



[www.ogel.org](http://www.ogel.org)

ISSN : 1875-418X  
Issue : Vol. 18 - issue 3  
Published : May 2020

This paper is part of the OGEL Special Issue on "*Changing LNG Markets and Contracts*" edited by:



**Agnieszka Ason**  
[View profile](#)

#### Terms & Conditions

Registered OGEL users are authorised to download and print one copy of the articles in the OGEL Website for personal, non-commercial use provided all printouts clearly include the name of the author and of OGEL. The work so downloaded must not be modified. **Copies downloaded must not be further circulated.** Each individual wishing to download a copy must first register with the website.

All other use including copying, distribution, retransmission or modification of the information or materials contained herein without the express written consent of OGEL is strictly prohibited. Should the user contravene these conditions OGEL reserve the right to send a bill for the unauthorised use to the person or persons engaging in such unauthorised use. The bill will charge to the unauthorised user a sum which takes into account the copyright fee and administrative costs of identifying and pursuing the unauthorised user.

For more information about the Terms & Conditions visit [www.ogel.org](http://www.ogel.org)

© Copyright OGEL 2020  
OGEL Cover v5.0

# Oil, Gas & Energy Law Intelligence

## Destination Flexibility in LNG Sales Contracts by J.E.B. Atkin

### About OGEL

**OGEL** (Oil, Gas & Energy Law Intelligence): Focusing on recent developments in the area of oil-gas-energy law, regulation, treaties, judicial and arbitral cases, voluntary guidelines, tax and contracting, including the oil-gas-energy geopolitics.

For full Terms & Conditions and subscription rates, please visit our website at [www.ogel.org](http://www.ogel.org).

### Open to all to read and to contribute

OGEL has become the hub of a global professional and academic network. Therefore we invite all those with an interest in oil-gas-energy law and regulation to contribute. We are looking mainly for short comments on recent developments of broad interest. We would like where possible for such comments to be backed-up by provision of in-depth notes and articles (which we will be published in our 'knowledge bank') and primary legal and regulatory materials.

Please contact us at [info@ogel.org](mailto:info@ogel.org) if you would like to participate in this global network: we are ready to publish relevant and quality contributions with name, photo, and brief biographical description - but we will also accept anonymous ones where there is a good reason. We do not expect contributors to produce long academic articles (though we publish a select number of academic studies either as an advance version or an OGEL-focused republication), but rather concise comments from the author's professional 'workshop'.

OGEL is linked to **OGELFORUM**, a place for discussion, sharing of insights and intelligence, of relevant issues related in a significant way to oil, gas and energy issues: Policy, legislation, contracting, security strategy, climate change related to energy.

# Destination Flexibility in LNG Sales Contracts

James Atkin\*

## Introduction

In commodity sales, fungible goods are traded by multiple sellers, buyers and traders, on a global basis, utilising established standard trading terms with transparent price indices. Coal, oil, iron ore, grain, sugar, the list goes on. In such trades, destination flexibility is generally assumed. However, while LNG is a commodity, generally fungible in nature, it fundamentally differs from other commodities.

LNG by its nature is a relatively expensive commodity, requiring significant investment in all parts of the LNG chain; liquefaction, transportation, and regasification. Until recently, due to the costs involved, only a few players participated in the production, sale, purchase and trading of LNG. On the sell-side, IOCs and NOCs dominated. On the buy-side, European, American and North-East Asian utility companies created the demand. In turn, utility companies in certain jurisdictions had monopolistic control over their domestic / regional energy markets, allowing for a high-level of energy consumption certainty. Consequently, such LNG buyers were willing to procure LNG on a long-term basis, which provided the financial security required for the significant investments associated with the development of liquefaction facilities. Such a market structure created the environment for “*A to B linear contracts*”, with LNG tankers operating as “*floating pipelines*”. In such a context, not providing for destination flexibility in LNG sales contracts is perhaps understandable.

Fast-forward to today. In Europe, the European Union (**EU**) has broken-down the monopolistic practices of energy companies in European member states, to create a single energy market, which has transformed the Atlantic Basin. In America, the shale gas revolution has opened the LNG market to new LNG producers, including in the first wave of U.S. LNG, certain utility companies with limited historic exposure to the LNG industry. Such players have generally adopted a “tolling model” philosophy, avoiding commodity price risk, and generating profits from rates of return on infrastructure investment. Under the tolling model, subject to trade compliance requirements, end-destination of LNG produced (or even, to an extent, whether LNG is produced), are secondary considerations.

Innovative developments have also contributed to the changing LNG landscape. Floating regasification facilities offer a relatively low-cost option for nations to enter into the LNG market, creating significant new LNG demand, at a time of heightened focus on global carbon commitments. In turn, renewable energy’s share of the energy mix in all nations continues to grow. However, renewable energy is, by its nature, uncertain and variable, which presents serious demand uncertainties for regional and national utility companies. In Japan, utility companies have also faced the unprecedented challenges of a nuclear shut-down following the Fukushima tragedy, and liberalisation of the gas and power markets.

