Force majeure notices from Chinese LNG buyers: prelude to a renegotiation?
In early February, as the Chinese government imposed quarantines and travel restrictions on large parts of the country to stem the spread of the coronavirus (COVID-19), China's largest LNG importer, CNOOC invoked force majeure on cargoes. The move was backed by force majeure certificates, offered by the China Council for the Promotion of International Trade, leading to other Chinese buyers 'mulling force majeure options', but the notice was rejected by Total, Shell and Qatargas. Other suppliers 'including commodity trading houses like Trafigura and Middle East gas producers' also reportedly received force majeure notices but these have not been officially confirmed. CNOOC's decision to invoke force majeure was prompted by logistical constraints at receiving ports, but there has been a growing concern in the industry that these notices are an attempt to renegotiate contracts. On 5 March 2020, as economic activity in China was gradually recovering, Reuters reported that PetroChina issued force majeure notices to its suppliers of piped gas and ‘at least one LNG supplier’, highlighting the weakness of domestic demand and the pressure this is placing on China's large gas importers.

This comment briefly discusses force majeure clauses in LNG sale and purchase agreements (SPAs), the consequences of buyer's force majeure and explores the potential outcomes as well as the impact of force majeure declarations on the LNG industry. It argues that even though Chinese buyers have a number of reasons to seek contractual changes, they are unlikely to blatantly breach contracts in a way that would put supply security at risk. Such force majeure claims may, however, start a conversation about future revisions to contractual terms, even though sellers would at best agree to add more flexibility clauses and will resist outright price revisions. Over the coming years, the pressure from the Chinese government and buyers to move to more flexible prices will undoubtedly increase, but given uncertainty around domestic price reforms, any concrete steps toward renegotiation will probably have to wait until China has established some form of domestic pricing reference.

**Force majeure clauses in LNG SPAs**

Force majeure, broadly speaking, refers to unexpected external circumstances that impede performance under a contract. The LNG industry is no stranger to this concept and SPAs for deliveries to various markets, including Asia, generally contain such clauses. Typically, force majeure clauses list examples of events that can be considered as force majeure including Acts of God (such as an earthquake, hurricane, or epidemic), acts of war, and acts of government. But there is no standard force majeure clause in SPAs and each contract will apply its own understanding of force majeure. However, many SPAs expressly exclude certain circumstances from the scope of force majeure including financial hardship, inability of the party affected to make a profit, market

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6 For publicly known examples of force majeure clauses in Asian SPAs, see Clause 14 of the SPA between Sabine Pass Liquefaction LLC and Korea Gas Corporation, 30 January 2012 (available at https://www.sec.gov/Archives/edgar/data/1383650/000138365012000009/exhibit101kogasspa.htm) and Clause 18 of the SPA between Qatar Liquefied Company Limited (2) and Pakistan State Oil Company Limited, 8 February 2016, available at https://psopk.com/files/home/use_full_links/qn_executed_redacted_version.pdf
7 Some SPAs classify ‘epidemic’ as an Act of God, some others list it as a separate example/category
changes, or loss of demand. Some SPAs clarify that ‘any’ change in the demand of the buyer’s customers shall not qualify as force majeure.

Technically, a force majeure claim requires a notice from the affected party (buyer or seller), leading it to be excused from its obligations under the relevant SPA. In the context of a buyers’ force majeure, it will be relieved, to the extent prescribed by the SPA, from its take-or-pay obligation. Under most SPAs, the immediate result will be the suspension or reduction of deliveries for the duration of the force majeure event. Some LNG SPAs, and the more recent ones, prescribe a structured process which can involve multiple steps to be completed before the buyer can cancel cargoes.

A buyer claiming force majeure will usually be required to undertake mitigation efforts to ensure resumption of normal performance of the contract in the shortest practicable time. In addition to the general mitigation efforts, some SPAs impose specific obligations on the buyer such as accepting reduced volumes or using all reasonable endeavours to receive LNG at any delivery terminal that is not affected by the force majeure event. Notably, some SPAs specify limits to the buyer’s obligations following force majeure, stipulating for example, that the buyer shall not be obligated to incur any extraordinary costs or to take any commercially unreasonable actions to overcome any event of buyer’s force majeure. After the force majeure event has ended, some SPAs require the buyer to use reasonable endeavours to take LNG previously excused for force majeure in the subsequent contract years in order to restore the overall contracted volume. Other contracts allow the seller to sell the affected LNG supplies to third parties for the period that force majeure is reasonably anticipated to continue, effectively removing the buyer’s obligation to take force majeure restoration quantities at a later date.

