

IOGP comments on the Initial Review on Potential Standardisation of LNG Sale and Purchase Agreements

To: Energy Charter Secretariat

The International Association of Oil and Gas Producers (IOGP) represents around 80 oil and gas companies responsible for producing one third of the world's gas and half of its oil, as well as service companies and national oil industry associations. IOGP's members operate in all major producing regions and have several decades of experience in LNG.

IOGP welcomes the opportunity to respond to the first BakerBotts report to the Energy Charter: "Initial Review on Potential Standardisation of LNG Sale and Purchase Agreements". We understand that the Energy Charter Secretariat was mandated to explore the current situation of LNG contracts and their potential standardisation. We would like to make the following comments on the first report, which hopefully will be useful for the next phase of the work. IOGP welcomes the invitation to follow this work and provide our comments and suggestions on this matter.

Evolving Gas Markets

Natural gas has a key role to play in energy systems, and will continue to do so in the future, because of its scalability, reliability and efficiency, as well as cleaner burning properties and competitive costs. LNG is simply a method of transportation of natural gas, allowing remote resources to reach areas of customer demand. The LNG industry is becoming increasingly global and links previously regional markets in Asia, Europe and North/South America with multiple supply options. Both suppliers and customers benefit from these developments, which are providing a wide choice of natural gas sales/supply options ranging from traditional long-term contracts to shorter term and spot arrangements to meet evolving customer and supplier needs, increasing competition and security of supply.

The report suggests that, if LNG becomes a truly "liquid" commodity, traded from "hubs" with hub pricing, one standard LNG SPA may be feasible. We don't know whether/when this can be achieved, but a logical first step seems to be to promote the development of natural gas markets. There are still barriers for natural gas (whether delivered by pipeline or as LNG) to reach certain areas, due in particular to lack of interconnectivity and market depth. In markets where infrastructure and demand do exist, the access to buyers and sellers can be limited by regulations or local monopolies. In Europe for example the view on market development is that the completion of the Internal Energy Market is key for the efficient use of LNG terminals in some locations. IOGP agrees that establishing an efficient, liquid and deep market place in Europe which delivers internationally competitive price formation where natural gas delivered via pipeline competes on a level playing field with natural gas delivered via LNG, is an effective mechanism of attracting LNG supplies.

Complex nature of the LNG SPAs

We appreciate that the authors of the report recognise the complexity of LNG Sale and Purchase Agreements (LNG SPAs) and the negotiations associated with them. The majority of LNG contract terms are subject to extensive negotiations between sellers and buyers of LNG and are reflective of the particular circumstances of each transaction.

Consequently we support the conclusion that the factors which determine the seller-buyer relationship are too numerous and variable to permit universal standardisation of LNG SPAs at this time. Furthermore, the use of standard LNG terms or contracts as a starting point often involve long and complex negotiation to tailor the final agreement to the specific set of circumstances of buyer and seller for that particular deal. This is also evidenced by the fact that there are already a lot of long-term LNG contract models but those have had limited application.

Destination Flexibility

The terms within LNG SPAs are arrived at through commercial negotiations, in combination with applicable law, and reflect a value trade-off between the needs of the buyer and the needs of the seller. With regard to destination flexibility, LNG supply contracts are generally agreed on either a DES/DAP/DAT basis where the seller provides shipping to the receiving terminal, or on a FOB basis where the buyer arranges shipping of the LNG from the loading terminal. Contracts signed on a DES/DAP/DAT basis will typically have an agreed delivery terminal, which is necessary for the seller to determine the shipping logistics and costs of the deliveries which are all factored into the contract pricing. This applies for both long term and short term contracts. Pricing for contracts signed on a FOB basis may also be based on an expected destination in order to ensure that the price is within the relevant “market” for both buyer and seller. Again, this applies equally to long term and short term contracts. Hence, today's issues with contractual provisions are generally caused by changes in the market that were unexpected or that counterparties have not yet been able to address through negotiation.

Buyer Volume Flexibility

In a global market for natural gas, the flow of LNG will be determined by supply / demand fundamentals. In this context buyer volume flexibility is closely linked with destination flexibility to divert LNG cargoes to higher demand (price) regions. Recent examples of large scale LNG diversions and reloads demonstrate the existence of flexible LNG SPAs. It is this flexibility to respond to market signals that is reflected in the varying degrees of utilization seen in LNG regasification terminals worldwide, despite most holding long term bookings for their capacity.

Price Review Clauses

LNG contract prices are the result of extensive negotiations and reflect the specific circumstances of each transaction. However, during the term of the contract (most of which run for many years) market changes may occur that are unexpected or have not been adequately contemplated, potentially altering the balance of the original agreement between buyer and seller. This equally applies to contracts for pipeline gas. Price review clauses provide a contractual opening for restoring the balance, and often

specify a mechanism for dispute resolution. However, any price adjustment itself must be negotiated by buyer and seller and be acceptable to both unless they move to more formal, costly and time consuming dispute resolutions such as arbitration. There are numerous examples where negotiations have failed and the dispute is brought to a court of arbitration for resolution.

Conclusions Regarding Initial Review

IOGP agrees with the conclusion that development of a fully standardised LNG SPA for universal application is not currently feasible. The development of a standardized LNG SPA in certain contexts may be possible. We believe it could be helpful to focus on a master LNG spot contract as there are already a lot of long-term LNG contract models available and those have had only limited application.

The suggestion to address certain key “trends and issues” by standard provisions, such as price review clauses, may overlook that contractual issues are often caused by the fact that the legal provisions have proved inadequate to anticipate market changes. Even with the best price review clause there will always be the possibility that during the term of a contract the balance shifts in favour of either buyer or seller, resulting in disputes that are brought to a court of arbitration.

IOGP’s recommendation for the task force would be to promote the development of an efficient natural gas market framework that encourages investment in infrastructure and resource development. This can best be achieved by:

- delivering internationally competitive, market based, non-subsidized price formation;
- flexibility to freely negotiate commercial arrangements with counterparties of choice;
- promote contract sanctity and stability of legal and regulatory frameworks;
- establish, maintain and administer fit for purpose, transparent and non-discriminatory legislation and regulations.

IOGP believes these characteristics are key to attracting LNG supplies and are a prerequisite for the development of an efficient, flexible and transparent global LNG market, rather than the development of standardized SPAs.

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