

IS THE LNG INDUSTRY READY FOR STRICT LIABILITY?

By Philip R. Weems and Kevin D. Keenan
King & Spalding LLP (Houston / London)

It has been said that "a lie gets halfway around the world before the truth has a chance to get its pants on."¹ It seems that misconceptions travel equally as fast. One misconception that appears to have spread throughout the LNG world is that the International Maritime Organization's Hazardous and Noxious Substances Convention (the Convention)² will never be of particular significance to the LNG industry. On the contrary, the truth is that the Convention, an international treaty providing more than US\$350 million in compensation to victims of a casualty involving hazardous and noxious substances (HNS), is likely to become effective in the very near future and, unlike any prior international treaty dealing with transportation liability, will have a direct impact on LNG shipments into countries which adopt it. The Convention will substantially increase, in any member state, the potential liability of LNG shipowners and of LNG cargo owners for damages to third parties.

Because the International Maritime Organization (the IMO) completed its work on the Convention almost eight years ago, from afar it appeared that the Convention would simply die a slow death due to the lack of a sufficient number of countries taking the requisite steps to ratify it.³ The reality behind the scenes is quite different, however, and recent events evidence considerable governmental support for the Convention, including: (i) the issuance of European Council Decision 971/2002, which cleared the way for and encouraged EU member states to ratify the Convention unilaterally; (ii) a June 2003 meeting of the HNS Correspondence Group in Ottawa, Canada, during which delegates from a number of HNS importing nations agreed on a concrete governmental implementation plan; and (iii) an October 2003 meeting of the IMO's Legal Committee in London, during which the Legal Committee adopted the Ottawa recommendations, smoothing the way for earlier ratification of the Convention.

As a result of these and other recent developments, the Convention is arguably closer to being a reality than one might think. Despite the fact that very few in the LNG industry know what it entails (understandably so given its complexity and, until recently, its relegation by many to the obituaries column in the international conventions digest), so long as the Convention continues to gain the momentum which it has recently found, it could well be a reality in the very near future. Supposing it becomes a reality, why should the LNG industry care? Because, for the first time, an international liability regime will make LNG shipowners and cargo title holders strictly liable for accidents solely as a consequence of LNG being classified as HNS. Because few in the LNG industry appear to be taking the inherent commercial risks of the Convention into consideration in current commercial dealings.

¹ Sir Winston Churchill (1874-1965).

² International Convention on Liability and Compensation for Damage in Connection with the Carriage of Hazardous and Noxious Substances by Sea (1996).

³ Until recently, only eleven nations had actually signed the Convention and only two had formally taken the requisite steps to ratify it. As of October, 2003, four countries have ratified/acceded to the Convention. Although there is a slight legal distinction between ratification and accession, that distinction is not material here and, as a result, both concepts are used interchangeably throughout this article to mean the act by which a state incorporates an international convention into its domestic laws.

Because, with the recent proliferation of terrorist activities worldwide, the LNG industry can no longer rely on sound technology and responsible management to avert casualties.

In an effort to highlight the importance of the changes that will follow ratification and implementation of the Convention, this article briefly discusses and attempts to put into perspective the latest developments on the road toward that end. It examines the LNG industry's historical contribution to the drafting of the Convention and provides a sneak preview into how the Convention is designed to work. Finally, it discusses the likely effects the Convention will have on the LNG industry.

CONVENTION EFFECTIVENESS –WHAT WILL IT TAKE?

Twelve states must ratify the Convention before it can enter into force and take effect.⁴ In addition, four of those twelve ratifying states must each have not less than 2 million units of gross tonnage in their registered merchant marine, and HNS importers in the twelve ratifying states must collectively have received 40 million tonnes of cargo that would be covered by the Convention within the preceding calendar year. While these gross tonnage and import tonnage requirements may appear to impede the Convention's entry into force, their overall effect on full implementation is not as significant as one might think given the broad scope of the 5,000+ substances defined as HNS in the Convention,⁵ the sheer volume of imports across the entire range of HNS as so defined,⁶ and the size of the registered shipping fleets in those nations that are likely to ratify the Convention in the near term.⁷ Thus, it is not the objective criteria that impede adoption of the Convention; rather, the most vexing problems arising since the IMO finalized the Convention in 1996 have been more in the subjective political arena. That being the case, a crucial political hurdle to implementation was very recently overcome through a decision within the European Union.