Prior to the resumption of normal performance, SPAs routinely require that parties continue to perform their contractual obligations to the fullest extent possible. Admittedly, force majeure can prove to be a difficult period in a long-term relationship. Disputes concerning the scope or operation of force majeure clauses are quite common and, in the context of buyer’s force majeure, are most likely to arise from the outset if the seller questions the existence of a force majeure event. Throughout the period of force majeure, disagreements are likely to concern volume reductions, diversions, or payments for deferred cargos, demurrage, or restoration quantities. To mitigate the risk of disputes, the parties can be obligated to negotiate in good faith and endeavour to find a solution acceptable to both parties. Certain SPAs also require the parties to meet at regular intervals and discuss in good faith the impact of the force majeure event on their business relationship.

If the force majeure event lasts for an extended period of time (for example, for a period greater than 12 consecutive months), a party may be entitled to terminate the contract for prolonged force majeure. In such cases, as the SPA will usually specify, the terminating party ‘shall have no further obligations to the other.’ In the event of such termination by the buyer, SPAs will sometimes require the buyer to agree to negotiate, in good faith, terms and conditions under which it would resume purchases of LNG when the force majeure event ends. The obligation to commence post-termination contract negotiations (essentially, a renegotiation) is rather unusual and unlikely to be contemplated in relation to a contract which remains in force for the duration of the force majeure event.

What happens next?

Given the differences in contractual frameworks discussed above, there are several potential outcomes of force majeure declarations from Chinese buyers. Each case depends on its own facts but, generally speaking, it is difficult to succeed on a force majeure claim if the underlying cause lies in changes to downstream market circumstances. Law reports are indeed ‘replete with failed attempts to invoke end-

See, for example, GIIGNL 2011 Master FOB LNG Sales Agreement (available at https://giignl.org/system/files/111231_giignl_fob_msa2011_final.pdf), Clause 12.8: ‘For the avoidance of doubt, any change in the demand of the Buyer’s customers for LNG or Natural Gas shall not qualify as Force Majeure

For example, the contract can stipulate that the parties shall use all reasonable efforts to re-schedule the delivery of the affected LNG cargo and the buyer shall be entitled to cancel such cargo only if the parties are unable to agree on the re-scheduling of that cargo within a stipulated period of time.

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Force majeure cases are rarely straightforward and even a specific reference to a potentially relevant event (like ‘epidemic’, ‘quarantine restrictions’, or ‘acts of government’) under an SPA would not typically guarantee force majeure relief. In most cases, and depending on the applicable law, the buyer will still need to fulfill several contract-specific requirements, as per the definition of force majeure under the relevant SPA. At this point, there are five possible outcomes of the force majeure notices (filed and expected to be filed) by Chinese LNG buyers:

1) Cargo diversions and other alternative arrangements

Although no seller is publicly known to have accepted a force majeure notice from a Chinese LNG buyer invoking circumstances related to the coronavirus outbreak, there have still been changes to scheduled deliveries. Several cargoes have reportedly been diverted from China and there are currently several LNG vessels stranded off the China coast in limbo. Dozens of other cargoes due to land in China in the coming weeks are likely to face diversions, delays, or be subject to other temporary adjustments. Some sellers have publicly stated their willingness to accommodate requests for alternative arrangements.

Diverting cargoes to other Chinese ports is one option but that would prove difficult (if at all possible under the different contracts) given that most provinces are under quarantine and travel restrictions—although one cargo was reportedly diverted from Zhejiang in southern China to Tianjin in the North, but even that report was unconfirmed by the cargo owner and may not have discharged at the port. Moreover, the southern ports serve export-oriented provinces where activity is currently extremely subdued while the northern provinces tend to serve a larger residential market, where winter heating demand will soon be over. Furthermore, China has limited gas storage and much of that was full before the Chinese New Year so buyers have little flexibility to take cargoes and store them. Indeed, PetroChina’s recent reported invocation of force majeure was due to weak demand and bulging stocks. Given expectations that demand will recover later this year, however, deferring volumes could be a desirable outcome for the buyers, but would raise a host of invoicing problems for the sellers such as whether to apply the pricing at the time of the actual delivery or at the original delivery date. So the fact that buyers have reportedly resorted to force majeure claims has fuelled concerns that their goal was to renegotiate contracts rather than simply defer volumes, although industry sources suggest a number of buyers initially asked for deferrals and were declined.