The speed with which the LNG market has evolved is remarkable. It is perhaps unsurprising that LNG sales contracts executed in the late 1990’s did not anticipate such changes. However, as the LNG market continues to evolve, destination flexibility is now a key issue. In this article we will examine how the key gas consuming markets of Europe and Japan have

---

\* James Atkin, Partner, Orrick, Herrington & Sutcliffe (UK) LLP, [jatkin@orrick.com](mailto:jatkin@orrick.com)

sought to promote destination flexibility in LNG sales, and whether such efforts are likely to achieve a global, flexible and transparent LNG market.

## **European Union/ Atlantic Basin**

### *(1) Philosophical Mission*

The EU is an economic and political union, currently comprised of twenty-seven European member states. At the core of its mission is the establishment of a single (or ‘internal’) market, to support the free movement of goods, capital, services, and people within the EU. In line with this objective, the EU’s target is to liberalise the European energy market and secure a liquid gas market for all member states. Natural gas plays a fundamental role in Europe’s energy mix, meeting a quarter of the EU’s energy needs; LNG enables the EU to promote diversification of sources of supply and ensure enhanced levels of energy security. In January 2020, there were twenty-four large-scale LNG import terminals in the EU, and various small-scale LNG facilities. In recent years, Spain has been the largest importer, receiving a quarter of the EU’s total LNG imports, followed closely by France, and then Italy and the UK.

The legislation which under-pins the creation of a single European gas market is the Treaty on the Functioning of the European Union (*TFEU*), which establishes two fundamental competition rules. Firstly, Article 101 TFEU prohibits anti-competitive agreements, that is, agreements or concerted practices which have as their object or effect the prevention, restriction or distortion of competition in the EU, and which may affect trade between member states. Secondly, Article 102 TFEU prohibits abusive conduct by companies that have a dominant market position, in so far as it may affect trade between member states. Each article can be enforced by the European Commission directly or by the competition authorities of a member state. However, it is important to note that Articles 101 and 102 TFEU only apply to matters which affect trade within the European Economic Area (*EEA*); Articles 101 and 102 TFEU do not have extraterritorial effect. Fines may be imposed for anti-competitive practices, to reprimand the breaching entity and to deter others. The scale of any fine imposed will depend on the length and severity of the relevant infringement but is capped at 10% of the violating company’s global annual turnover.

Over the past twenty years the European Commission has conducted numerous investigations into potentially anti-competitive practices by non-member state suppliers of gas and LNG to the EEA. Each such investigation, which is considered in detail below, was settled by the European Commission with the relevant gas or LNG supplier. As a result, the position adopted by the European Commission in each settlement has not been confirmed by the European Court of Justice. However, such investigations, together with the published settlements, provide important guidance on how the European Commission typically views certain types of provisions and practices in contracts for the supply of gas and LNG to EU member states.

### *(A) Destination Restrictions and Use Restrictions*

Historically, certain LNG sale contracts included provisions which restricted an LNG buyer’s right to use LNG (“*use restrictions*”) and/or the territory into which LNG, or regasified LNG, could be delivered (“*destination restrictions*”). The purpose of such use and destination restrictions were generally to mitigate the risk of an LNG seller having to compete with its

own LNG buyers for new market and customer opportunities. While such restrictions may have been acceptable to LNG buyers in an era of national monopolistic European energy providers, such restrictions were incompatible with the European Commission's vision of a single European gas market. As a result, the European Commission argued such restrictions were a serious breach of EU competition law, preventing cross-border trade within the EEA. The development of the European Commission's analysis of such restrictions can be tracked through the following investigations:

(i) **Nigeria LNG Ltd. (NLNG)** - the European Commission conducted an investigation of the LNG sales practices of NLNG, and on 12 December 2002 announced that it had reached a settlement with NLNG, under which NLNG: (a) agreed to delete a provision from an LNG sales contract which prevented one of its European customers from re-selling gas outside of its national borders; and (b) undertook not to introduce similar destination or use restrictions in future LNG sale contracts, including "*indirect*" destination restrictions, in the form of "*profit-splitting mechanisms*" (**PSMs**), that is, provisions which require the sharing of profit made when LNG, or regasified LNG, is resold by the LNG buyer to a third party. It is interesting to note that the Press release issued by the European Commission recording the NLNG settlement unequivocally states "*Both the so-called territorial sales restrictions and profit splitting mechanism violate European Union competition rules*".<sup>1</sup> This view was confirmed in an article published by the Directorate-General Competition in Spring 2004, which notes that PSMs "*have a similar object and/or effect as territorial sales restrictions and are equally void in accordance with [Article 101(2) TFEU]*".<sup>2</sup>