⁴ As a matter of international law, signing a convention is merely a signal of intent to make the convention part of the signing country's laws and does nothing to alter, from a legal standpoint, obligations in the signing country. Formal ratification/accession to an international convention, on the other hand, requires formal enactment of a law in the acceding country recognizing the terms and conditions of the particular convention and incorporating same into the laws of the acceding country. Following the passage of such laws, the legal obligations in the ratifying country are altered to bring them in line with the particular convention ratified. As a final step – and as a manifestation of intent toward other member states – most conventions require a formal statement to be filed with the sponsoring organization, in this case the IMO, indicating the acceding country's willingness to be bound by the terms of the ratified convention.

⁵ Of the 5,000+ substances currently classified as HNS by the Convention, the vast majority are chemicals. *Insurance Aspects of the HNS Convention, Submission by European Chemical Industries Council*, Ottawa, Canada, June 3-5, 2003.

⁶ Taking LNG alone (it being but one of more than 5,000 substances designated HNS in the Convention), the EU member states which imported LNG in 2002 took in more than half of the required 40 million tonnes of cargo. *Global LNG Trade Matters – 2002*, Poten & Partners – LNG in World Markets, March 2003, at 32. Given that LNG comprises less than 5% of total worldwide HNS cargoes annually, with crude oil comprising approximately 89%, the import tonnage threshold will not impede the Convention's implementation. IMO Legal Committee, Monitoring Implementation of the HNS Convention, *Draft Guide to the HNS Convention*, September 14, 2001.

⁷ Of the twelve nations that have either ratified or signed the Convention to date (Angola, Canada, Denmark, Germany, Finland, Morocco, the Netherlands, Norway, Russia, Sweden, Tonga, and the United Kingdom), eight have, in their individual fleets, registered gross tonnage exceeding 2 million units. *Lloyd's World Fleet Statistics* (2002).

EU RATIFICATION CLEARED

To date, the Convention has been ratified by Russia, Angola, Morocco and Tonga.⁸ Despite the fact that five European Union (EU) member states signed the Convention when it was adopted by the IMO in 1996, no EU member state has yet ratified it. Rather than an indication of unwillingness to ratify on the part of the EU signatory states, this delay has largely been a result of legal and jurisdictional problems in the EU which resulted in EU member states being unable to ratify the Convention unilaterally⁹ despite a number of states having reportedly begun the ratification process.¹⁰ However, a recent decision of the European Council (the Council Decision) cleared the way for EU member states to ratify the Convention without further authority from Brussels.¹¹ Thus, while only four nations have ratified the Convention to date, the Council Decision is expected to accelerate the accession of EU member states now that the outstanding legal issues have been resolved in Brussels.¹² More importantly, in addition to clearing a path toward accession within the EU, the Council Decision set June 30, 2006, as a target date for all EU member states to ratify the Convention.¹³ A widely held belief is that once certain EU member states – many with large and well-developed shipping industries – accede to the Convention, a parade of ratifications will follow from within the EU and abroad. In particular, John Wren, Chairman of the HNS Correspondence Group and Head of Branch for Shipping Policy at the UK Department for Transport, argues that, given the Council Decision and the attitude toward the Convention in Brussels, all EU member states¹⁴ will eventually ratify the Convention.¹⁵ Whether Mr. Wren's sentiment is an accurate prediction or not, the LNG industry can ill-afford to ignore the possibility.

⁸ The Russian Federation was the first to ratify the Convention on May 6, 2000. The Republic of Angola and the Kingdoms of Morocco and Tonga ratified the Convention on March 21, 2002, May 6, 2003 and September 18, 2003, respectively.

⁹ The Convention has specific jurisdictional and enforcement rules in Articles 38, 39 and 40. However, the Convention's jurisdictional scheme was in direct conflict with European Council Regulation CR 44/2001 which prohibits EU member states from assuming obligations with third parties when EU rules and – by extrapolation – other EU member states may be affected by those obligations. Essentially, CR 44/2001 permitted only the EU itself to ratify the Convention, rather than the individual EU member states. Commission Proposal for a Council Decision Authorizing the Member States to Ratify in the Interest of the European Community the [Convention], 1996, COM(01)674 final.

¹⁰ The United Kingdom and Ireland have already taken significant steps toward ratification.

¹¹ Council Decision 02/971/EC, 2002 OJ (L 337/55).

¹² Personal interviews with John Wren, Chairman of the HNS Correspondence Group and Head of Branch, Shipping Policy, UK Department for Transport, October 3 and October 27, 2003.