2) Force majeure disputes

If the solutions discussed in the first scenario would prove difficult to agree on, or insufficient, the parties can be expected to seek recourse to the dispute resolution mechanisms in their contracts. Industry sources suggest that arbitration would likely be the next step.

3) Suspension of deliveries

If a force majeure notice from a Chinese buyer is accepted by a seller, the outcome will be dictated by the contract and is likely to vary from contract to contract. Clearly, the most desired outcome for a

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11 Chinese authorities have ordered several measures, including lockdowns and closures, in an effort to contain the spread of the coronavirus.
13 For example, the Qatari energy minister was quoted as saying that the country’s energy companies are ‘actively engaged’ in accommodating requests to reschedule or re-route oil and gas cargoes to China. See https://www.reuters.com/article/us-china-health-lng-tankers/virus-outbreak-knocks-four-asia-bound-lng-tankers-off-course-sources-idUSKBN20712G.
Chinese buyer will be the suspension of its performance under the contract. The acceptance of a force majeure claim, to the extent that a seller would be willing to halt deliveries, would certainly give buyers a much needed reprieve. However, a buyer is likely to be required by a contract to agree on, or at least consider, cargo diversions, delays, or other alternative arrangements, before it can take the advantage of the force majeure clause. At the same time, finding alternative arrangements for LNG cargoes will be challenging, especially in the current market context of subdued demand and high levels of uncertainty as the coronavirus spreads globally. Negotiations on these arrangements are likely to prove futile in some cases, opening up the option of cancelling cargoes.

4) Contract termination

In the event of a prolonged force majeure, it is possible, but according to industry sources rather unlikely, that Chinese SPAs would stipulate termination of the entire contract. From a seller’s perspective, there is little incentive to terminate a contract with a large LNG-hungry customer in an oversupplied market. For buyers too there is a reputational risk (unless both parties agree that termination should only trigger a constructive renegotiation of the terms). Perhaps more importantly though Chinese buyers must ensure security of supply and cancelling contracts could leave them exposed to shortages. Just as there is currently a strong downside risk to demand growth (discussed below), a strong stimulus in H2 2020 could lead to an upside in demand. The majors were very strongly criticised in 2017—2018 for the supply shortages that winter and cannot risk being caught short again. They are therefore unlikely to exercise any termination rights under their SPAs without the prospects of renegotiations and the certainty of ample alternative supplies. That PetroChina is also citing force majeure on pipeline flows indicates that in the immediate term, the majors are grappling with the limitations of the domestic infrastructure as demand is plummeting.

5) Contract renegotiation

This then leaves the option of contract renegotiation. Industry sources suggest that force majeure notices were invoked on higher cost cargoes first and given the broader context of China’s slowing gas demand growth and domestic concerns about price dislocations, Chinese buyers have numerous reasons to be unhappy with their current contracts (see below).

Although SPAs are unlikely to offer a buyer any rights to reopen the contract specifically due to the occurrence of a force majeure event, force majeure notices (and the looming risk of force majeure arbitrations) may be used by Chinese buyers as a bargaining chip in contract renegotiations. The changes in China’s demand outlook and its reform goals had created considerable uncertainty surrounding domestic cost structures even before the outbreak of COVID-19, raising concerns that the majors would seek to review their existing contracts. The use of force majeure has only reinforced that concern.

The end of long-term contracts in China?

While Chinese decision makers value supply security, and therefore value the certainty associated with long-term contracts, changes in China’s gas demand profile combined with ongoing policy changes to deregulate the midstream have made long-term contracts a growing strain for the major importers’ profits. Given the government’s emphasis on supply security, the majors must toe a fine line between reviewing their pricing agreements and ensuring the availability of gas. But with policy-driven changes to the demand outlook, even before the coronavirus outbreak, this too has become a challenge.

After gas demand growth in China surged in 2017–2018 (Figure 1), leading LNG imports to rise by 18 bcm y/y on average, growth slowed in 2019 to a more modest 11 bcm (Figure 2). This was due to a combination of factors: first, China’s economic growth slowed considerably in 2019, weighing heavily on industry which is the largest consumer of gas in the country. Second and related to this, the government-mandated coal to gas switch also slowed due to concerns over insufficient gas supplies and the rising cost burden of the fuel switch. Third, domestic gas production rose as decision makers grew increasingly concerned.
At the same time, given expectations that a number of LNG import terminals will be transferred or sold to the new midstream company, which was officially launched in December 2019, there is considerable uncertainty within China about cost structures and future price reforms. While, for now, asset transfers to the midstream companies will not impact the supply contracts that underpin supplies into the pipeline or terminals, there is an expectation that these will be reviewed in due course. The question is whether this negotiation will happen within the contractual framework (i.e. when a long-term contract is set to end or at a designated price review point) or through a more aggressive review trigger. None of China’s long-term contracts are set to expire in 2020 and only PetroChina’s 0.5 Mtpa contract with PNG LNG is due to end in 2021.