(ii) **Gazprom/ ENI** - the Gazprom-ENI investigation is interesting, as it involved restrictions imposed by both Gazprom and ENI in their gas supply arrangements. Like the NLNG investigation, the European Commission allowed the companies to resolve the issues identified by the European Commission commercially, rather than through the initiation of formal procedures, recognizing the challenges for market participants associated with the transition from a monopolised, to a liberalised, European energy market. As with the NLNG settlement, it was announced in October 2003 that Gazprom had agreed to delete all territorial sales restrictions imposed on ENI, and the parties agreed not to include similar provisions in future gas supply agreements. In addition, ENI agreed to: (a) delete a consent clause, requiring Gazprom to obtain ENI's consent to sell gas to other customers in Italy; (b) offer significant gas volumes to customers outside Italy for a period of five years; (c) increase capacity in the ENI controlled Trans-Austria Gasleitung (**TAG**) pipeline; and (d) promote an improved third-party access regime for the TAG pipeline.<sup>3</sup> This settlement reflects the dual importance of destination flexibility, and non-discriminatory access to infrastructure to ensure the free flow of gas.

(iii) **Sonatrach** - in 2007 the Sonatrach investigation ended with a "common understanding" between the European Commission and the Algerian Government, pursuant to which the Algerian Government agreed to cause Sonatrach to delete territorial restrictions from all existing LNG sales contracts for supply to the EU, and not to include such provisions in

---

<sup>1</sup> European Commission, 'Commission settles investigation into territorial sales restrictions with Nigerian gas company NLNG', 12 December 2002, [https://ec.europa.eu/commission/presscorner/detail/en/IP\\_02\\_1869](https://ec.europa.eu/commission/presscorner/detail/en/IP_02_1869)

<sup>2</sup> European Commission, Competition policy newsletter 2004 -1, 'The territorial restrictions case in the gas sector: a state of play' by Harold Nyssens, Concetta Cultrera and Dominik Schnichels, Directorate-General Competition, unit E-3, [https://ec.europa.eu/competition/publications/cpn/2004\\_1\\_48.pdf](https://ec.europa.eu/competition/publications/cpn/2004_1_48.pdf)

<sup>3</sup> European Commission, 'Commission Reaches Breakthrough with Gazprom and ENI on Territorial Restriction Clauses', 6 October 2003, [http://europa.eu/rapid/press-release\\_IP-03-1345\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-03-1345_en.htm?locale=en)

future LNG sales contracts.<sup>4</sup> However, as may be implied from the duration of the Sonatrach investigation, negotiations were not entirely straight-forward for the European Commission, as Sonatrach sought to replace territorial restriction clauses with PSMs.

Through its negotiations with the Algerian Government, the European Commission developed a more nuanced approach to PSMs, as compared to the settlement achieved with NLNG. While territorial restrictions were confirmed as “*hardcore restrictions of competition*”, a PSM was considered to have the potential to be anti-competitive, if the PSM removed or reduced the LNG buyer’s incentive to divert LNG. The European Commission identified the point of transfer of title and risk as the key factor in determining the legitimacy of inclusion of a PSM in an LNG sale contract, that is, once an LNG buyer takes title and risk to the LNG, the LNG buyer should be free to divert the LNG to any destination of the LNG buyer’s election. As a result, inclusion of a PSM in an FOB LNG sale contract is likely to be viewed by the European Commission as a restriction of competition contrary to Article 101 TFEU. In contrast, if a PSM was included in a DES LNG sales contract, as delivery takes place at the discharge port, the LNG cargo remains the property of LNG seller and diversion of the LNG cargo requires the agreement of LNG seller, and so depending on how the PSM is structured, the PSM should not amount to a resale restriction contrary to Article 101 TFEU.

As a result, the Sonatrach case marks an important stage in the evolution of the European Commission’s analysis of destination restrictions in LNG sales contracts. It is worth noting that in the EU’s Press release of the “common understanding”, it states “*Sonatrach is aiming to transform the remaining FOB and CIF existing LNG contracts to sales under DES terms*”. More on that to follow below.

(iv) ***Other Investigations*** - the European Commission has continued to conduct investigations into the trading practices of significant LNG and gas suppliers to the EU, reaching a wide-ranging settlement with Gazprom in 2018, which was primarily focused on Gazprom’s gas sales arrangements to Central and Eastern European countries. Under the settlement Gazprom agreed: (a) to remove all contractual barriers to the free flow of gas, including export restrictions and provisions requiring gas to be used in a specific country; (b) to facilitate gas flows to and from isolated markets in Central and Eastern Europe, particularly Bulgaria and the Baltic states, including through the provision of swap arrangements; (c) to implement a mechanism to ensure competitive gas prices benchmarked to Continental Western European gas market prices; and (d) not to otherwise leverage its dominant market position.<sup>5</sup> Separately, the European Commission is currently investigating the trading practices of Qatar Petroleum, which are alleged to include provisions which prevent the diversion of LNG cargoes to alternative destinations, restrict countries into which LNG can be diverted, and restrict the quantities of LNG which may be diverted.<sup>6</sup> At the time of publication of this article, the investigation remains ongoing.