¹³ Council Decision 02/971/EC, 2002 OJ (L 337/55), Article 3. The Council Decision also set June 30, 2004 as a target date by which all EU member states should inform the European Council and the European Commission of their prospective dates of ratification or accession.

¹⁴ Note that while liability under the Convention for LNG-related casualties ends at the import terminal (*i.e.*, the Convention does not apply to natural gas downstream of the regasification facility), liability follows chemicals, LPGs and oil all the way to the ultimate receiver. Thus, even landlocked states will have an interest in acceding to the Convention so as to offer the Convention's protections to victims of HNS-related casualties further ashore.

¹⁵ Personal Interviews with John Wren.

LIABILITY UNDER THE CONVENTION GENERALLY

The Convention's liability allocation scheme consists of two tiers. The first tier imposes liability on the shipowner.¹⁶ The second tier imposes liability at large on the various industries importing HNS. Most importantly, strict liability applies under both tiers. By definition, a strict-liability regime imposes liability regardless of fault. Thus, unless one of the limited defences under the Convention is available, a shipowner whose ship washes ashore in rough seas and causes a casualty involving HNS will be liable in Convention member states in accordance with the Convention's first-tier liability formulae, regardless whether it would otherwise have been liable in accordance with general principles of fault and negligence. Herein lies an important distinction between the Convention and other limitations regimes. Where traditional regimes are invoked to limit a shipowner's liability in the event it is found legally to be at fault, the Convention actually imposes liability regardless of fault.

Under tier one, the owner of a vessel carrying HNS and suffering a casualty in a state having ratified the Convention will be strictly liable for an amount not exceeding a sum determined with reference to the gross tonnage of the vessel involved in the casualty. Thus, with very few exceptions,¹⁷ the shipowner will be liable for any damages caused by HNS during transit, regardless of fault or negligence. While there are many LNG tankers currently trading that will enjoy lower limits under the Convention due to their smaller tonnage, a 138,000 m³ LNG tanker comes very close to the 100 million special drawing right (SDR)¹⁸ limit set out in Article 9(1) of the Convention. Given that the industry is moving continually toward larger LNG tankers, for the sake of argument we shall assume that the 100 million SDR limit will typically be reached. Based on the value of the SDR today,¹⁹ the first-tier limitation of liability for larger LNG tankers would be somewhere in the neighbourhood of US\$143 million per event.

Not surprisingly, as a means to ensure that shipowners carrying HNS have the capacity to meet their tier-one obligations, the Convention also mandates certain minimum insurance coverage and requires proof of cover upon entering and leaving a port of a Convention member state.²⁰ Under the Convention, proof of insurance coverage must be issued by the state of the ship's registry if that state is a party to the Convention or, if the vessel's flag state is not a party to the Convention, by any state that is a party to the Convention.²¹ Thus, to craft a simple example, suppose LNG is imported into Italy from

¹⁶ Under Article 7(1) of the Convention, the shipowner's liability is limited to damages "caused by any [HNS] in connection with their carriage by sea on board the ship." Under Article 1(9) of the Convention, "carriage by sea" means the period from the time when the HNS enters any part of the ship's equipment, on loading, to the time the HNS ceases to be present in any part of the ship's equipment, on discharge.

¹⁷ The Convention explicitly exempts from first-tier strict liability any damages (i) resulting from acts of war, hostilities, civil war, insurrection or certain natural phenomena, (ii) wholly caused by an act or omission done with intent to cause damage by a third party (*e.g.*, terrorist strikes), and (iii) wholly caused by the negligence or other wrongful act of any governmental authority responsible for the maintenance of lights or other navigational aids. The Convention, Article 7(2)(a-c).

¹⁸ The Special Drawing Right is an artificial currency established by the International Monetary Fund. The value of the SDR is determined with reference to a weighted average of currencies including the U.S. Dollar, the Euro, the Japanese Yen and the British Pound. The SDR is used in a number of international conventions as a means of easing conversion rates among member state currencies.

¹⁹ SDR = US\$1.43467 (October 28, 2003).

²⁰ The Convention, Articles 12(1) and 12(12).

²¹ *Id.* at 12(2).

