STEPHENSON HARWOOD

## Offshore Energy Law

# Is the end of long term LNG charters nigh?

Time was when LNG vessels were employed on long term, usually 20 year, charters, and nothing else. The vessel was recorded as an asset in the books of the ship owner. Any question whether, given the length of the charter, the asset should more properly be recorded as an asset of the charterer could be answered by reference to the expected life of an LNG vessel. One of my tasks as a junior lawyer was to advise on the employment of an LNG vessel for a second 20 year period on expiry of the first.

Times have changed. In January 2016 the new international accounting rules for leases were introduced: IFRS16. As a result, the consensus among the accounting profession is that, with effect from 1 January 2019, any charter exceeding one year should be treated as a lease; at least the capital element of charter hire should be recorded on the charterer's balance sheet as an asset and a liability. This applies to all charters, not just those described as "bareboat charters".

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### "Any charter exceeding one year should be treated as a lease"

This change was driven by the aviation industry, which does not share the shipping industry's practice of differentiating between a bareboat charter, which is characterised as a lease, and a period time charter, which is characterised as a contract for the provision of services. The essential difference between these two forms of charter is that the first transfers possession of the vessel and maintenance obligations to the charterer, whereas the second does not. Sadly, the rules make no such distinction; the crucial test is whether the charterer has the right to use the asset during the relevant period. It is conventional in a period time charter that the charterer has the exclusive use of the vessel during the charter period.

Shipping professionals would argue that a time charter takes on the appearance of a lease due only to inapposite language; it refers to delivery and re-delivery of the vessel and to payment of hire and off-hire, being terms borrowed from bareboat charters, and wrongly applied to time charters.

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The argument continues that, as the true nature of a time charter is the carriage of goods in accordance with charterers' legitimate orders, it is sufficient only for a time charter to be revised to provide for commencement and cessation of services in place of delivery and re-delivery, and for a zero day rate in place of off-hire, mirroring terms found more frequently in, for example, a drilling services contract.

However, if these were the only revisions to a standard time charter, the difficulty would remain that if the owner is obliged under typical time charter terms to provide the service using a dedicated vessel, it is hard to avoid the conclusion that, during the charter period, the charterer has the right to use the nominated vessel.

A quick solution may be to draft the charter period as no more than one year, renewable for up to 20 years, at charterers' option. However, in such case, the accounting rules would take account of the probability that the options will be exercised. If the purpose of the charter is to service a 20 year LNG sale contract, the relevant test would be easily satisfied.

A more sophisticated alternative would be to maintain the long charter period, but to remove the charterers' right to use a dedicated vessel. Thus, the owner would be entitled to perform the service using any vessel meeting the charterparty requirements. In effect, the period charter would be converted into a form

analogous to a contract of affreightment, which would, in reality, be performed as consecutive voyage charters (assuming the owner would prefer to nominate the same vessel for lengthy periods of the charter).

For this change to be effective it would be necessary, following normal accounting practice, for it to apply in substance and not just legal form. Thus a lease would not be avoided if the reality is that only one vessel would be used throughout the charter period. IFRS 16 requires that the owner should have the practical ability to substitute the performing vessel throughout the charter period. Whether an owner would have the capability to achieve this, or whether charterers would be willing to forgo control over the vessel to be nominated may be open to doubt.

## "A lease would not be avoided if the reality is that only one vessel would be used throughout the charter period"

Whether these changes will have a major impact on longer term chartering remains to be seen. It may be that auditors of chartering companies would be willing to take a generous approach to whether a charterer has the right to use a vessel under a contract for services, if to treat the contract as a lease would be a radical departure from existing practice.

However, it would appear the new rules are intended to introduce radical change. On the question whether such change would cause drastic deterioration in the charterers accounts, it should be noted that where the lease is recorded as both an asset and liability of the charterer, the net position may not be radically altered, and that only the capital element of the charter hire is recorded in the charterers' books. This element is easily ascertained in the provisions of a long term LNG charter.

## "The new rules are intended to introduce radical change"

Charterers may decide that, rather than risk convoluted restructuring of familiar charter terms, they should now turn their attention to restructuring the charter economics, accepting that the capital element will be recorded on its balance sheet. Given that the new accounting rules will take effect at the early stage of any new LNG project currently being contemplated, that decision will need to be made soon.

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Stuart Beadnall
Partner, London
T: +44 20 7809 2936
E: stuart.beadnall@shlegal.com



STEPHENSON HARWOOD