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Practice Groups:

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Japan's Competition Regulator Questions LNG Destination Clauses

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The Japan Fair Trade Commission (“JFTC”), Japan’s competition regulator, recently published results of an investigation into destination restrictions in liquefied natural gas (“LNG”) supply contracts. The results of the investigation were published in a report on June 28, 2017, entitled “Survey on LNG Trades (Chapter 4E Ensuring of Fair Competition in LNG Trades)” (the “Report”).¹

JFTC appears to have undertaken the preparation of the Report in response to changing market conditions, where an increase in LNG supply (and suppliers) and the associated drop in prices could make inflexible long-term contracts unattractive to buyers, including in Japan, which consumed approximately 34% of the world’s LNG in 2015.² The market view, however, is that Japanese buyers probably have contracted for LNG in excess of their needs in the short and medium term, making the enforceability of destination clauses of paramount relevance.

Destination restriction clauses prohibit the buyer under an LNG sale and purchase agreement from redirecting or reselling the LNG in any particular cargo. Japanese electrical utilities in particular believe that the clauses unfairly disadvantage them, because they are less able to react quickly to changes in the domestic generation mix, where coal has taken over much of the baseload from nuclear, and where renewables, solar in particular, have an increasing market share. Destination restriction clauses also make the buyers less nimble in the face of price changes (which from the sellers’ perspective, is precisely the point -- any windfall should accrue to the seller).

The Report, while not having the force of law, indicates that JFTC generally takes a dim view of arrangements whereby a seller limits the flexibility of a buyer to resell a product. Looked at cynically, the JFTC has signaled that it intends to treat LNG destination restriction clauses much like it does resale price maintenance undertakings for retail goods, notwithstanding the complexity, exceptionally high capital costs and peculiarities of the global LNG market.

JFTC’s views, largely in its own words, as set forth in the approved but unofficial English version of the Report, are as follows:

¹ <http://www.jftc.go.jp/en/pressreleases/yearly-2017/June/170628.files/170628-2.pdf>.

² IGU World LNG Report 2016.

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Provision	Specific Concepts	Position Under the Antimonopoly Act
Destination clauses in Fixed-Term Free On Board ("FOB") Contracts		Highly likely to be in violation
	Providing profit share clause	Not considered as reasonable; highly likely to be in violation
Destination clauses in Fixed-Term Deliver Ex Ship ("DES") Contracts	If in order to define a delivery point	Not in itself problematic
	If a provision is included to require "seller's consent" to diversion or the provision of the requirements of "fairly necessity [sic]" and reasonableness to diversion	Not in itself problematic
	If seller's consent is required even if fair necessity and reasonableness are demonstrated	A refusal is likely to be in violation
	When a seller, on an operational or contractual basis, requests competition-restraining requirements for diversion	Highly likely to be in violation
	Providing a profit share clause when a seller requires from a buyer compensation in exchange for giving consent on a diversion of contract requirements (destination) according to a request from the buyer and for an agreement to allow them to resale	Cannot be said that it is unreasonable; not in itself problematic
	When a profit share clause contributes to unreasonable profit sharing with a seller: (i) by setting a high percentage of the resale profit without properly considering seller's actual contribution to resale or by using a gross profit as a resale profit; or (ii) when such clauses have some effects to prevent a buyer from reselling due to a seller's request for the disclosure of the profit or cost structure	Likely to be in violation
Disclosure of information regarding resale	When clauses requiring disclosure of information regarding resale have the effect of "prevent[ing] a buyer from reselling due to a seller's request for the disclosure of the profit or cost structure"	Likely to be in violation
	When seller does not require a breakdown of resale costs in detail and evidence therefor, and information sharing is minimized	Therefore, it is desirable

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Take or Pay	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	Likely to be in violation
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Not surprisingly, much of the concern has revolved around whether JFTC's positions are intended to have retrospective effect, which could of course imply the possibility of forced renegotiation of LNG sale and purchase agreements.

Fixed-Term FOB Contracts

A key takeaway is that JFTC believes that no destination restriction in a fixed-term FOB contract is compliant. JFTC believes that the passage of title to the buyer at the flange at the port of loading strongly supports the position that any attempt to contractually restrict sales after that point is anticompetitive.

Fixed-Term DES Contracts

JFTC's views on destination restriction clauses in fixed-term DES contracts are more nuanced. JFTC believes that clauses whose purpose is to define a delivery point would be compliant, and if the provision requires seller's consent to diversion (as long as the seller's consent may not be unreasonably withheld), then the provision may be compliant.

If seller's consent is required even if buyer can demonstrate the need for the change and a reasonable basis fair necessity and reasonableness; however, then JFTC believes that the consent requirement could have an anticompetitive effect. In particular, if consent is conditioned on the buyer agreeing to or imposing competition-restraining requirements, then JFTC believes that the provision would be non-compliant.

Profit-Sharing Clauses

Profit-sharing clauses whereby a seller requires compensation in the form of a profit share from a resale of the cargo in exchange for the seller's consent to diversion are in principle permissible but may be questioned if the seller's share is particularly high (the commentary suggests that 50% would be appropriate, in particular if the seller contributed in some way to achieving the profit) or if the buyer will feel constrained from reselling because of a reluctance to disclose the cost structure or terms of sale. A contract that does not require the buyer to provide a breakdown of resale costs is "desirable."