Algeria on an Algerian-flagged vessel. Suppose also that Italy has ratified the Convention but Algeria has not. Before the tanker bringing LNG from Algeria could enter the Italian port, that tanker would be required to produce, upon demand by Italian authorities, a certificate of cover issued by any competent authority in a Convention member state.²²

The second tier of the Convention exists because of the view, heralded in the early days of the Convention's consideration, that a shipowner would find it very difficult to obtain liability insurance coverage to meet the per-event SDR limits. As a means of sharing the load, the Convention's second tier of liability imposes burdens on HNS-importing industries broadly by way of mandatory contributions to a fund established by the Convention (the HNS Fund) and made available in the event the liability limits of the first tier are exceeded or in the event the shipowner is unable to meet its obligations under the first tier.²³ When a casualty involving HNS occurs in a Convention member state, the shipowner will first be liable up to the 100 million SDR (approximately US\$143 million) limit discussed above. To the extent that damages incurred in connection with that casualty exceed the first-tier limit, or to the extent that the shipowner cannot meet its first-tier obligation, claimants may be entitled to compensation from the HNS Fund,²⁴ in each case up to a maximum of 250 million SDR (approximately US\$358 million), inclusive of the shipowner's first-tier contribution, if any.

Thus, although the limits in the first tier alone will more than double the amount of the LNG shipowner's liability under the widely adopted London Convention²⁵ (applicable today in forty nations), it is the second tier that harbours the most potential impact for the LNG industry. While there could conceivably be a myriad of combinations, there are three baseline scenarios under which the HNS Fund could be called upon to compensate victims of a casualty involving HNS. To illustrate all three, suppose a casualty (not necessarily related to LNG) occurs in a Convention member state and the damages amount to US\$400 million in the aggregate. The first scenario is the one where the shipowner is fully insured in accordance with the Convention. In this case, the shipowner would bear the first 100 million SDR (US\$143 million) of liability and the HNS Fund would be called upon to pay out an additional 150 million SDR (US\$215 million). The second scenario is one in which the shipowner is uninsured and the entire 250 million SDR (US\$358 million) would be payable from the HNS Fund. The third is where the casualty is caused by the intervening act of a third party (*e.g.*, a terrorist organization) with intent to cause damage. While the Convention's tier-one liability scheme exempts the shipowner from liability for casualties caused by intentional malfeasance of intervening third parties,²⁶ tier two contains no such exemption. Thus, victims of a casualty caused by an intervening third party in a Convention

²² Provided that implementing legislation in Convention member states is sufficiently uniform and comprehensive, the mandatory insurance provisions of the Convention should serve to mitigate the risk that a vessel carrying HNS and suffering a casualty will be uninsured or even mildly underinsured.

²³ The Convention, Article 14(1).

²⁴ The claimant must be able to prove that there is a reasonable probability that the damage resulted from an "incident" involving one or more ships. The Convention, Article 14(3)(b). Moreover, if the HNS Fund proves that the alleged damage resulted from the intentional act or negligence of the person who suffered the damage, the HNS Fund may be exonerated wholly or partially from its obligation to pay compensation. The Convention, Article 14(4).

²⁵ Convention on Limitation of Liability for Maritime Claims (1976). For a more detailed comparison of different liability schemes in use throughout the world today in relation to the LNG industry, see Philip R. Weems and Kevin D. Keenan, *Liability for Marine Casualties*, LNG JOURNAL, Sept.-Oct. 2002, at 32.

²⁶ The Convention, Article 7(2)(b).

member state would be entitled to claim against the HNS Fund, in which case the HNS Fund would be fully liable up to the 250 million SDR limit (US\$358 million).²⁷

Although the liability is limited in all three of the above scenarios – stopping in this example US\$42 million short of fully compensating the hypothetical claimants – the HNS Fund clearly has the potential to significantly impact HNS importers in Convention member states, especially in the latter two scenarios where the HNS Fund would in most cases be liable to the full extent of the Convention’s liability limit.

THE HNS FUND AND ITS EVOLUTION

In response to now-infamous oil pollution casualties such as the Torrey Canyon,²⁸ the IMO has for decades concentrated on liability regimes in the oil industry because of the significant risk of pollution damage. However, in advance of widespread public pressure expected to follow a serious catastrophic incident involving the sea carriage of HNS, in particular harmful chemicals, the Convention was first put on the drawing board in the late 1970s. Like the CLC and the Fund Convention²⁹ which preceded it in the crude oil pollution liability arena, the Convention contains provisions establishing a fund into which importers of HNS will be obligated to contribute following a casualty, with the amount of such contributions being based on, among a number of other factors, the amount of HNS imported by each such receiver in the calendar year immediately preceding the calendar year in which the casualty occurs.³⁰ Unlike the CLC and the Fund Convention, both of which are relevant to the shipment of crude oil and certain crude oil products only, the Convention cuts across four distinct industries (chemicals, LNG, LPG and crude oil / crude oil products), each having a vastly different safety record and, thus, arguably covering vastly disparate risks.³¹ On the one hand is the LNG industry, with an excellent safety record spanning more than four decades.³² On the other hand are the crude oil, chemical and LPG industries, all of

