Energy Intelligence

# NATURAL GAS WEEK



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## New Pressures Facing US LNG Sales Contracts

Unprecedented low gas prices and weaker demand exacerbated by the coronavirus pandemic have made buyers of US LNG among the most badly hit players as they are locked into expensive long-term contracts that are uncompetitive in today's market.

Lessons from the coronavirus pandemic are expected to add further pressure on US developers pursing final investment decisions (FIDs) to rethink their business models and devise ways to respond to buyers' needs for greater volume flexibility and price checks.

"I assume buyers will ask for the moon in this type of environment," a source with a US LNG seller told Energy Intelligence. "I imagine a lot of speculative US greenfield projects are getting desperate."

A precipitous drop in spot prices has triggered up to 80 cargo cancellations for June and July loading. Assuming each cargo commands a fixed charge of $3 per million Btu, rough calculations show offtakers must fork over almost $750 million to US sellers even though the cargoes were rejected. However, the fixed charges are a sunk cost as they were already slated to be paid under US tolling contract terms.

The US LNG industry pioneered destination-free contracts, and its linkage to Henry Hub prices made strong economic sense earlier this decade when oil was trading above $100 per barrel. But Brent crude is now around $40/bbl and LNG markets have changed significantly.

Even before the pandemic, buyers were pushing for different pricing mechanisms and new provisions to ensure US LNG prices did not deviate too much from market rates. However, reforms would pose a challenge to existing US models that allow a pass-through of infrastructure fees in LNG prices.

Pricing US LNG against Henry Hub in a cost-plus pricing formula represents a low-risk model for US exporters, but it puts much price risk on buyers, which are selling the gas in Europe and Asia based on different indexes. European buyers want US players to price their LNG based on a netback to the Dutch TTF European benchmark, but that may not sit well with lenders to US suppliers.

US developers have been tweaking their pricing propositions even before the pandemic slashed demand and prices (NGW Sep.16'19). Cheniere Energy signed a 15-year deal to buy the equivalent of 850,000 tons per year (0.12 billion cubic feet per day) of LNG from Houston-based gas producer Apache, which Cheniere plans to liquefy and sell from an expanded Corpus Christi LNG terminal on the Texas Gulf Coast.

Payments to Apache will be based on international LNG prices less a fixed liquefaction fee and costs incurred by Cheniere, and the deal will allow it to sell non-Henry Hub-indexed LNG without taking on spread risk.

NextDecade signed a 2 million ton/yr sales and purchase agreement (0.27 Bcf/d) with Royal Dutch Shell based on a hybrid formula -- 75% of the volume priced off Brent and for 25% off US gas indexes, including Henry Hub.

The fixed fee for US contracts has come under pressure since the pioneer contract was signed in 2011 between the former BG Group and Cheniere for 3.5 million tons/yr (0.47 Bcf/d) at $2.25/MMBtu from Cheniere's Sabine Pass terminal in Louisiana.

Venture Global's 10 million ton/yr Calcasieu Pass (1.3 Bcf/d) project was the last US greenfield venture to be sanctioned last August with fixed fees rumored to be at or just below $2/MMBtu, depending on the offtaker. "Some buyers noted that the fixed charge is essentially a capital recovery term for the project's capital costs so sellers should reduce the charge after the project has recovered its capital costs," said a former US LNG seller.

To improve volume flexibility and ensure US prices are on par with market prices, buyers may also seek to include clauses in new contracts that are already available in traditional oil-linked contracts. "Buyers may push for free downward quantity tolerance (DQT) and price reviews for future US contracts," says Daniel Reinbott, a partner with consultancy Ashurst.

But price reviews, typically every five years, would put pressure on the infrastructure tolling model adopted by most US projects. As US developers have been focused on selling all their volumes in long-term contracts to maximize their revenue, incorporating DQTs would require sellers to devise new marketing approaches, including selling spot and short-term volumes.

However, another source with a second-wave terminal developer points out there is no basis for a price review because the market for liquefaction fees today is much lower than those secured by the earlier projects. "US Gulf Coast contracts are totally transparent and tied to the underlying market price of the natural gas," he said. "This is unlike traditional oil-linked LNG contracts where there is no real relationship between the price of the feed gas and the price of the LNG. The underlying natural gas has no market value since a stranded asset, hence the opportunity for price reviews."

Non-US contracts may also be vulnerable as buyers seek to reduce their "take-or-pay" obligations, which are designed to provide the seller with a guaranteed revenue stream to support large up-front investments for costly LNG projects. Buyers want to exercise their DQT rights throughout the contract year, rather than just once a year; have the option but not the obligation to receive make-good cargoes in subsequent years; and divert cargoes without sellers' consent.

Coronavirus-driven lockdowns triggered some major LNG buyers, notably in China and India, to issue force majeure warnings to sellers earlier this year. But sellers have challenged the legality of such claims, asserting that a demand loss should not relieve buyers of their contractual obligations.

"Parties will pay more attention to the force majeure clause such as the circumstances a party may claim force majeure relief, including what they must demonstrate, how and to what extent the affected party's obligations are excused as well as potential consequences if a party makes a claim where there is no evidence to support such a claim," Reinbott said.

Buyers may be tempted to include an option to terminate the contract under certain circumstances, but lawyers think this is still fraught with difficulty.

Any significant demand-killing event "could change the underlying economics of a contract to the extent a termination right may be desirable. But that itself will change the whole risk profile of the contract," said Richard Nelson, partner with King & Spalding. He believes lenders would find it hard to accept early termination triggers and sellers may require more quid pro quo in terms of less flexibility or higher prices to mitigate their risks. ?

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