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Does the ADP in Your LNG SPA Meet Your Needs?

By Merrick White*

In this article, the author explains the process that typically takes place when sellers and buyers of long-term liquefied natural gas sales and purchase agreements agree on the annual delivery program.

It has typically been a mildly contentious annual process when the sellers and buyers of many of the world's long-term liquefied natural gas ("LNG") sales and purchase agreements ("SPAs") agree on the Annual Delivery Program ("ADP"). Both parties' operations teams discuss, haggle and settle on an LNG delivery program that roughly meets both parties' needs. The discussions are framed by the terms of the applicable SPA but guided by cooperation and the goodwill generally found in long-term buyer-seller LNG relationships. Lawyers tend not to be involved but that may not always be the case.

PRICE DISCREPANCIES

With a global gas/LNG shortage and spot prices reaching record highs, there recently was a huge discrepancy between long-term LNG and spot LNG prices. At the time of drafting this article, Platts JKM[1] was quoted at $33.85/MMBtu and Title Transfer Facility ("TTF")[2] was quoted at $32.15/MMBtu for January 2022 delivery. However, a long-term LNG SPA at a relatively good LNG price of 13.5 percent Brent would be at $11.34/MMBtu with Brent at $84/bbl. An approximate $20/MMBtu difference or, for a mid-range LNG cargo size of 3,800,000 MMBtu, a $76 million difference per cargo.

With this level of price difference, every cargo is vital. For sellers, any cargo that can be delivered spot rather than under a term SPA can provide significantly greater profits, and the converse is true for buyers. Many LNG buyers have recently adopted a strategy of buying a significant proportion of their LNG demand on a term basis but with spot purchases covering demand growth and swing. For these buyers, ensuring as many of their (currently lower priced) term cargoes arrive during the high demand, high cost winter months

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[1] JKM reflects the spot market value of cargoes delivered ex-ship ("DES") into Japan, South Korea, China and Taiwan.

[2] TTF, the Dutch Title Transfer Facility, is a virtual title transfer point used for pricing spot LNG sales in NW Europe.

with lower price summer spot purchases making up any annual demand shortfall can significantly reduce their weighted average LNG purchase price.

The early long-term SPAs were developed for a point-to-point trade, often with a fleet of ships sailing continuously between a loading terminal and one or two particular receiving terminals serving a single SPA. Discussions on an ADP were relatively simple with both parties strongly incentivized to align delivery windows to reduce shipping and demurrage costs and ensure sufficient LNG supplies. But if the parties could not agree on a delivery program, typically the seller had the final say.

However, the LNG industry has changed significantly since those early days, particularly with the advent of portfolio traders, diversion clauses (with or without profit sharing elements), upward and downward quantity tolerance and, most importantly, the spot market: all driving a more flexible, efficient and commercial LNG market. As the LNG market has developed, so has the drafting of the ADP provisions, with buyers increasingly wanting to set firmer delivery windows and have stronger rights for Upward Quantity Tolerance ("UQT"),[3] Make-Up[4] and Make-Good[5] cargoes.

So how does the gulf between spot and term prices and the development of LNG SPAs impact the ongoing ADP discussions? Instead of coordinated discussions between both parties' operations teams to ensure that an ADP is developed that meets both their needs, it has the prospect of becoming a conflict zone where the addition or subtraction of a cargo from an ADP or an earlier or later cargo delivery window can have major financial consequences for the disadvantaged party.

The typical ADP setting process involves the provisional exchange of data between buyer and seller. From the buyer, its request for Make-Up, Make-Good and UQT quantities, as well as its desired delivery windows. From the seller, its provisional delivery windows and quantities.

Then, there is a period of discussion between the parties followed by the determination of an agreed ADP or, typically, if the parties cannot agree, an ADP prepared by the seller.

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[3] Upward Quantity Tolerance ("UQT") and Downward Quantity Tolerance ("DQT") are rights of a buyer to add cargoes to, or deduct cargoes from, its base annual contract quantity.

[4] Make-Up—if a buyer has paid for a cargo of LNG that it did not take (Take or Pay) then the buyer typically has rights to subsequently receive an equivalent cargo of LNG free of charge in later years.