²⁷ If the actions of the intervening third party arise in the context of a war, insurrection or other hostility, the HNS Fund is not liable. *Id.* at Article 14(3). Unfortunately, it is unclear as to whether a terrorist strike would be considered to constitute a “war, insurrection or other hostility” in today’s political climate. Thus, while the exemption in tier one is explicit, the exemption in tier two is tenuous at best and relies upon a terrorist strike being construed as part of a larger conflict.

²⁸ In March of 1967, the supertanker “Torrey Canyon” struck Pollard’s Rock in the Seven Stones reef between the Scilly Isles and Land’s End, England, dumping more than 31 million gallons of crude oil into the English Channel.

²⁹ International Convention on Civil Liability for Oil Pollution Damage (1969); International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage (1971). The International Oil Pollution Compensation Fund (the IOPC Fund) was established under the Fund Convention and, like the HNS Fund, is financed by receivers of the covered commodity – oil.

³⁰ Much like contributions to the IOPC Fund, contributions to the HNS Fund will be made only after a casualty occurs. The Convention, Article 17(1).

³¹ Despite the fact that crude oil is covered by the Convention, Article 4(3) clearly states that it “shall not apply to pollution damage as defined in the [CLC].” Thus, prior to the activation of the LNG account, crude oil poses a cross-industry subsidization risk to LNG only to the extent a casualty in that industry results in non-pollution property damage or loss of life.

³² For a general discussion on the safety of LNG, see the recent industry-sponsored study coordinated by the Institute for Energy, Law and Enterprise (University of Houston Law Center), *LNG Safety & Security*, at 73, 77-79 (Oct. 2003), http://www.energy.uh.edu/lng/documents/IELE_LNG_Safety_and_Security.pdf. In over 40 years of LNG shipping, there have only been 8 incidents involving any spillage of LNG and no incidents involving LNG cargo-related fires. *Id.*

which have far less stellar safety records.³³ Clearly, having a fund cutting across four separate industries could – and likely would – lead to the safer industry (*i.e.* LNG) subsidizing the more dangerous (*e.g.* toxic and polluting chemicals).

Fortunately, while it took some time to kick-start the LNG industry into paying closer attention to the subsidization risks under earlier proposed versions of the Convention, representatives of LNG buyers and sellers began to recognize this and other potential problems with the Convention and, to their credit, began to react constructively. Beginning in the late 1970s, the IMO made development of a convention on HNS liabilities a top priority; however, the IMO's first attempt at a one-tier HNS convention funded by shipowners alone was rejected in 1984.³⁴ The IMO took another run at HNS at the end of the 1980s, presenting a two-tiered proposal it hoped would be accepted. By 1991, the LNG industry – in particular the Indonesian delegation to the IMO – took notice of growing support for the Convention and, more importantly, the fact that the LNG industry might be forced to pay for damages caused by other industries.³⁵ In February of 1992, the Indonesian delegation submitted a report to the Legal Committee of the IMO outlining some of the delegation's problems with the then current draft (the Indonesian Report). As the world's leading producer of LNG, the Indonesian delegation was in as strong a position then as any to advocate for reform, and advocate it did. Ultimately, while there were a number of elements to the delegation's arguments, essentially its objections came down to the fact that the HNS Fund commingled LNG with more than 5,000 other substances – mainly chemicals. As a result, because levies paid into the HNS Fund were to be based primarily on tonnage of cargo, there existed a very real likelihood that LNG receivers would end up subsidizing other, more dangerous HNS receivers. To paint a simple example, even back then far more LNG was transported worldwide than, say, cyanide, vinyl acetate, hydrochloric acid or lead concentrates. Yet such chemicals clearly posed then – and pose now – a far greater risk to persons and the environment than LNG.³⁶ Under the 1991 draft of the Convention, receivers of such chemicals would make far fewer contributions to the HNS Fund than would LNG receivers because of the disparity in volumes shipped and, ultimately, LNG receivers would likely end up compensating victims of cyanide poisoning or any number of other ills resulting from the accidental discharge of such chemicals. Understandably, this was not particularly

³³ In September of 2002, the United Kingdom's delegation to the IMO Legal Committee presented a report citing 57 incidents involving HNS worldwide since 1995. Of those 57 accidents, 29 involved chemicals, 22 involved crude oil and oil products and 6 involved LPGs. None involved LNG. IMO Legal Committee, Monitoring Implementation of the [HNS] Convention, *Report on Incidents Involving HNS*, September 19, 2002.

