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Client Alert

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Japan Fair Trade Commission Survey of LNG Trades

INTRODUCTION

On 28 June 2017, the Japan Fair Trade Commission (the "**JFTC**") published its highly anticipated "Survey on LNG Trades" (the "**Survey**") that reviews the impact of destination restrictions on long term LNG imports into Japan and their effect on a competitive LNG market. The English translation of the Survey can be downloaded here:

http://www.jftc.go.jp/en/pressreleases/yearly-2017/June/170628.html

This paper reviews the JFTC's conclusions in the Survey and assesses how these may impact future long term sales of LNG to Japan for both new and existing LNG contracts.

SUMMARY

The Survey drew five conclusions in relation to the long term supply of LNG to Japan, which are summarised as follows:

(1) Destination clauses and restrictions on diversions under long term FOB[i] contracts are highly likely to be in violation of the Antimonopoly Act (Unfair Trade Practices: Trading on Restrictive Terms) (the "**Antimonopoly Act**");

(2) Destination clauses under long term DES contracts that define a delivery point are, in themselves, unlikely to infringe the Antimonopoly Act;

(3) Under long term DES[ii] contracts, requiring the seller's consent for a diversion proposal, with such consent being subject to conditions relating to "*reasonableness or operational necessity*" (e.g. ship to shore compatibility), does not contravene the Antimonopoly Act. However, competition restraining requirements for diversions imposed by the seller are highly likely to be in breach of the Antimonopoly Act;

(4) Act Under long term DES contracts, requiring the buyer to share the profits arising from a diversion with the seller is not inherently a breach of the Antimonopoly, but if the profit sharing mechanism unreasonably favours the

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seller or requires the disclosure of the profit or re-sale cost structure and this limits the buyer's ability to re-sell the LNG, then the inclusion of such terms is likely to result in a breach of the Antimonopoly Act; and

(5) Under some circumstances, the presence of Take or Pay clauses in long term LNG contracts may constitute a violation of the Antimonopoly Act.

The JFTC also requires LNG sellers to: (i) ensure that competition restraining clauses or restrictions on the re-sale of LNG are not included in new LNG contracts or in revisions of existing contracts (presumably meaning that new or revised contracts should comply with the five conclusions set out above); and (ii) review their existing LNG contracts for competition restraining practices and restrictions on re-sale. It is unclear whether LNG sellers are required to renegotiate their existing LNG contracts to ensure compliance with the JFTC's conclusions.

REVIEW AND IMPLICATIONS

1. **Destination Restrictions[iii] and Diversion Restrictions[iv] under FOB Contracts**

The Survey analysed the scope of destination restrictions and conditions on diversions in relation to long term FOB contracts.

The Survey considered the sellers' perspectives as to why destination restrictions are required and why their inclusion may be reasonable, notably: (i) so that the seller can ensure that the buyer's vessel returns to the loading port in time for the next loading, thereby preventing interruptions to the Annual Delivery Programme; and (ii) a seller's LNG sale price is determined based on the destination market.

The Survey also reviewed the buyers' views on the same issues and concluded that in relation to the first argument put forward by the sellers: (i) the seller does not need to ensure the vessel's timely return to the loading port as this is the buyer's responsibility and an LNG contract will typically provide for damages in favour of the seller if the buyer fails in this respect; (ii) in the current market, it is not necessary for the same vessel to return to the loading port as alternate vessels can be chartered fairly readily; and (iii) history indicates that an Annual Delivery Programme can be frequently adjusted without harm to either party. Further, in relation to the sellers' second contention, it was determined that there is no empirical evidence of a correlation between destination flexibility and LNG prices.

The Survey concluded that: (i) in relation to destination clauses in FOB contracts, "*it cannot be said that providing destination clauses itself under a fixed-term FOB contract is necessary and reasonable, and such a provision is likely to be in violation of the Antimonopoly Act*"; and (ii) in relation to diversion clauses in FOB contracts, "*restrictions on diversion… … are highly likely to be in violation of the Antimonopoly Act*". This is a clear indication from the JFTC that both destination and diversion restrictions in long term FOB contracts for LNG sales are considered violations of the Antimonopoly Act.

