

LNG for Japanese Buyers: End of the Road for Destination Clauses?

A recent announcement by the Japanese antitrust regulator could spell the end of destination clauses in certain Asian LNG SPAs.

Key Points:

- Asian LNG buyers are seeking to form a buyers' club to negotiate better and more flexible terms.
- The Japanese antitrust regulator has announced that certain LNG SPA contract terms may be anti-competitive and in violation of Japanese antitrust law.

Introduction and summary

The Japanese antitrust regulator, the Japan Fair Trade Commission (JFTC), announced on June 28, 2017 the results of its investigation into restrictive clauses typically found in long-term liquid natural gas sale and purchase agreements (LNG SPAs), with a particular focus on destination restrictions.

The main conclusions from the investigative report are summarized below:

- Destination clauses and diversion restrictions under long-term free-on-board (FOB) LNG contracts are highly likely to violate Japanese antitrust law.
- Given the nature of long-term delivered ex-ship (DES) LNG contracts, the presence of destination clauses and reasonable diversion restrictions is unlikely in itself to violate Japanese antitrust law.
- Diversion profit sharing provisions in FOB LNG contracts are, as a general matter, not considered to be reasonable, and are highly likely to violate Japanese antitrust law.
- Diversion profit sharing provisions in DES LNG contracts are not inherently problematic, but if such arrangements restrict the ability of the buyer to on-sell or are unreasonably favorable to the seller, then such arrangements are likely to be in violation of Japanese antitrust law.
- "Take or pay" provisions in LNG contracts are acknowledged to be necessary for the purposes of financing capital intensive LNG developments, but may in certain circumstances violate Japanese antitrust law.

Background to inclusion of “destination clauses” in LNG SPAs

It is an established principle that long-term “take or pay” offtake contracts are a pre-requisite for obtaining third-party financing for capital-intensive LNG projects. Because gas prices can vary significantly from region to region, there are price arbitrage opportunities for buyers if they are free to on-sell the LNG in other markets. As a result, sellers have sought to limit a buyer’s ability to resell purchased LNG cargoes outside the buyer’s own region, through the inclusion of territorial sales restrictions or “destination clauses” in the LNG SPAs. These clauses designate specific LNG receiving terminals for the LNG cargoes sold under the SPA and restrict the buyer from nominating alternative delivery points outside of the buyer’s home destination.

Antitrust considerations

LNG buyers have long argued that territorial restrictions in LNG SPAs interfere with buyers’ ability to manage their gas portfolios and exploit arbitrage opportunities and therefore the territorial restrictions are anti-competitive. The use of destination clauses in LNG SPAs with European buyers has already become uncommon due to a series of rulings the European Union Commission handed down starting from 2002. The EU Commission held that certain types of destination restrictions in contracts between non-European producers and European buyers infringe European competition law by preventing cross-border trade, and undermine the goal of a single gas market in Europe. However, such clauses remain common in SPAs with Asian buyers, who have traditionally supported some of the largest LNG projects in recent years as “foundation buyers.”

Buyers’ market

With the current glut in gas supply and downward pressure on gas prices, LNG buyers are enjoying a reversal of fortune after years of high demand and oil prices in excess of US\$80/barrel. In March of this year the world’s biggest LNG buyers, all Asian, reportedly agreed to join forces and form a buyers’ club to negotiate better and more flexible terms. Japan’s JERA, Korea’s KOGAS and China’s CNOOC, which together account for the purchase of one third of global LNG production, signed a memorandum of understanding under which they agreed to “cooperate in the joint procurement of LNG.” With their combined purchasing power, they have the ability to secure significant concessions, including more flexible terms, from LNG sellers.

Japanese government’s actions

For some time now, the Japanese government has been supporting Japanese LNG buyers’ calls for more flexible destination clauses. In September 2013, Japan’s Minister of the Ministry of Economy, Trade and Industry (METI) referred in a keynote address for the Second LNG Producer-Consumer Conference, to the European Union’s efforts to seek to enhance gas market liquidity by requiring more flexible destination clauses in contracts involving European buyers. He went on to say that Japan would be promoting cooperation with the European Commission in order to learn from their experiences in this area.¹ At the G7 Energy Ministerial Meeting held in May 2016, METI publicized its “Strategy for LNG Market Development,” which referred to the stepping up of efforts to eliminate destination clauses as one of the specific actions METI intended to take in order to realize its market strategy.² This announcement was followed in June 2017 by the cabinet of Prime Minister Shinzo Abe approving the Investments for the Future Strategy 2017, which expressed support for removing destination clauses in order to promote the expansion of LNG markets in Asia for the sake of Pan-Asian energy security.³

Japanese antitrust regulator's report

In line with the Japanese government's actions, in July 2016 the JFTC launched an investigation into trade practices in respect of LNG sold to Japanese buyers. The results of the investigation,⁴ announced on June 28, 2017, included an antitrust analysis of a number of restrictive clauses typically found in long-term LNG SPAs, including diversion clauses and related profit-sharing mechanisms, and "take or pay" obligations⁵. However, JFTC attention clearly focused on considering whether destination clauses impede fair competition and contravene Japanese competition law. The JFTC stated in its report that "[w]hen a supplier (a seller under a fixed-term contract) prevents a user (a buyer) from reselling LNG by means of imposing destination restrictions which tend to cause a situation where new entrants are excluded in the fixed-term contract market (Asian market) or in the spot contract market (World market) and/or their trading opportunities are lessened in these markets, such conduct is deemed to have 'foreclosure effects'." The JFTC added that such practice is, in principle, a violation of the Japanese antitrust law that prohibits the use of unfair restrictive terms that frustrate fair and free trade.

