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Ideas

Japanese Antitrust Scrutiny of LNG Supply Agreements

06 March 2017

Firm Thought Leadership

The Japanese competition enforcement agency, the Japan Fair Trade Commission ("JFTC"), has recently begun investigating whether destination clauses in long-term LNG supply contracts with Japanese buyers violate Japanese competition law. The JFTC's investigation, which may affect both DES and FOB contracts, could have significant consequences. The investigation may result in the forced renegotiation of LNG SPAs. It may also complicate the renewal of SPAs expiring in the near future and the negotiation of new SPAs. In addition, the JFTC investigation may trigger price review procedures or other dispute resolution mechanisms generally included in LNG SPAs. Finally, the Japanese Antimonopoly law provides the JFTC with powers to impose administrative sanctions on the parties to anti-competitive agreements.[2]

It cannot be excluded that other antitrust enforcement agencies in the Asian region will follow the Japanese precedent and subject LNG SPAs in their jurisdictions to antitrust scrutiny as well.

Destination clauses included in LNG supply contracts provide that shipments of LNG must be delivered to the designated destination point, prohibiting diversions and even reloading/redelivery to another receiving terminal. The vast majority of LNG sold into Japan is supplied under long-term take-or-pay contracts, with limited destination flexibility. In fact, it is believed that 80% to 90% of these contracts include destination restriction clauses, requiring the buyer to receive and regasify the cargo at the designated destination point.[3]

The JFTC investigation arises against the backdrop of the current over-supply of the Japanese LNG market; it is estimated that Japanese buyers will face a surplus of 12.2 billion cubic meters of LNG in 2017 and 8.6 billion cubic meters in 2019.[4] Eliminating destination restrictions would provide LNG buyers with more flexibility and opportunities to resell their LNG excess volumes, although regional arbitrage opportunities may be limited.[5]

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Asian prices have traditionally been linked to international crude oil prices. High oil prices between 2008 and 2014 impacted Asian LNG import prices, which climbed from an average of $10/MMBtu before the Fukushima disaster to approximately $18/MMBtu by mid-2012.[6] While prices remained relatively constant through 2014, the Japanese LNG import price began to drop in 2015, and ultimately fell 78%[7] to $6.381/MMBtu in October 2016.[8] Similarly, the average price of spot LNG for delivery in Japan decreased by 84% from $18.3/MMBtu in 2014 to $7.9/MMBtu in 2015.[9] The average price of spot LNG for delivery in Japan had further dropped to $6.1/MMBtu in October 2016.[10] International arbitrage opportunities, which were significant before 2015, have now diminished significantly.[11]

Many LNG contracts in Japan are JCC-based. JCC, which is an acronym for Japan Crude Cocktail or Japanese Customs-Cleared Crude Oil, is a published price index for the basket of crude oils imported into Japan. Japanese LNG buyers are increasingly trying to move away from using exclusively JCC-based pricing, with proposals for gas or LNG-specific price markers such as the Henry Hub index, the Platts JKM (Japan Korea Marker),[12] and combinations of JCC with JLC (Japan LNG Cocktail) or JKM.

The Japanese Ministry of Economy, Trade and Industry ("METI") supports the gradual replacement of JCC-based pricing and has suggested the establishment of Japan as an international LNG trading hub by the early 2020s.[13] In METI's view, this would involve minimizing the number of long-term LNG contracts and increasing the number of short-term and spot contracts, coupled with abolishing or relaxing destination clauses. The creation of a liquid Asia LNG trading market, however, remains a subject of debate because of both (i) the current lack of liberalization of the Japanese energy market and limited pipeline interconnection, and (ii) concerns regarding the liquidity of the market in light of the restricted number of buyers in Japan.[14]

LNG demand in Japan is decreasing

The sharp increase in Japanese LNG demand that resulted from the sudden loss of nuclear power generation capacity in the aftermath of the Fukushima disaster caused Japan to stand out as the world's largest LNG importer, accounting for 34% of the global LNG trade in 2015. Between 2011 and 2015 approximately 59 long-, medium- and short-term LNG contracts were concluded with Japanese buyers.[15]

However, any assumption that LNG demand in Japan would continue to grow appears to be wrong. In 2015, LNG imports into Japan decreased for the first time since 2009.[16] According to the International Group of Liquefied Natural Gas Importers ("GIIGNL"), LNG imports were 4.7% lower in 2015 than in 2014 and dropped a further 6.2% between 2015 and 2016.[17]

Several factors have been key in affecting Japan's LNG demand. First, METI's policy initiatives to end the existing regional monopolies in the power and city gas sectors exposed those sectors to more competition, opening them to new entrants and providing consumers a broader choice of suppliers.

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METI's policy target includes a 27% allocation for LNG in 2030.[20] As the METI policy target reflects, demand decrease for LNG is expected to result from the increased use of nuclear and renewables.

In sum, Japan's energy generation mix appears to be changing significantly, with overall LNG demand continuing to decrease. At the same time, Japanese LNG buyers, faced with over-supply and, in many cases, locked into take-or-pay contracts, are under significant pressure to reduce their LNG procurement costs. These factors, coupled with METI's policy initiatives, provide background for the JFTC's antitrust investigation into LNG destination clauses.

