COMMENTARY

AUGUST 2017

Japanese Report: LNG Sale and Purchase Agreement Destination Restrictions Likely Anticompetitive

IN SHORT

The Background: Contracts for the sale of liquefied natural gas traditionally limit the ability of the LNG buyer to freely resell the cargoes acquired under the contract. This helps LNG sellers manage their markets and operations but also limits the ability of LNG buyers to optimize their supply arrangements over time. With Japan entering a period of excess LNG, such restrictions are receiving increasing scrutiny both from buyers and the Japanese government.

The Report: The Japan Fair Trade Commission published a survey report finding that destination restrictions in many LNG sale and purchase agreements (especialy those with FOB delivery terms) are likely to be in violation of the Antimonopoly Act. This finding was not unexpected, but the detail of what it means for different classes of existing and future LNG contracts warrants careful attention.

Looking Ahead: For future LNG sales contracts into Japan with FOB delivery terms, destination restrictions will likely need to be avoided. For contract extensions, this may require existing contract terms to be amended. For existing contracts, care will need to be taken with exercising existing rights, and some provisions may need to be renegotiated. The analysis will differ between sales with delivery at the supply source (FOB sales) and sales with a delivery point in Japan (Ex Ship sales), with restrictions harder to justify for FOB sales.

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On June 28, 2017, the Japan Fair Trade Commission ("JFTC") published a survey report ("Report"), concluding that destination restrictions provided in liquefied natural gas ("LNG") sale and purchase agreements ("SPAs") in certain cases are likely to be in violation of the Japan Antimonopoly Act ("AMA"). As a result, sellers and buyers of LNG into Japan will need to modify their future contracting approaches and review their existing contracts and contract management processes.

Background and Context

After the Great East Japan Earthquake in 2011, Japan increased LNG imports mainly because all the nuclear power plants in Japan were shut down, and instead, thermal power plants started to consume larger amount of fossil fuel. However, nuclear power plants are restarting operation little by little following tightening of safety regulations. As a result, we are likely entering into a period of excess LNG in Japan, which is the largest LNG importer in the world. However, it will not be easy for buyers to resell surplus LNG to third parties due to destination restrictions contained in a large number of LNG SPAs.

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Other forces have also combined to put pressure on destination restrictions, including review and regulation by the European Union in the 2000s, the rise of destination-free sales out of the United States (where approved), Japan's desire to create an LNG trading hub expressed at the G7 Energy Ministerial Meeting, and the general "buyer's market" in LNG that has persisted for some time.

Against this background, the JFTC published the Report in June of this year. The Report, while not legally binding, is likely to have significant impact on LNG contracting into Japan and perhaps more widely as well.

Key Points of the Report

Under free on board ("FOB") contracts, title to and risk of LNG are transferred from sellers to buyers at the loading terminal of the LNG shipping port, and sellers are not responsible for the transportation of the LNG thereafter. As the seller is not responsible for shipping, the JFTC stated that destination clauses are "likely" to be in violation of the AMA. Further, the JFTC concluded that "the restrictions on diversion as well as the provision of destination clauses" are "highly likely" to be in violation of the AMA.

Under contracts for sales with a delivery point in Japan ("Ex Ship contracts"), since sellers are responsible until the unloading of LNG at the destination port, the JFTC accepted that destination clauses, the provision to require seller's consent to diversion, and the provision of the necessary and reasonable requirements to diversion are unlikely to have AMA issues. However, the JFTC stated that if a seller does not give consent to a diversion where a buyer's request meets any requirements of necessity and reasonableness, such refusal is "likely" to be in violation of the AMA. In addition, the JFTC cautioned that if a seller imposes competition-restraining requirements for diversion, such as the prohibition on commercial resale, it is "highly likely" to be in violation of the AMA.

The Report also examined profit-share clauses and take-or-pay clauses, indicating they may also be in violation of the AMA in certain cases.

Implications

At the end of the Report, the JFTC gave a warning to LNG sellers that: (i) at the time of concluding a new contract or renewal of existing contracts, LNG suppliers should not include provisions or adopt trade practices that anti-competitively prevent resale of LNG by buyers; and (ii) even in the case of existing contracts before expiration, anti-competitive trade practices to prevent resale of LNG by buyers are required to be reviewed and amended. Also, as a future course of action, the JFTC expressed that the "Japan Fair Trade Commission will take strict actions against any violations of the Antimonopoly Act." Precisely what steps it would take is not stated.

In addition to the uncertainty as to next steps that might be taken by the JFTC, it should also be noted that not all contracts fit neatly into the categories used in the Report's conclusions. In particular, destination, diversion, and profit-sharing terms themselves can differ significantly.

For these reasons, each buyer and seller of LNG into Japan will need to audit its existing contracts and contract management approaches. For example, decisions around diversion approvals may require referral to legal departments and need to be properly documented and recorded.

Participants in other markets should also consider these changes, both in terms of possible opportunities for broader LNG trading and also possible knock-on effects such as responses by other regulators, particularly in Korea and China.

THREE KEY TAKEAWAYS

1. Those negotiating contracts for the sale of LNG into Japan, whether new contracts or extensions of existing contracts, must have careful regard to the findings in the Report. In particular, it would appear very difficult to include destination restrictions as they are in FOB contracts, and any restrictions in Ex Ship contracts would need to be carefully considered and drafted.

2. Those managing existing LNG contracts into Japan will need a strategy in response to the Report. We would recommend sellers conduct an audit of their existing contracts and implement appropriate changes to their contract management procedures.

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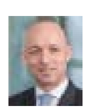
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3. Those interested in the broader LNG market should take time to understand the findings of the Report and consider what other risks and opportunities they may trigger.


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