### *(B) European Commission Approach to Profit-Splitting Mechanisms*

---

<sup>4</sup> European Commission, ‘Commission and Algeria reach agreement on territorial restrictions and alternative clauses in gas supply contracts,’ 11 July 2007, [https://ec.europa.eu/commission/presscorner/detail/en/IP\\_07\\_1074](https://ec.europa.eu/commission/presscorner/detail/en/IP_07_1074)

<sup>5</sup> European Commission, ‘Antitrust: Commission Imposes Binding Obligations on Gazprom to Enable Free Flow of Gas at Competitive Prices in Central and Eastern European Gas Markets’, 24 May 2018, [http://europa.eu/rapid/press-release\\_IP-18-3921\\_en.htm](http://europa.eu/rapid/press-release_IP-18-3921_en.htm)

<sup>6</sup> European Commission, ‘Antitrust: Commission opens Investigation into Restrictions to the Free Flow of Gas Sold by Qatar Petroleum in Europe’, 21 June 2018, [http://europa.eu/rapid/press-release\\_IP-18-4239\\_en.htm](http://europa.eu/rapid/press-release_IP-18-4239_en.htm)

As you will note from the case summaries above, the European Commission's approach to PSMs has evolved, from an initial view that all such mechanisms likely infringe EU competition law, as set-out in the NLNG settlement, to a more nuanced approach as reflected in the Sonatrach case. Therefore, the key take-aways from the European Commission's analysis are as follows:

(i) ***Transfer of Title and Risk*** - inclusion of a PSM in an FOB sale contract is likely to be considered a violation of EU competition law, as it restricts the LNG buyer's freedom to deal with the LNG, after it has been delivered. In contrast, a PSM in a DES LNG sale contract should generally be acceptable (subject to the considerations in the following paragraphs), as any change in delivery point requires the agreement of the parties, and such agreement may be conditioned on a change in price. If a provision in a DES LNG sale contract restricts the LNG buyer's use of the regasified LNG, then such a provision is highly likely to constitute a serious violation of EU competition law. The key issue, therefore, is that the PSM must apply before the gas is delivered.

(ii) ***"Raw" v. "Net" PSMs*** - if a PSM is included in a DES LNG sale contract, it is important to ensure the PSM is not structured in a way which could reduce the profit margin attributable to the LNG buyer, in a way which could be interpreted as having as its purpose the restriction of the LNG buyer's incentive to request the diversion of an LNG cargo. In this respect, the Directorate-General for Competition considered in the article *"Profit splitting mechanisms in a liberalised gas market: the devil lies in the detail"*<sup>7</sup> the following two forms of PSM to illustrate the concern:

(1) 'Raw PSMs', that is, a 50/50 split between LNG seller and LNG buyer of the gross price difference realised between the "upstream price", essentially the FOB price, and the on-sale price agreed at the alternative destination, with LNG buyer responsible for all costs incurred in the LNG sale; and

(2) 'Net PSMs', that is, a 50/50 split between LNG seller and LNG buyer, which is applied to profits realised from the diversion to the alternative destination, after profit which would have been realised from the delivery of the LNG to the original destination are retained by LNG buyer, with LNG buyer responsible for all costs incurred in the LNG sale.

If costs are assumed to be the same in both the originally scheduled destination and the alternative destination, a 'Raw PSM' can have the effect of reducing the profit margin to be enjoyed by LNG buyer in the alternative destination, as compared to the profit margin which could have been realised by LNG buyer in the originally scheduled destination. As a result, a 'Raw PSM' is likely to be considered to have as its purpose the restriction of LNG buyer's incentive to request the diversion of an LNG cargo. In contrast, 'Net PSMs' allow the splitting of the actual incremental profit achieved at the alternative destination, which should result in a higher profit margin being realised by LNG buyer. Consequently, 'Net PSMs' in DES LNG sales contracts are unlikely to be viewed as restricting competition, as LNG buyer will be entitled to receive higher profits from selling the LNG in the alternative jurisdiction.

---

<sup>7</sup> European Commission, Competition policy newsletter 2005 -1, 'Profit splitting mechanisms in a liberalised gas market: the devil lies in the detail' by Harold Nyssens and Iain Osborne, Directorate-General Competition, unit B-1, [https://ec.europa.eu/competition/publications/cpn/2005\\_1\\_25.pdf](https://ec.europa.eu/competition/publications/cpn/2005_1_25.pdf)

(iii) **Confidentiality** - a key consideration for any PSM is the anti-trust risk associated with sharing information between actual or potential competitors, whether to secure agreement for the proposed diversion, or to ensure the agreed allocation of profits realised from the diversion. Risk associated with confirmation of the allocation of profits can be relatively easily achieved through an independent third-party black-box audit mechanic. However, ensuring compliance with anti-trust laws when sharing information to agree a proposed diversion is more complex, and information to be shared between the parties must necessarily be limited. Therefore, the parties should consider adopting mechanics which mitigate downside price risk, if a diversion is agreed at the request of the other party.