³⁴ David J. Bederman, Comment, *Dead in the Water: International Law, Diplomacy, and Compensation for Chemical Pollution at Sea*, 26 VA. J. INT'L L. 485 (1986).

³⁵ Co-author Philip Weems served as counsel to Virginia Indonesia Company (VICO) (and, in a select capacity, to PERTAMINA, Indonesia's state-owned energy company) in relation to HNS issues from 1991-1996; during such time he was named an Indonesian delegate to several IMO Legal Committee meetings concerning the Convention. Many of the points made below are supported by materials from the personal files of Mr. Weems and consist of correspondence between various persons involved in the LNG industry's effort to address problems in the early Convention drafts.

³⁶ To address the issue of LNG safety, in 1992 PERTAMINA commissioned Lloyds Register to undertake a risk assessment of marine transportation of LNG in comparison to marine transportation of other substances. The resulting 118 page report, presented to the IMO Legal Committee at its 67th Session, confirmed that “the design, dedication and nature of LNG carriers contribute significantly to reducing the hazards of LNG transportation...” and “...as LNG will vaporize and is non-toxic, there is no significant direct environmental damage caused by a spill.” Lloyds Register Report, *Risk Assessment Review of the Marine Transportation of Liquefied Natural Gas*, Executive Summary, page viii (Sept. 1992).

palatable. Indeed, from an LNG industry standpoint, the HNS Fund would serve only to elevate costs unnecessarily unless changes could be made to the draft.

The Indonesian Report served as a wake-up call to the LNG industry and, in May of 1992, representatives from across the industry met in Kuala Lumpur to discuss the way forward. In attendance at the Kuala Lumpur meeting, called by the Indonesian delegation, were 65 representatives from Japan, Korea, Taiwan, Malaysia, Algeria, Nigeria, Italy, Australia, France, Brunei, Abu Dhabi, the U.K. and the U.S.³⁷ One of the early positions coming out of Kuala Lumpur and later meetings called for the industry to try to exclude LNG from the Convention altogether, while another called for the LNG industry to pool together to form its own voluntary liability scheme akin to TOVALOP and CRISTAL (both of which served as interim liability regimes pending the widespread adoption of the CLC and the Fund Convention).³⁸ Ultimately, the industry succeeded in advocating the establishment, provided certain LNG import volumes are achieved,³⁹ of a separate account for LNG within the HNS Fund and, in so doing, provided for itself considerable insulation from the historically higher-risk and far more accident-prone chemical, crude oil and LPG industries.⁴⁰ Although the LNG industry thus succeeded in controlling its own financial exposure under the Convention, the actual operation of the separate LNG account presents additional concerns vis-à-vis the various sellers, buyers and other participants in the LNG value chain. These concerns are discussed at greater length below.

EFFECTS OF THE CONVENTION ON THE LNG INDUSTRY

The most immediate and obvious effect of the Convention on LNG buyers and sellers in Convention member states will be increased costs – both in terms of the premiums for insurance cover against increased liability limits and in terms of the per unit cost of LNG when contributions to the HNS Fund are factored into existing and prospective supply arrangements. The requirement that all ships carrying HNS must have proof of coverage sufficient to meet the vessel's tier-one liability limits may help to ensure that the tier-two compensation scheme is little used, but it nonetheless translates into increased costs for shipowners because the coverage amounts will need to be significantly greater than, say, those in place in countries not signatories to the Convention. Insurance premiums will likely increase, partly to cover the costs incurred by the P & I Clubs in procuring adequate

³⁷ Co-author Philip Weems attended the Kuala Lumpur LNG industry meeting on behalf of Indonesian LNG producers.

³⁸ This voluntary scheme was jointly proposed by representatives of Shell International Marine and of Groupe International des Importateurs de Gaz Naturel Liquéfié (GIIGNL).

³⁹ Under the Convention, the LNG account does not become active until the total quantity of LNG received in Convention member states during the preceding year exceeds 20 million tonnes. The Convention, Article 19(3)(b). Until that time, assuming none of the other accounts are already active, any casualty involving HNS occurring in a Convention member state will result in a bill being sent to all HNS receivers in Convention member states, regardless of which industry was involved in the casualty. Nonetheless, if, as many expect, the EU member states accede to the Convention *en masse* by 2006 following the Council Decision discussed above, then it is likely the effectiveness of the separate LNG account will coincide closely with the effectiveness of the Convention. As noted above, total LNG imported among EU member states in 2002 exceeded 20 million tonnes.