Notably, the JFTC drew a distinction between (i) LNG SPAs on FOB terms, under which LNG is delivered by the seller to a shipment port in the exporting country and the buyer bears all expenses and risks associated with transporting the LNG to the destination port, and (ii) LNG SPAs on DES terms, under which LNG is delivered by the seller to a destination port in the importing country, and the seller bears all expenses and risks associated with transporting the LNG to the destination port.

In the JFTC's view, destination clauses and diversion restrictions in FOB contracts are likely to be in violation of the Japanese antitrust law because the delivery point is the loading terminal and imposing restrictions on the destination of the LNG is neither necessary nor reasonable. The JFTC also notes that clauses requiring the buyer to share profits from a diversion with the seller in FOB contracts is highly likely to be in violation of Japanese antitrust law.

On the other hand, in the case of DES contracts the JFTC considers that destination clauses which require the seller's consent for any diversion of the cargoes or which impose reasonable conditions on diversion of cargoes, are "natural" and therefore could be justified. However, if the seller refuses to give consent to the buyer's request for the diversion of cargoes, despite the buyer having satisfied reasonable conditions, such refusal is likely to be in violation of Japanese antitrust law. Additionally, the JFTC stated that arrangements in long-term DES contracts requiring the buyer to share profits from a diversion with the seller are not inherently problematic, but if such arrangements restrict the ability of the buyer to on-sell or are unreasonably favorable to the seller then such arrangements are likely to be in violation of Japanese antitrust law.

In the report's conclusion, the JFTC notes that "when LNG sellers conclude a new contract or revise a contract after the expiration of its term, LNG sellers should not provide competition-restraining clauses nor engage in business practices which lead to the restrictions of resale and so on. Also, as for the existing contracts before their expiration, LNG sellers should, at least, review any competition-restraining business practices which lead to restrictions of resale and so on."

Implications for current and future LNG projects

Some of the largest LNG projects undertaken in recent years involve LNG SPAs with Asian buyers. In 2016, more than 70% of LNG imports were to the Asia-Pacific and Asia regions.⁶ Following the Fukushima disaster, Japan's energy security has become all the more dependent on imported LNG. Indeed, 31.6% of global LNG production in 2016 was purchased by Japanese buyers, and 25.9% of global LNG trade was under long-term LNG SPAs with Japanese buyers.⁷

Although the JFTC's comments are not enshrined in a binding law or regulation and are merely a side note to its investigation report, the comments are expected to impact Japanese market practice and sellers negotiating new LNG SPAs. Similarly, extensions to expiring LNG SPAs may face increased resistance to territorial restrictions. Indeed, the European Union and Japan reportedly intend to sign a memorandum of cooperation aimed at "accelerating efforts in facilitating more flexible LNG contracts" and moving away from agreeing restrictions on the resale of LNG. The European Union and Japan are also reportedly considering co-hosting a meeting of major LNG producing and consuming countries in order to discuss ways to secure transparency in the LNG market.⁸

However, less clear are the implications of JFTC's conclusion that "as for the existing contracts before the expiration, LNG sellers, at least, should review competition-restraining business practices which lead to restrictions of resale and so on," since most existing long-term LNG SPAs are unlikely to be governed by Japanese law and the point of sale for FOB contracts typically is the exporting terminal (and therefore beyond the jurisdiction of Japanese law). The Japanese angle, if any, could come into play at the time of enforcement of a foreign arbitral award or court judgement in Japan against a Japanese buyer.

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Endnotes

¹ <http://www.meti.go.jp/english/speeches/20130910.html>.

² http://www.meti.go.jp/english/press/2016/pdf/0502_01b.pdf.

³ (Available only in Japanese) http://www.kantei.go.jp/jp/singi/keizaisaisei/pdf/miraitousi2017_t.pdf.

⁴ (Only an excerpt available in English) <http://www.jftc.go.jp/en/pressreleases/yearly-2017/June/170628.html>.

⁵ Though not the primary focus of the report, the JFTC stated that the presence of "take or pay" clauses in long-term LNG SPAs may violate Japanese antitrust law but did not provide detailed guidance on when such clauses may be deemed to violate Japanese antitrust law. However, the commentary in the report suggests that a key consideration is whether the seller imposes a strict "take or pay" provision, abusing its bargaining power, even after the seller has had a sufficient return on initial investment.

⁶ See International Gas Union, World LNG Report – 2017 Edition, at p. 8.

⁷ Figures provided by Gas Strategies.

⁸ <http://www.the-japan-news.com/news/article/0003799181>.