(iv) **Clarity of Terms** - the PSM must be drafted clearly to ensure LNG buyer can determine in advance the profit which will likely be achieved from a proposed diversion. If the PSM is vaguely drafted and requires negotiation between LNG seller and LNG buyer for a diversion to be agreed, the PSM may be viewed as imposing a restriction on LNG buyer's incentive to request a diversion, or otherwise having the same object as a destination clause, which in turn could constitute a violation of EU competition laws.

(v) **Scope of EU Competition Law** - EU competition law is not generally applied on an extraterritorial basis, unless the conduct in question affects trade between EU member states. As a result, the European Commission is unlikely to investigate PSMs which apply to transactions between member states and third countries unless they have appreciable restrictive effects on competition within the EU/ EEA.

In summary, the European Commission has provided helpful guidance on the drafting of PSMs. Inclusion of a PSM in an FOB LNG sale contract, which applies to the diversion of an LNG cargo between member states is likely to be viewed as a violation of EU competition law. In contrast, a PSM in a DES LNG sale contract should be acceptable, but care needs to be taken in the structuring and drafting of the PSM, including in relation to the sharing of commercially sensitive information.

However, as noted above, the European Commission's policy in this area has not been challenged in the European Courts. Market players generally seem to have adjusted their trading practices to comply with the announcements made by the European Commission through the settlements and Press releases discussed above. We need to query, however, whether the distinction made between FOB and DES sales by the European Commission is justifiable from an economic and market effect perspective. Whether LNG seller, or LNG buyer, is responsible for procuring an LNG vessel, is a matter of commercial negotiation, and experienced LNG players can take delivery on both an FOB and a DES basis. Noting Sonatrach's statement that future LNG sales to the EU would only be conducted on a DES basis, it is debatable whether the transfer of title and risk in LNG should be the key issue for this analysis, but rather the structure of the PSM (whether Net, Raw, or otherwise) should be the key determinant.

## *(2) Third Party Access Regime*

An essential complement to contractual destination flexibility, is the ability of an LNG buyer to deliver LNG to alternative destinations, whether to incumbent capacity-holders in the relevant jurisdiction, or preferably, the right to contract for regasification capacity in third-party owned facilities. In this respect, in support of the EU's mission to establish a unified

internal gas market, the EU unveiled the “*Third Energy Package*”<sup>8</sup> in 2009, to introduce regulated third party access (*TPA*) to the EU, requiring owners of gas transmission and distribution facilities, including LNG regasification terminals, to make capacity available on an objective and non-discriminatory basis to all eligible third parties. While the Third Energy Package has provided the legislative framework for gas market reforms, national regulators of member states are tasked with implementing the TPA regime and must ensure regulated tariffs are applied to ensure there is no abuse of market dominance.

Importantly, the legislative framework allows for an exemption to the TPA regime for “*new gas infrastructure*”, that is, infrastructure which was not completed by 4 August 2003, including regasification facilities, for a defined period. To benefit from the TPA exemption, infrastructure owners need to satisfy certain criteria - for example, the new infrastructure must improve security of supply and boost competition in the relevant gas market, and the infrastructure owner must demonstrate that the investment is unlikely to be made if the exemption is not granted. If the relevant national regulator is satisfied that the exemption criteria have been met for a proposed regasification terminal, the terms of the exemption may impose a requirement on the terminal owner/ operator to adopt a “use-it-or-lose-it” mechanic, to oblige any capacity-holder to offer any unutilised regasification capacity to the market. Such anti-hoarding arrangements seek to ensure that any spare capacity is made available and utilised effectively, reflecting the EU’s wider policy objective of encouraging competition by allowing more LNG market players to have access to the regasification terminal’s available capacity.

## **Japan**

Over the last seven years, various aspects of the LNG industry which have concerned the Japanese regulatory authorities have been central themes of the METI sponsored LNG Producer-Consumer Conferences in Japan. In the early years, the focus was on LNG pricing, with the aim to move away from JCC oil-linked prices. Later, the emphasis was on flexibility in the LNG market, and cooperation among producing and consuming nations to develop the LNG market. Such issues are of fundamental importance to the Japanese economy, as Japan imports roughly 94% of its primary energy supply and has no international gas supply pipelines. Japan’s reliance on hydrocarbons was further increased following the nuclear shutdowns in response to the Fukushima disaster.

The LNG pricing issue reflected the lack of a regional gas hub, with no single jurisdiction/ region in Asia having the gas-on-gas competition required to support a hub like Henry Hub in the U.S., NBP in the U.K., or TTF in Continental Europe. Such pricing concerns were largely addressed by the first wave of U.S. liquefaction projects, which generally priced LNG sales by reference to U.S. gas hub prices. However, increasing flexibility in the Asian/ Japanese LNG market is more challenging given the historical context.