⁴⁰ Crude oil and LPG also have separate accounts. While the crude oil account will become effective almost simultaneously with the Convention because of the prolific worldwide crude oil trade, LNG will initially be lumped together with LPGs and chemicals. Thus, it is these two industries that pose the greatest cross-industry subsidization risk to LNG.

reinsurance⁴¹ and partly to cover the increased liability limits for shipowners and the additional liabilities falling on cargo title holders.⁴²

While the P & I Clubs have indicated they will issue policies covering the increased liability in Convention member states, the larger issue is the contingent liability that arises from the Convention's second tier. Under Article 19(1)(b) of the Convention, when LNG is imported into a Convention member state, the party holding title to the LNG immediately prior to discharge will be the party responsible in the event a contribution is required to be made to the HNS Fund. As title transfer is a term universally agreed upon in the typical LNG sale and purchase agreement (the SPA), and as most SPAs in the LNG industry are long-term arrangements – some spanning more than twenty-five years – there is a very real possibility that buyers and sellers of LNG could find themselves and their projects taking on contingent liabilities they had not anticipated when the SPA was signed.

From the seller's perspective, the difficulty arises where the seller agrees to a long-term *ex ship* price and, following execution of the SPA, finds that the country to which the LNG is to be exported has ratified the Convention, thus making the seller potentially liable for any contributions to the HNS Fund. Given the likelihood that the only agreement through which the contribution can be pushed downstream is the SPA itself, the LNG seller in this case is stuck with the liability – the contribution, if any, coming directly out of its bottom line. Similarly, for LNG purchased on an FOB basis, a buyer may find it difficult to move the Convention's second-tier contingent liability downstream if it already has long-term contracts in place for resale of the gas. In such circumstances, shifting liability downstream may be possible; it may not. It all depends, of course, on the term of the agreement with the downstream customer and the leverage of the parties involved. As an interesting contrast, this particular problem was not nearly as acute in the crude oil business in the lead up to the implementation of the CLC and the Fund Convention because crude oil is generally sold under so-called "evergreen" contracts – 90-day cancellable supply arrangements – which, following a contribution to the IOPC Fund (established under the Fund Convention) after a casualty, could quite easily be renegotiated so as to push the per barrel price of the contribution downstream to the end-user on subsequent volumes. Unfortunately, this approach is not so easily done in the LNG industry under the present long-term SPA model. Thus, parties might consider this issue when negotiating their SPA, perhaps agreeing to split the cost of any future contribution or otherwise allocating the risk in accordance with their respective positions of leverage. Buyers, of course, should also consider this issue when negotiating the terms and conditions under which their downstream customers will purchase natural gas from the regasification facility.

If an LNG cargo title holder (an LNG Contributor) is responsible for payments to the LNG account, how much will the LNG Contributor be required to pay? The Convention's operation in this regard may be surprising to many. For each LNG Contributor, the amount to be paid from year to year, if any, will be determined with reference to the percentage of LNG covered by the Convention which such LNG Contributor held title to during the prior

⁴¹ IMO Legal Committee, Monitoring Implementation of the [HNS] Convention, *Report of the Special Consultative Meeting of the HNS Correspondence Group*, August 6, 2003.

⁴² Note that, while the P & I Clubs are keen to say that premiums are determined on the basis of the insured's "track record," it cannot be ignored that with liability limits increasing almost three-fold under the Convention (over and above what they are now under the London Convention, which applies in the majority of LNG-trading nations worldwide), the risk profile will change significantly and increased premiums are probably unavoidable. In addition, it is likely that insurance in some form will be taken out by LNG title holders against the risk of liability under tier two of the Convention.

calendar year.⁴³ For example, suppose an LNG Contributor held title to 15% of the shipments of LNG covered by the Convention in the prior calendar year and the HNS Fund were called upon to pay out the full 250 million SDR (US\$358 million) under the second tier. Under these circumstances, the LNG Contributor would be assessed a liability under the Convention equal to 38 million SDR (US\$54 million). While this example might seem unrealistic at first glance, it could in fact be a conservative illustration in the case where the Convention becomes effective with just enough LNG import tonnage to activate the LNG account and where, among the LNG-importing nations party to the Convention, a single LNG Contributor has a significant share of import tonnage. As the Convention gains more widespread acceptance and the total amount of LNG covered by the Convention increases, contingent liabilities shouldered by individual LNG Contributors under tier two should diminish.