Potential Implications

The foregoing conclusions of the Survey have potential implications on the following:

(1) **Existing Contracts**: As a majority (or probably all) of the FOB contracts for LNG sales to Japan are not governed by Japanese law, it is legally unclear how the JFTC position applies to these contracts. For example, if the contract is an FOB sale of LNG from Australia which is governed by English law, the sale of LNG takes place in Australia and this raises significant legal questions as to how, or if, a

Japanese regulation applies to such a contract. Further, how does the JFTC propose to enforce its position in relation to foreign companies that do not conduct any business in Japan? Potentially, a Japanese buyer may divert a cargo, in breach of its FOB contract, and, if a claim is brought against it by its seller, use the JFTC position as a defence.

(2) **Trade/Political Sanctions**: Some LNG selling countries impose trade or political sanctions that apply to the export of goods from those countries. These sanctions are, in many cases, destination restrictions. For example, if a Japanese company is buying LNG on an FOB basis from a US LNG exporter, the LNG contract entered into between these two parties will require the Japanese buyer to comply with specific export authorisations (containing destination restrictions), imposed by the US Department of Energy, which are applicable to its US seller. In this scenario, will the JFTC determine that the LNG contract is in breach of the Antimonopoly Act due to its agreement to such destination restrictions?

(3) **New FOB Contracts**: As the JFTC's findings in the Survey in relation to the prohibition of destination and diversion restriction clauses in FOB contracts has been broadly anticipated by the LNG industry and (despite potential legal arguments regarding whether such Japanese prohibitions apply to an FOB sale) the sellers, based on their experience of the EU's approach to destination restrictions in long term LNG contracts, are already likely to be negotiating new deals that comply with the JFTC's position on destination and diversion restrictions.

2. **Destination Clauses under DES Contracts**

The JFTC recognised that having a fixed destination is a fundamental element of a DES sale. In essence, to be a DES sale, the LNG must be delivered at an agreed port. Therefore, a DES sale itself is not a violation of the Antimonopoly Act. However, limitations on the diversion of DES cargoes to other receiving terminals may be a violation of the Antimonopoly Act: please see sections 3 and 4.

Potential Implications

A DES contract structure can continue to be used for long term LNG sales to Japanese buyers.

3. **Diversions under DES Contracts**

The JFTC recognised that under a DES structure, the seller is responsible for the shipping of LNG and delivering the LNG to the receiving terminal. Therefore, the seller has valid operational and commercial concerns in relation to changing the scheduled LNG receiving terminal and it is reasonable for a diversion proposal to be subject to the seller's consent in these circumstances. However, if the seller refuses to permit (or the DES contract prohibits) a diversion for other reasons, then this is highly likely to be a violation of the Antimonopoly Act.

The Survey specified the considerations of a seller which are generally regarded as reasonable in rejecting a diversion request, and also those reasons that would be considered anti-competitive as follows:

Acceptable Reasons for Diversion Rejection

It is considered reasonable for a seller to reject a diversion request if:

(1) there are issues on ship-shore compatibility and safety at the diversion receiving terminal;

(2) additional costs are incurred (unless such additional costs are reimbursed by the buyer); and

(3) it results in a longer shipping journey that would impact the ability of the vessel to return to its next loading port on time (unless there is a reasonable alternative vessel chartered at the buyer's expense).

Anti-Competitive Reasons for Diversion Rejection

The following conduct undertaken by a seller in relation to a buyer's diversion request or the inclusion of the following restrictions on diversion in a DES contract are likely to be considered as anti-competitive behaviour by the JFTC:

(1) if the DES contract contains limitations that only permit the buyer to call for a diversion for specified operational constraints (e.g. if the receiving terminal is near tank tops) but not for other reasons;

(2) if the seller rejects a buyer's diversion request on the grounds that the proposed diversion is for the buyer's commercial advantage;

(3) if the seller rejects a buyer's diversion request due to the proposed sale to another customer of the seller; and

(4) if the seller or the DES contract only permits diversions due to the seller's direct sale to a third party who is the owner of the relevant diversion receiving terminal.

Potential Implications

While the JFTC is clear that having a named destination (LNG receiving terminal) in a DES contract is not in itself a violation of the Antimonopoly Act, it clarified in the Survey that the DES contract must permit diversions from such named LNG receiving terminal unless the seller has valid reasons for rejecting a diversion request.