Japan is currently the leading LNG importer in the world and Japanese utility companies have underpinned the development of the LNG market, through long-term take-or-pay contracts. As noted above, such LNG was often sold under so-called “*A to B linear contracts*”, with limited, to no scope, for LNG buyer to change the end-destination of an LNG cargo. Such “*destination restrictions*” may generally have been acceptable to Japanese utility companies

---

<sup>8</sup> The “Third Energy Package” is comprised of two directives (including one concerning common rules for the internal market in gas (2009/73/EC)) and three regulations (including one concerning conditions for access to the natural gas transmission networks ((EC) No 715/2009)).



given the certainty of demand in their regional markets. However, in the last few years, the Japanese utility companies have faced multiple challenges, including the forced shutdown of nuclear facilities with uncertain restart schedules, the growth of renewable power, and the liberalization of the electricity and gas markets. As a result, Japanese utility companies are experiencing unprecedented uncertainty of LNG demand, which has focussed attention on “destination restrictions” in LNG sales contracts. To help to address the issue, the Cabinet of the Japanese Government decided to promote the abolition of destination restrictions in LNG sales contracts, and from July 2016 to May 2017, the Japan Free Trade Commission (**JFTC**) conducted a survey into the Japanese LNG market, to determine the extent and effect of destination restrictions in LNG sales contracts.

The results of the JFTC investigation were published in a report<sup>9</sup>, released in June 2017, in which it was noted that for long-term contracts for LNG supply to Japan which include diversion clauses: (a) for FOB sales, 51% required LNG seller consent to diversions inside Japan, and 90.9% required LNG seller consent for diversions outside Japan; and (b) for DES sales, 96.1% required LNG seller consent to diversions inside Japan, and 100% required LNG seller consent for diversions outside Japan. The JFTC then analysed in detail whether such destination restrictions (and any associated PSMs) may violate the Japanese Antimonopoly Act, and reached the following conclusions:

*(A) Structure of the LNG market*

The JFTC view the global LNG market as falling into two broad categories:

(i) the *Asian market*, characterized by fixed-term LNG sales contracts, under which LNG sellers predominantly located in the Middle East, Southeast Asia and Australia supply end-users in Asia, including Japan; and

(ii) the *World market*, that is, the global spot market.

The JFTC are concerned with the effect destination restrictions in “*Asian market*” LNG sales contracts have on competition in both the “*Asian market*” and the “*World market*”. Importantly, the JFTC focus on the cumulative “*foreclosure effect*” of destination restrictions, that is, although a destination restriction clause in one LNG sales contract may not have a market-influencing effect, if multiple LNG sellers impose destination restriction clauses in multiple LNG sales contracts, the cumulative effect is more likely to have a “*foreclosure effect*” in the Asian market and World market.

*(B) Destination Restrictions*

(i) FOB sales

The JFTC’s basic premise is that destination restrictions in FOB LNG sales contracts are unnecessary, as LNG buyer is responsible for transportation of the LNG, and risk in the LNG passes to LNG buyer at the loading port. However, interestingly, the JFTC acknowledge that when parties negotiate an LNG sales contract, the anticipated end-destination is an important factor when agreeing the LNG price, due to the different price levels in North America, Europe and Asia, which reflect the various costs and risks associated with such destinations.

---

<sup>9</sup> The Japan Fair Trade Commission, 'Survey on LNG Trades', June 2017, [https://www.jftc.go.jp/en/pressreleases/yearly-2017/June/170628\\_files/170628-2.pdf](https://www.jftc.go.jp/en/pressreleases/yearly-2017/June/170628_files/170628-2.pdf)

As a result, it seems the JFTC may allow existing FOB LNG sales contracts which include destination restrictions to continue, recognising the commercial terms agreed by the parties of a destination restriction with a related LNG price. However, if such FOB LNG sales contracts are renewed, and for new FOB LNG sales contracts, it is clear, the JFTC will view destination provisions in FOB LNG sales contracts as “*likely*” to be in violation of the Antimonopoly Act, and restrictions on diversions will be “*highly likely*” to be in violation of the Antimonopoly Act.

(ii) DES sales

The JFTC’s basic premise is that destination restrictions in DES LNG sales contracts are necessary, as LNG seller is responsible for transportation of the LNG, and risk in the LNG only passes to LNG buyer upon delivery at the discharge port. However, if restrictions are imposed on diversions requested by LNG buyer, for the purposes of the Antimonopoly Act, it will be necessary to assess whether such restrictions are “*necessary and reasonable*”. In this respect, the JFTC provides the following helpful guidance:

(a) Requirement for “*fairly, necessity and reasonableness*” - the JFTC have expressed concern that if a DES LNG sales contract includes a diversion provision which only states the requirement for LNG seller’s prior consent, without detailing the circumstances in which such consent will be granted, anti-trust concerns will arise if LNG seller then fails to provide consent to a diversion, if LNG buyer’s request meets the “*requirements of fairly, necessity and reasonableness*”. In this respect, such requirements are reasonably standard in the LNG industry, that is:

- (A) ship-shore compatibility and safety of the alternative receiving terminal;
- (B) LNG buyer bears the additional costs associated with the diversion; and
- (C) the diversion will not adversely affect LNG seller’s annual delivery program.

