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The Changing Meaning and Role of Long-term International Gas Contracts

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Original purpose of long-term contracts

- Large international gas trade projects face an original vicious circle
- Developing the reserve and the transportation facilities only makes sense if there is a market.
- But a market can only exist if there is supply.
- Exporting into a not fully developed market when transportation facilities are not already in place is a challenge

Key features of long-term contracts

- The vicious circle could be overcome through a set of mutually supporting clauses:
  - Take or pay
  - Price indexation
  - Where relevant – destination clauses
- In addition, the duration was very long, but that was not the only characteristic
- "Buyer takes the market risk, seller takes the price risk"
- Historically, a very successful model

But conditions have changed

- Conditions however have changed,
- Partly because of legal and regulatory changes (the process of creation of a single competitive European gas market)
- But more importantly because demand and supply conditions have changed:
  - Demand is not growing, or actually declining
  - Much infrastructure is in place already
  - New suppliers are coming to the fore, competing for market share

Competition is a fact

- Competition cannot be legislated, but when competitive conditions emerge, it cannot be avoided
- Traditional clauses, such as take or pay and price indexation, simply cannot be defended if markets become competitive, and dictate lower – or indeed higher – prices
- Hence these clauses are being revised

New-style long-term contracts

- Growing flexibility in take or pay
- Indexation to hub prices
- Practical impossibility of enforcing destination clauses, even where legal, especially for LNG
- Long-term is in fact shorter than it used to be (10-20 years rather than up to 35)
- Not the same kind of contract!

The outlook

- So, is there a future for gas long-term contracts?
- Probably yes, because transaction costs are reduced if the parties have a reasonably stable relationship and a well-established framework for dealing with each other
- However the exporter takes more of the price risk (maybe – not sure) and the importer less of the market risk

Thank you!

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