While the Survey provided examples of the acceptable and unacceptable reasons for a seller to reject a diversion request, it seems that these are given as illustrations rather than as an exclusive list of reasons for or against rejection of a diversion request. However, it does appear that the JFTC's underlying philosophy in determining whether a seller' reason for rejecting a diversion request will be judged as reasonable hinges on whether: (i) there are any bona fide safety issues; (ii) there are any operational reasons that would impact subsequent LNG operations in a material way and for which no reasonable alternative can be found; and (iii) it would be inequitable for the seller to incur additional costs without reimbursement. Given the uncertainty surrounding what classifies as a valid reason for rejection, it is likely that further clarity will be required from the JFTC to enable new DES contracts to be agreed that are in compliance with the JFTC's policy.

The JFTC state "*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.*". This implies that, as a minimum, sellers should review their contracts (what does "*review*" entail?) but does it require the sellers to actively renegotiate them? As a seller under a DES contract does undertake activities in Japan, the JFTC will have a nexus under which it can bring actions against such seller. This may impact the desire of sellers to renegotiate their existing DES contracts.

4. **Diversion Profit Sharing under DES Contracts**

In the Survey, the JFTC identified that in many DES contracts, if a diversion is agreed by the seller, then the parties subsequently share the profit from the sale of the diverted cargo (with the profit typically being the difference between the price paid by the diversion buyer less the price that would have been paid by the buyer under the relevant DES contract and less any additional costs incurred in delivering the cargo to the diversion buyer). The JFTC determined that, in certain circumstances, this profit sharing mechanism could itself be anti-competitive and therefore in violation of the Antimonopoly Act. The Survey specified two areas where a diversion profit sharing mechanism may be anti-competitive:

(1) where the seller takes an unreasonably high percentage of the re-sale profit without proper consideration of the seller's contribution to the re-sale. The JFTC's discussion seems to indicate that it would be unreasonable for more than 50% of the profit to be allocated to the seller, and the JFTC's rationale for this finding is that the lack of profit opportunity for the buyer on the re-sale disincentivises the buyer to resell and therefore reduces competition; and

(2) if the seller requires details from the buyer of the re-sale price and costs, then, as these details are typically confidential or commercially sensitive, the buyer may be unable, or unwilling, to divulge them. The JFTC argues that as a result, the buyer may be unable, or less likely, to pursue diversions, which is anti-competitive.

Potential Implications

In relation to diversion profit sharing mechanisms, the Survey contained little detail as to how the seller's contribution to the re-sale should be valued, and accordingly, what constitutes a reasonable profit share. In the absence of further details in this area, it may be difficult for parties to a DES contract to agree terms for profit sharing that comply with the JFTC's stance.

In relation to the disclosure of diversion prices and costs, the Survey provided no guidance as to how a diversion profit should be determined in the absence of the actual price and cost data. Is the seller expected to rely on a buyer's calculation of profit without any supporting data? Perhaps a solution would be for independent auditors to check a diversion profit calculation, thereby removing the need to divulge such confidential information to the seller, but this would add to the transaction costs.

The Survey indicated that many of the existing diversion profit sharing clauses do not comply with the JFTC's position and consequently this is likely to be an area where significant amendments to existing DES contracts will be required.

5. **Take or Pay Provisions**

The Survey briefly analysed the traditional take or pay mechanisms found in many long term LNG contracts and acknowledged that the "*guarantee of sustainable and full payment of contract by users is an important element for a final investment decision*" for LNG projects and that take or pay "*has some necessity and reasonableness, and providing such clauses is not itself problematic under the Antimonopoly Act*".

However, the JFTC considered that "*some contracts provide for Take or Pay clauses even after a full payment of loans related to an initial investment in an LNG Project*" and this seems to imply that the seller's need for secure offtake of LNG is in some way diminished once the development loans have been repaid. Thereafter, the

JFTC concluded that "*when a seller's bargaining position is superior to that of a buyer and the seller unilaterally imposes Take or Pay clauses and strict minimum purchase obligation without sufficient negotiation with the buyer even after the seller has already got sufficient return for initial investment, strict minimum purchase obligation as well as providing Take or Pay clauses are likely to be in violation of the Antimonopoly Act*".

