Weems is a partner with King & Spalding in Houston, where a substantial amount of his law practice includes structuring, negotiating and documenting LNG projects. Mr. Weems has acted as lead counsel for the long-term time charter of numerous existing and new-build LNG vessels. He serves on the Board of the Association of International Petroleum Negotiators.