However, certain scenarios considered in the JFTC report, in which LNG buyer may make a “*reasonable*” proposal to LNG seller, do not conform to LNG market norms. For example, it is proposed that if a diversion may interfere with LNG seller’s shipping schedule, LNG buyer could procure an alternative LNG tanker to deliver the cargo. In such circumstances, LNG seller’s refusal of the proposed diversion would not be reasonable. Yet, such a proposition is a potentially significant risk for LNG seller, effectively adjusting the commercial terms of the LNG sale from a DES to an FOB delivery, causing LNG seller’s own LNG ship to lie idle, and requiring compatibility checks and scheduling adjustments to accommodate LNG buyer’s LNG tanker. If such requests were to be made by multiple LNG buyers to an LNG seller, or on multiple occasions by the same LNG buyer it could cause significant disruption to the smooth operation of a liquefaction facility.

In any event, the JFTC helpfully conclude that if a DES LNG sales contract has a diversion provision which requires LNG seller’s consent, or which sets-out the requirements of “*fairly, necessity and reasonableness*”, such a provision should not violate the Antimonopoly Act. However, if in practice, an LNG buyer’s request satisfies the tests of “*fairly, necessity and reasonableness*”, and LNG seller rejects such request, such refusal is likely to violate the Antimonopoly Act.

(b) Competition restraining conditions - the JFTC also provides certain examples of provisions which if included in diversion clauses in DES LNG sales contracts would impose competition restraining conditions, and would be highly likely to violate the Antimonopoly Act, including if diversions are:

- (A) only permitted due to LNG buyer's operational reasons;
- (B) not permitted for commercial reasons;
- (C) not permitted for resale to LNG seller's other customers; or
- (D) diversions must be performed by LNG seller to the relevant third party.

In summary, including destination restrictions and/ or diversion provisions in future FOB LNG sales contracts, will likely be viewed by the JFTC as violating the Antimonopoly Act. In turn, while destination provisions in DES LNG sales contracts may be reasonable, including competition restraining conditions in a diversion provision will be treated as a prima facie violation of the Antimonopoly Act. If a diversion clause requires LNG seller's consent, and LNG buyer's request satisfies the "*fairly, necessity and reasonableness*" criteria, if LNG seller subsequently rejects the diversion request, such a refusal is highly likely to constitute a violation of the Antimonopoly Act.

### *(C) Profit Splitting Mechanics*

The JFTC raised a number of concerns with the adoption of PSMs in diversion provisions, including: (1) the method of calculation, that is, similar to EU concerns, whether "profit" is defined on a "gross profit" or a "net profit" basis, and in turn, the clarity of the calculation for determining such "profit"; (2) the percentage of profit to be shared by LNG buyer with LNG seller; and (3) the requirement for LNG buyer to disclose to LNG seller various information for the alternative sale, to verify the calculation of the profit to be shared. Due to such concerns, the JFTC's over-arching view is that PSMs cause foreclosure effects, which violate the Antimonopoly Act.

#### (i) FOB sales

As may be anticipated from the analysis of destination clauses above, the JFTC consider inclusion of a PSM in an FOB LNG sales contract to be highly likely to violate the Antimonopoly Act. The JFTC note any arguments suggesting a PSM may be required in an FOB LNG sales contract are unsustainable when new LNG sales contracts are concluded, or expired LNG sales contracts are revised. Therefore, it seems the JFTC may allow players in the LNG market to maintain existing terms for FOB LNG sales contracts (recognizing any diversion provision/ PSM will have formed an essential part of the negotiated terms of the LNG sales contract). However, the JFTC is clearly putting the LNG market on notice that inclusion of PSMs in future FOB LNG sales contracts may be subject to investigation.

#### (ii) DES sales

Like the European Commission, the JFTC draws a distinction between DES and FOB LNG sales contracts, by recognising that PSMs may be reasonable in the context of a DES LNG sales contract, as control of the LNG will not have passed to LNG buyer before the diversion is performed. In this context, a PSM may be viewed as providing compensation for LNG

seller's agreement to change the terms of sale. The JFTC suggest a PSM may be deemed to be unreasonable if: (1) the resale profit is calculated on a gross, rather than a net basis (deducting costs of both parties in performing the diversion from the profit calculation); (2) the PSM requires disclosure of price sensitive information to LNG seller; or (3) LNG seller is allocated a high percentage of the resale profit, without contributing to such resale.