Turning back to the above example, because any major casualty involving LNG in a Convention member state would result in a levy by the HNS Fund on all LNG Contributors, the LNG Contributor above would incur such liability regardless whether the casualty involved LNG to which it held title. Thus, the practical operation of the LNG account will result in LNG Contributors subsidizing damages caused by other LNG Contributors. To the extent it is the large-volume LNG Contributors incurring the casualties, an argument can be made that there is fairness in the arrangement because, after all, their share of the total levy from the HNS Fund will be significant. To the extent that the small-volume LNG Contributors incur the casualties and the large-volume LNG Contributors pick up the lion's share of the bill, that argument becomes far less tenable. Thus, although cross-subsidization between industries is avoided through activation and use of the LNG account, subsidization between larger and smaller LNG importers is a distinct possibility. Moreover, because the number of LNG Contributors may – and likely will – change from year to year and because the volumes imported from year to year will fluctuate, ascertaining the extent of an individual LNG Contributor's contingent liability under the Convention is a bit of a moving target.

CONCLUSIONS

Unlike existing maritime liability conventions applicable to LNG, none of which actually impose liability following a casualty, the Convention does. Moreover, subject to certain defences available to shipowners and LNG cargo title holders, it imposes liability regardless of fault. In such a no-fault, or strict-liability system, the claimant need only show that the carriage of HNS at sea was a causal factor in the resulting injury, irrespective of who is to blame (*i.e.*, proof of causation rather than proof of fault). Indeed, strict liability for LNG shipowners and cargo title holders, a prospect which was once well beyond the horizon, now looks as though it looms just beyond the port bow. If recent developments are any indication, the Convention will likely be a reality in the near future. Four nations have already ratified the Convention and, assuming certain registered tonnage and cargo volume thresholds are met, only eight remain before the Convention takes effect. Recent developments in the EU make those eight far more likely than they were even a year ago.

It was on the basis of a stellar track record that the industry was able to effect the significant changes to the Convention that were accepted by the IMO Legal Committee

⁴³ Under Article 17(2) the annual contributions for the LNG account are calculated on the basis of the amount of LNG discharged during the preceding calendar year, or such other year as the Assembly may decide. Pursuant to Article 25 of the Convention, the "Assembly" consists of all Convention member states.

between 1992 and 1996. That track record, although well-deserved, is based on a strict adherence to safety protocols and a reliance on sound technology and responsible management. Given the political climate we find ourselves in today and the increased likelihood of third-party malfeasance, the old rules may no longer apply and a belief that the Convention will not significantly impact the industry because of its historical safety record may well be misguided. As a result, the LNG industry – and those LNG buyers and sellers who are at present negotiating contracts to grow the industry and expand its scope and breadth – would be well advised to begin thinking about ways in which the Convention’s implementation might impact their respective business models. From the potential to impact the bottom line of an *ex ship* seller constrained by a long-term SPA to the ability to push downstream the costs incurred by an FOB buyer on the heels of a mandatory contribution to the HNS Fund, the Convention carries with it significant contingent liabilities. In our experience, neither the contractual arrangements now in effect nor those that are being presently negotiated take these contingent liabilities into account. At a minimum, we think business leaders and their counsel should consider very carefully the potential impact of the Convention on the importation of LNG into states which have ratified or which might conceivably ratify the Convention.

History has been kind to the LNG industry because of its close attention to safety issues, its proclivity to embrace first-class technology, and its proactive stance toward responsible management. Unfortunately, these steps alone may no longer be sufficient in today’s political climate and, as a result, financial risks arise if the Convention is not adequately considered. However, as it did in the 1990s when it rose to the challenge and advocated segregation of the HNS Fund into separate accounts, the LNG industry will adapt to the impending liability allocation that will follow the Convention’s ratification. Indeed, the industry may well adopt the mantra Sir Winston Churchill held when he proclaimed: “History will be kind to me, for I intend to write it.”⁴⁴

⁴⁴ Sir Winston Churchill (1874 - 1965).

ABOUT THE AUTHORS



Philip R. Weems, a partner with King & Spalding LLP in Houston, specializes in the legal aspects of developing, marketing and operating LNG and cross-border natural gas projects.



Kevin D. Keenan, a senior associate with King & Spalding International LLP in London, specializes in downstream energy-related projects and transactions, including oil, gas and LNG.