Adding to the uncertainty is the phase one deal between the US and China, under which China has committed to upping its intake of US energy imports from 2017 levels. Higher volumes of LNG imports would contribute to offsetting some of the trade imbalance but, given that China would need to redirect flows, this could also be an opportunity to change contractual commitments in support of more US imports. That said, a number of sellers will be able to divert US-origin cargoes from their portfolios without requiring contractual changes.

In this context of slowing demand growth and a mild winter, the coronavirus was a final blow to LNG markets. The travel restrictions and quarantines imposed throughout the country have led to operational issues at Chinese ports. These include a limited ability to change over staff and restrictions on transporting hazardous materials both of which are limiting LNG trucking from ports. Quarantines have also meant that workers were unable to return to work after the New Year holiday, further weighing on the logistics industry. PetroChina, for example, was reportedly forced to delay discharge timings for multiple cargoes because it couldn’t get workers to its Rudong, Dalian and Caofeidian LNG terminals to run them at full capacity. But PetroChina at the time did not invoke force majeure because of these delays.\footnote{Stephen Stapczynski, “CNOOC refuses LNG cargoes, declaring force majeure over coronavirus”, Bloomberg, 6 February 2020, https://www.worldoil.com/news/2020/2/6/cnooc-refuses-lng-cargoes-declaring-force-majeure-over-coronavirus} \footnote{See Michal Meidan, “China: Key Themes for 2020”, OIES Energy Comment, January 2020, https://www.oxfordenergy.org/publication-category/china-energy-programme/?v=79c81e85463}

In addition to the logistical bottlenecks, the economic standstill related to the quarantines to stop the virus’ spread has weighed on gas consumption. The Chinese New Year is typically a slow period for gas demand, but the extended break has cut an estimated 10 bcm of gas demand from the 2020 growth forecast, which was previously pegged at 30-35 bcm y/y.\footnote{Some of this lost demand could be made up for later this year, but that will depend on when the outbreak peaks and the strength of the ensuing economic stimulus. So, even though the force majeure invoked on cargoes was likely prompted by the lockdowns in this context, it would not likely be invoked in the same way if demand were recovering.}

Sources: China Customs, NBS, OIES

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\textbf{Figure 1: China gas demand}

\textbf{Figure 2: Gas balances, bcm}
logistical issues, given the context, it remains unclear whether Chinese buyers will use this to try to renegotiate their contacts. Total reportedly rejected force majeure as not all unloading ports were quarantined, stating that “There is a strong temptation from some long-term customers to try to play with the force majeure concept […]. To say I cannot take my cargo under the long-term contract, but I would like to buy spot is contradictory” suggesting “it is an ordinary negotiation”.18

**Price dislocations and reform weigh on Chinese buyers**

Given the slump in Chinese and Asian demand, combined with the surge in new liquefaction capacity globally, Asian spot prices have tumbled with JKM hovering at around $3/mmbtu, highlighting the growing differential with some of China’s more expensive term contracts. Most Chinese contracts are oil-indexed, albeit with different slopes and S-curve parameters. According to SCI, delivered prices in Beijing averaged $9/mmbtu during off peak periods in 2019, fetching a slightly higher $11.5/mmbtu in Southern China. Prices during peak demand periods were roughly $2/mmbtu higher.

**Figure 3: China CIF LNG, JKM, $/mmbtu**

Source: SHPGX, Platts, OIES

Supplies on the recently started Power of Siberia pipeline were reportedly $6/mmbtu in north east China, delivered at $7.4/mmbtu in Beijing. And with the anticipated changes to prices and cost structures due to the start-up of the new midstream companies, the domestic price dislocations are weighing on the majors. What is more, the government’s decision to reduce domestic natural gas prices in order to help companies restart operations could further reduce profit margins for importers.