Take or Pay

Take or pay provisions are very common in long-term supply contracts. Sellers often have high fixed costs and even variable costs that must be locked in for long periods of time, such as multiple year charter parties. Technical, efficiency, and yield considerations may dictate that production continue at predictable levels for extended periods of time.

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It is odd for a competition regulator to step into the contractual relationship on the basis of an unusual statutory scheme (note that determining the existence of "superior bargaining position" is more difficult than establishing the existence of market dominance, a more common measure) in an arrangement where the power dynamics are difficult to evaluate. In many LNG contracts, both buyer and seller are substantial parties, and while a national oil company may have a "superior" position in relation to its own reserves, and a utility may similarly have substantial buying power in its home market, both parties are at some level competing against dozens of buyers and sellers in a worldwide market.

There has been a good bit of speculation as to both market reaction and future JFTC action. Many sellers hope or believe that JFTC will apply the principles prospectively. Shinji Kakiuchi, Director of JFTC's Trade Practice Research Office, said that JFTC would consider on a "case-by-case" basis whether to take punitive action.

Two months on, the market has had an opportunity to ponder the implications. First, sellers take solace, and buyers no doubt feel a bit of disappointment, that this announcement was not binding but was only intended as a suggestion.

METI, the Japanese Ministry of Economy, Trade and Industry, which may have played a role in initiating and supplying material for the Report, wants to "show its attitude" to LNG suppliers: "We will strongly support this policy as being in Japan's national interest."

Through their reading of the likely approach to be taken by JFTC and other Japanese government actors, at least some LNG buyers believe that, at minimum, FOB contracts will be "destination free". Whether prospectively or retrospectively remains an open question. LNG suppliers, of course, have reacted with dismay, to say the least, believing that it is unfair for JFTC to question contracts entered into at arm's length between sophisticated parties by effectively prescribing that what they see as an unfair "destination free" provision. Notwithstanding the risks the sellers have taken in incurring enormous capital costs, in their view, buyers would reap any windfall profits.

Market chatter suggests that the major players are pleased with this development. Medium and small sized players, however, worry that requiring flexibility on resale this clause will alter the balance in their negotiations with suppliers, who will demand higher prices or margins in the spreads to factor in the possibility that their customers will reap the benefit of any resale.

Concern remains about whether and how JFTC will take action. Perhaps JFTC was simply trying to send a message and hopes that, given the possible use of its enforcement powers, counterparts of Japanese LNG buyers will "voluntarily" modify existing contracts and accept Antimonopoly Act-compliant terms in the future. In the meanwhile, a fuel mix mismatch will likely persist among Japanese power generators and industrial users.

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Annex

JFTC's Key Findings

Fixed-Term FOB Contracts

"The restrictions on diversion as well as providing destination clauses are highly likely to be in violation of the Antimonopoly Act (Unfair Trade Practices: Trading on Restrictive Terms), because its necessity and reasonableness under an FOB contract is less likely to exist than that under a DES contract."

Fixed-Term DES Contracts

". . . providing destination clauses in a fixed-term DES contract in order to define a delivery point is not in itself problematic under the Antimonopoly Act."

". . . under a fixed-term DES contract, the provision to require "seller's consent" to diversion or the provision of the requirements of fairly necessity [sic] and reasonableness to diversion are not in itself problematic under the Antimonopoly Act."

"However, in the operation of such requirements, even if a buyer's request meets any requirements of necessity and reasonableness from a seller, when the seller refuses its consent to diversion, such refusals are likely to be in violation of the Antimonopoly Act (Unfair Trade Practices: Trading on Restrictive Terms)."

"When a seller, on an operational or contractual basis, requests competition restraining requirements for diversion, such requirements are highly likely to be in violation of the Antimonopoly Act (Unfair Trade Practices: Trading on Restrictive Terms)."

Profit Share Clauses Under FOB Terms

". . . under a fixed-term FOB contract, in general, as providing profit share clauses is not considered as reasonable, providing profit share clauses is highly likely to be in violation of the Antimonopoly Act (Unfair Trade Practices: Trading on Restrictive Terms)."

Necessity and Reasonableness of Profit-Sharing Clauses Under DES Terms

". . . it cannot be said that it is unreasonable for a seller to require from a buyer compensation in exchange for giving consent on a diversion of contract requirements (destination) according to a request from the buyer and for an agreement to allow them to resale under a DES contract. Providing profit share clauses is not in itself problematic under the Antimonopoly Act."

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“However, when such clauses contribute to unreasonable profit sharing with a seller, (i) by setting a high percentage of the resale profit without properly considering seller’s actual contribution to resale or by using a gross profit as a resale profit ((A) below), or (ii) when such clauses have some effects to prevent a buyer from reselling due to a seller’s request for the disclosure of the profit or cost structure ((B) below), these are likely to be in violation of the Antimonopoly Act (Unfair Trade Practices: Trading on Restrictive Terms).”

Disclosure of information regarding resale

“. . . when clauses requiring disclosure of information regarding resale have the effect of “prevent[ing] a buyer from reselling due to a seller’s request for the disclosure of the profit or cost structure, such a request is likely to be in violation of the Antimonopoly Act. (Unfair Trade Practices: Trading on Restrictive Terms).

“Therefore, it is desirable that, at least, a seller should not require a breakdown of resale costs in detail and its evidence, and sharing information should be minimized.”

Take or Pay

“. . . 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 (Unfair Trade Practices: Abuse of Superior Bargaining Position)”

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