It appears that the JFTC adopts a bifurcated approach in relation to take or pay provisions: (i) prior to repayment of the project finance loans and to the extent reasonable and necessary, such provisions may not be anti-competitive; and (ii) once the project finance loans for the LNG project development are repaid, then it is unreasonable for a seller to impose a minimum purchase obligation on the buyer. At this time, the JFTC did not make proposals in the Survey as to the type of offtake obligations that would be considered reasonable. However, if the JFTC position imposes some form of relaxation of the take or pay provisions surely this would need to be balanced by a corresponding relaxation in the seller's obligation to deliver LNG. Also, the JFTC position results in some curious outcomes. There could be two identical DES contracts that include take or pay provisions; one DES contract is from a project financed seller and the other is not. Applying the JFTC position indicates that the DES contract from the project financed seller is not anti-competitive yet the other contract is.

Potential Implications

As take or pay provisions are commonly used structures in the LNG industry, the sellers of LNG to Japan will want clarity on various aspects of the JFTC ruling in relation to this. For instance, what constitutes a superior bargaining position for a seller? When is a seller considered to have unilaterally imposed a take or pay clause on a buyer? What constitutes sufficient negotiation between the buyer and the seller? And most importantly, what is a sufficient return on initial investment?

If the sellers of LNG to Japan cannot quickly get comfort around how take or pay provisions must be structured for sales of LNG to Japan, then for new LNG contracts (at least to the extent that there are no outstanding project finance loans), sellers may want to switch to a cargo-by-cargo damages regime, whereby the buyer must either: (i) pay for each cargo scheduled in the annual delivery programme and if the buyer does not take any scheduled cargo, the seller is entitled to sell such cargo and provide the buyer with the proceeds of such sale (net of selling costs); or (ii) pay the seller fixed damages assessed against the value of the cargo. Ensuring the sellers' minimum revenue in this manner removes the necessity for the inclusion of a take or pay mechanism.

6. **Conclusions**

The Survey and the JFTC's opinions on what constitutes anti-competitive behaviour will have several implications for existing and future long term LNG supplies to Japan.

Firstly, it is likely that Japanese buyers will be seeking to ensure that all future FOB contracts will be free from destination and diversion restrictions. The Japanese buyers are likely to also seek to have existing FOB contracts amended to comply with the JFTC's position as stated in the Survey.

Secondly, all buyers and sellers will have to carefully consider how diversion clauses can be constructed in both existing and new DES contracts so as to comply with the JFTC's constraints regarding a seller's right to reject a diversion and how any diversion profit sharing is to be managed.

Thirdly, the JFTC's position on take or pay provisions remain unclear and will need further clarification as to if, and how, it will apply to existing contracts. For future DES contracts, sellers may seek to avoid take or pay mechanisms and instead seek to impose different contracts structures that ensure a guaranteed offtake.

Lastly, it is unclear whether the JFTC position requires sellers to renegotiate existing contracts to conform to their position on what constitutes anti-competitive behaviour. For existing contracts, LNG sellers "*at least should review competition restraining business practices*" but the JFTC finish by stating they "*will keep monitoring the LNG market and take strict actions against any violations of the Antimonopoly Act.*"

7. **Contacts**

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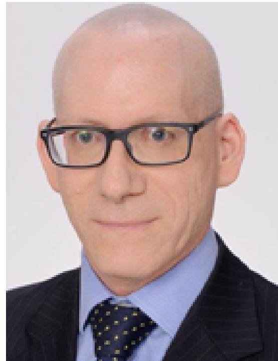

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[i] The JFTC defines FOB (Free on Board) as a term of delivery that designates the shipment port in an exporting country as the delivery point.
[ii] The JFTC defines DES (Delivered Ex Ship) as a term of delivery that designates the destination port in an importing country as the delivery point.
[iii] A destination restriction in an LNG contract is one which specifies that the LNG must only be delivered to a limited number of identified LNG receiving terminals (“**Primary Receiving Terminals**”).
[iv] A diversion restriction in an LNG contract is one which limits or prevents a buyer from having a cargo of LNG delivered to an LNG receiving terminal other than Primary Receiving Terminals.