But even though Chinese buyers have a number of reasons to seek changes in contractual relations with sellers, they have not achieved any spectacular outcomes in the past two decades of contract renegotiations. In particular, there is no evidence of any Chinese buyer securing a meaningful price reduction,19 and only limited evidence of successful revision of other terms in Chinese SPAs. In 2015, Sinopec reportedly sought to renegotiate its term deal with APLNG, citing delays to the construction of its Guangxi LNG terminal as a reason for not taking cargoes.20 Supply volumes for 2016 were ultimately

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19 One reason could be that the first SPAs for deliveries to China signed in early 2000s were ‘low-price’ contracts and later contracts with higher slopes, entered into in 2010s, could not have been reopened to date, mainly due to the inflexibility of the relevant price review clause (stipulating, for example, that the first price review can be triggered after a set number of years from the date of first delivery).

revised down as were CNOOC’s offtake volumes from BG. But it remains unclear to what extent these lower volumes exceeded the tolerance clauses within the contracts and whether changes to the supply deals also involved lower prices. Industry sources suggest that even the more aggressive efforts by Chinese buyers not to take or pay for volumes ended up with a resolution that yielded limited change to contracts, injecting perhaps more flexibility to volumes, destination, or other non-price terms, but not leading to dramatically lower prices.

Arguably, China's negotiating power has increased dramatically since 2015 and as the second largest consumer in Asia, should it choose to renegotiate contracts, sellers may be hard pressed not to, for fear of losing market share. But when considering the rationale for the recent force majeure claims, as well as China's prior record of contract renegotiations, Chinese buyers are likely to be less aggressive than the market fears. To be sure, as highlighted above, China’s largest LNG sellers have numerous reasons to seek contractual changes and the pressures to end long-term contracts will only increase over the next few years. Yet even though there is a growing consensus in China that the current long-term contracts are a bane for the industry, there is no clear view on what should replace them and critically, how prices should be structured.

Invoking force majeure may have been an attempt to test sellers’ willingness to review contractual terms prompted by logistical challenges. Disputes surrounding the losses incurred and invoicing for alternative arrangements could now ensue—for example, what is the appropriate price for a deferred cargo, its price at the time of deferral or time of delivery? Going forward, concessions around cargo diversions are likely to accelerate the removal of destination clauses from future contracts. At this point, sellers are unlikely, however, to formally accept force majeure notices or publicly acknowledge any flexibility they introduce into the contract for fear of triggering additional force majeure claims as the coronavirus spreads and other countries may opt for quarantines. At the same time, even though Chinese buyers may be willing to test sellers, they are unlikely to jeopardise their supplies. Even tough domestic production and pipeline imports continue to rise, these are unable to meet demand growth alone, leading to a growing dependence on LNG. In 2019, China imported 80 bcm of LNG, compared to 51 bcm of pipeline gas with domestic production, at 173 bcm, supplying more than half of demand.

While China's term contracts cover 85 bcm of LNG, an estimated 25 per cent of Chinese LNG imports in 2019 were spot volumes, of which private companies accounted for the majority. For any one of the three majors, reneging on contracts would not only run the risk of failing to provide supply security, which since the shortages of the winter of 2017–2018 have become a paramount priority for the government (which is also their majority shareholder) but also of ceding market share to another major, or to the multitude of private companies seeking to establish themselves in the domestic market.

A domino effect?

The reported declaration of force majeure by Chinese buyers comes at a challenging moment for LNG markets, as new supplies come online and demand growth slows. As the coronavirus continues to spread globally and demand weakens, sellers struggle to redirect cargoes amid high stock levels globally, leading to potential shut ins later this year and to a potential deferral of new final investment decisions (FIDs). A lone bright spot in the market has been India, where LNG buyers have reportedly tendered for as many as 67 cargoes by the end of February, capitalising on lower spot LNG prices.

In this context, most sellers are likely to work with buyers to defer cargoes or divert them to avoid force majeure. Indeed, rejecting a force majeure claim opens both sides up to additional costs and the possibility of arbitration, while accepting it could incentivise other buyers to invoke force majeure. The emergence of force majeure disputes (and potentially arbitrations) seems the most likely outcome for

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21 “Sinopec seeks reduced offtake from APLNG”, Argus, 9 December 2015
22 Oleg Vukmanovic, “Qatar and PetroChina alter LNG supply deal, winter spot price fallout”, 21 August 2015
now, and even though contract cancellations or renegotiations seem unlikely at this point, the force majeure clauses invoked by Chinese buyers may have started a conversation about future price revisions. Over the next few years, the pressure from the Chinese government and buyers to move to more flexible contracts and prices will undoubtedly increase, but until there is greater clarity on China’s domestic gas prices, buyers will be cautious about upending commercial relationships.