While the first two grounds of concern outlined above are reflective of the European Commission's approach and may readily be addressed by clear drafting and an independent third-party "black-box" audit mechanic to calculate the profit resulting from a diversion, the requirement for LNG seller to justify the resale profit is more complex. Using the JFTC's own example, a higher percentage allocation of profit to LNG seller may be supported by LNG seller providing support to identify resale customers. However, we assume such support should be limited to circumstances in which LNG buyer experiences operational/ market difficulties, as otherwise there may potentially be a risk of LNG seller and LNG buyer jointly conducting LNG marketing activities, which raises other potential anti-trust concerns.

It has been suggested by certain legal commentators that to justify inclusion of a PSM in a DES LNG sales contract, LNG seller is required to demonstrate "unquantifiable risks" associated with the diversion of an LNG cargo. Such arguments rely on the JFTC's observation that PSMs "have some reasonableness because of providing the immediate and smooth solution as to difficulty in determining the sellers' non-quantifiable risk which a diversion requested by a buyer causes". However, the focus on "unquantifiable risks" seems flawed on a full reading of the JFTC Report, for the following reasons:

(a) firstly, the JFTC's basic premise is that including PSMs in DES LNG sales contracts "is not in itself problematic under the Antimonopoly Act". Concerns will arise if: (1) there is an unreasonable allocation of profit to LNG seller; or (2) the PSM prevents LNG buyer from requesting a diversion due to concerns over the need to disclose the profit or cost structure of the diversion sale. No reference is made to the need for the parties to find an "unquantifiable risk".

(b) secondly, it is unclear what would constitute an "unquantifiable risk". The JFTC Report provides no guidance on the issue. In the context of the diversion of an LNG cargo, an "unquantifiable risk" may be a market reputational risk or a political risk, such as delivery of an LNG cargo to a sanctioned country. However, if such a risk were truly "unquantifiable", LNG seller would presumably be unable to obtain internal corporate approval to take such a risk. As a result, LNG buyer's diversion request would have to be rejected by LNG seller. Such a result does not seem to be consistent with the JFTC's analysis of PSMs in DES LNG sales contracts.

As a result, when negotiating PSMs in DES LNG sales contracts, parties should give due consideration to ensuring: (I) the calculation of any profit share is clear and concise and determined on a "net" basis, taking into consideration the costs to be incurred by both LNG seller and LNG buyer; (II) an independent third party auditor should be appointed to conduct a "black box" audit of any profits achieved from a diversion; and (III) the profit share to be allocated to LNG seller should be reasonable in the context of the contribution made by LNG seller to the relevant diversion. What the JFTC will consider to be "reasonable" in this context is unclear and will likely vary on a case-by-case basis, reflective of the underlying contribution made by the relevant LNG seller.

## *(2) Third Party Access Regime*

To support the liberalisation of the Japanese gas market, amendments were made to the Gas Business Act in June 2015 to promote TPA at regasification terminals. This effort was subsequently endorsed by METI in its “*Strategy for LNG Market Development*”<sup>10</sup>, which confirmed that open access to gas and LNG infrastructure in Japan is fundamental to increasing flexibility and liquidity in the Japanese energy market. METI’s “*open access*” objective is, therefore, reflective of the EU’s gas market reforms. However, the liberalization of the Japanese gas market is an ongoing process and has not yet had the time to achieve the TPA regimes adopted across the EU. Also, the structure of the Japanese energy market, which until recently was divided into regions, each with a monopolistic gas utility company and a separate monopolistic electricity utility company, makes it difficult for international LNG players to secure enough LNG demand in the Japanese market to satisfy a full cargo lot of supply. As a result, owners/ operators of Japanese regasification terminals have understandably been reluctant to allow their facilities to be used as third-party storage facilities. There is a clear political drive to liberalise the energy market, and so the unbundling of assets and adoption of objective and non-discriminatory TPA rights will likely be realised in the near future.

## **Conclusion**

The LNG market is constantly evolving, and LNG will be an essential part of the energy transition, supporting the move to a net zero emissions world. By its nature, the LNG market will continue to grow and develop to ensure transparency and flexibility. Building on the foundations that have been established in Europe, the U.S. and Japan, the next vital step to ensure a truly flexible market, will be for other governments in the Pacific region to adopt open and transparent TPA regimes, for both regasification capacity and downstream gas transportation facilities. Singapore and Malaysia are leading the way. Japan, China, India and Thailand are all making strong progress. However, until full non-discriminatory and objective TPA is achieved, there will continue to be an impediment to global LNG destination flexibility.

---

<sup>10</sup> Ministry of Economy, Trade and Industry, Government of Japan, 'Strategy for LNG Market Development, Creating flexible LNG Market and Developing an LNG Trading Hub in Japan', 2 May 2016, [https://www.meti.go.jp/english/press/2016/pdf/0502\\_01b.pdf](https://www.meti.go.jp/english/press/2016/pdf/0502_01b.pdf)