[5] Make-Good—if a buyer has exercised DQT in a prior year, it may have the right to request the cancelled cargoes be delivered in a subsequent contract year.

Obviously, if the parties agree the ADP any conflicts have been resolved but, if they struggle to resolve all conflicts, then what happens? As discussed above, buyers have increasingly been successful in obtaining stronger rights under their SPA to secure the quantities and delivery windows they need during the ADP process. It is not necessarily solely in the seller's discretion as it may have been in the past. Each SPA's terms must be carefully assessed to determine the exact rights of each party to determine the quantities and delivery windows. If these are not followed, then claims for breach of contract could ensue and damages may arise.

MAKE-UP AND MAKE-GOOD

First, Make-Up and Make-Good. Throughout 2019 and 2020, LNG demand shrank drastically and, consequently, the spot price for LNG fell significantly too (JKM was around $3.00 /MMBtu in 1Q of 2020), often below the long-term price for LNG. As a result, some buyers had contracted more LNG than they could on-sell and may have incurred take or pay payments. Many buyers also exercised as much Downward Quantity Tolerance ("DQT") as was available under their long-term SPAs. For buyers, this had the dual effect of: (1) reducing their term supply, which, if post DQT reductions, was now below their demand, could be topped up with cheaper spot cargoes, and (2) also placed more cargoes in the market helping depress the spot price. Now the pricing position has reversed. With spot prices significantly above term prices, LNG buyers will be wanting their corresponding Make-Up and Make-Good cargoes.

Typically, buyers will seek to negotiate some level of obligation on the seller to provide these Make-Up, Make-Good and UQT cargoes, and there will be a hierarchy for delivery of them—with either UQT or Make-Up cargoes satisfied first and Make-Good cargoes satisfied last.

What determines whether one of these cargoes can be delivered? Typically the SPA will contain obligations on the seller to deliver these cargoes, as well as constraints that the seller must comply with before cargoes can be delivered to other parties, e.g., the seller may have to: (1) deliver a UQT request; (2) only deliver Make-Up if the seller has cargoes of LNG available after it has first satisfied the base contract quantities of LNG for other long-term customers; and (3) use [all] reasonable endeavors to deliver Make-Good cargoes. The obligations and constraints for different categories of LNG cargo vary considerably between SPAs, but as with all such provisions, the devil is in the details:

- What constitutes an available cargo?
- What are the base quantities of other customers?
- Which other customers should be considered?

- How are these issues evidenced?
- What would constitute [all] reasonable endeavors in these circumstances?

Second, once quantities are resolved, when should the cargoes be delivered? Again, SPAs can vary enormously on the rights granted to a buyer to fix delivery windows. Some buyers have agreed delivery profiles that ensure the majority of cargoes are delivered in the Northern Hemisphere winter months, but in some cases, a seller must undertake one or more of the following:

- Deliver cargoes to the buyer in a "non-discriminatory manner";
- Deliver cargoes on a "rateable basis";
- Use "[all] reasonable endeavors to align the delivery windows with buyer request";
- "Match the buyers requested delivery windows as closely as reasonably practicable";
- Must "take account of all information provided by the buyer"; or
- Act as "a reasonable and prudent operator, in a non-discriminatory manner use all reasonable endeavors to effect the material considerations of the buyer."

As with the allocation of UQT, Make-Up and Make-Good, there may be a hierarchy of preferential rights for buyers to nominate a delivery window (e.g., with long-term customers taking preference over spot sales). Similarly to the issues around quantities, there can be considerable uncertainty as to what these contract obligations and constraints actually impose on the parties.

CONCLUSION

For many years, the drafters of SPAs have deliberately drafted in the grey zone between a seller's absolute right to determine quantities and delivery windows and a buyer's firm rights to do the same. In the past this has led to grumbles but with around $76 million per cargo at stake, things are likely to get much louder. And with gas demand rising sharply as economies recover from COVID-19 and little new LNG capacity coming on-stream, this tension looks likely to continue in the near future, with parties in real difficulties potentially having to turn to their SPA's dispute resolution clauses to consider their options.