B. The origin of the JFTC's antitrust investigation

The JFTC antitrust investigation appears to be supported by METI and key Japanese LNG buyers. In May 2016, METI took the position that destination clauses in LNG contracts obstruct the evolution of a "flexible and liquid LNG market" in Japan.[21] In its view, the abolition or relaxation of destination clauses would trigger increased arbitrage selling, leading to lower prices. In the same vein, Japan's largest utilities (JERA, Tokyo Gas, Kansai Electric Power and Osaka Gas) support the removal of such clauses from their contracts in order to provide them with both greater flexibility regarding the use of purchased LNG volumes and a better response to fluctuations in LNG demand.[22] In particular, it has been reported that JERA seeks to move towards international market pricing, to diversify its portfolio away from long-term contracts, to refuse to enter into contracts with destination clauses and to renegotiate existing contracts to remove those clauses.

C. We have seen this before: The European Union's position on destination clauses

Inspiration for the JFTC investigation may have come from the European Union. The European Commission has interpreted EU competition law to prohibit destination clauses that interfere with intra-EU trade. Thus, destination clauses that prevent onward sales within the EU are considered to be unlawful restrictions of competition "by object" that are prohibited by Article 101 TFEU. This means that a finding of antitrust liability is independent of actual negative effects on competition in Europe, and minimizes the importance of conventional efficiency arguments that underlay the use of destination clauses in LNG supply contracts.

In the early 2000s, the European Commission investigated a number of European gas supply agreements involving Gazprom, Sonatrach and Nigeria LNG. Its investigations led to settlements that removed destination clauses. In addition, the investigated companies committed not to introduce such restrictions in future contracts.[23] The European Commission continues to oppose destination clauses in a number of ongoing investigations.[24]

The EU is the only jurisdiction where destination clauses in LNG contracts have explicitly been treated by regulatory authorities as anti-competitive. It is, moreover,

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The JFTC antitrust investigation is in line with and supports METI's LNG strategy. Judged by international standards, the JFTC investigation is in its early stages, but may proceed quickly. Recently, the JFTC requested Japanese LNG buyers to provide information on whether clauses can be changed, terms of delivery and number of cargoes received since 2013.[25]

The JFTC has also started to reach out to prominent LNG suppliers, and has sent Requests for Information to a number of them.[26] Subject to the JFTC's discretion, responding to such Requests for Information can be either voluntary or mandatory. In practice, it is generally the former. Depending on the course of the antitrust investigation, and before any finding of anti-competitive activity, the JFTC may request additional information from the investigated companies.

The JFTC investigation will assess whether destination clauses qualify as 'unfair trade practices' under the Japanese competition rules, in particular the Japanese Antimonopoly Act no. 54 of 1947 and the Fair Trade Commission Public Notice on Designation of Unfair Trade Practices no. 15 of 1982 ("Notice"). The Notice lists various types of unfair trade practices, including the notion of 'trading on restrictive terms', which the JFTC is most likely to use as the legal test for assessing the legality of LNG destination restrictions.[27] It is likely that the JFTC will conduct an effects- based analysis because (unlike in the EU) no per se illegality standard exists under Japanese competition law. If destination clauses are held to violate Japanese competition law, the consequence for existing agreements could be significant. In this regard, the JFTC has the power to issue cease-and-desist orders, which may include an injunctive relief or the instruction to delete destination clauses from LNG contracts.

E. What does the JFTC investigation mean for LNG exporters to Japan?

It would be unprecedented for the JFTC to declare destination clauses included in LNG supply contracts unenforceable. However, if it does so, there is the possibility that the JFTC's decision could justify a party to an LNG SPA to trigger various contractual rights, including Force Majeure, price adjustment and more. In any event, such findings could materially impact the commercial balance reflected in LNG contracts, could raise complex issues regarding the enforceability of those supply agreements and could at minimum trigger complex discussions regarding alternative pricing mechanisms, diversions, reload opportunities and other contract terms found in LNG SPAs. Obviously, the JFTC's position may affect both existing and future supply contracts. On a more fundamental level, any such intervention may negatively affect Japan's credibility as a reliable trading partner.

It remains to be seen whether the JFTC will continue to aim for a head-on collision with LNG suppliers, leave the status quo or steer towards negotiated settlements intended to provide Japanese buyers with increased flexibility. The former scenario will first and foremost call for a robust antitrust defense, while the latter scenario will more readily involve the identification of the merits of remedies and contractual amendments

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[3]*LNG contracts in Japan*, Credit Suisse, July 2016 and *Japan said to review if LNG contracts barring resale violate law*, Bloomberg, July 2016.
[4]*More than $600 billion is at stake as Japan probes LNG deals*, Bloomberg, July 2016.
[5]It is not clear where the excess LNG volumes would be resold. In this respect, Yuji Kakimi, JERA's president, commented that *"… till the middle 2020s, a large amount of LNG will wander around the world seeking its final consumer. […] Arbitrage among Europe, North America and Asia will also be more commonplace."* Gas price tumble comes as markets are increasingly interlinked, The Financial Times, 10 March 2016.
[6]EIA report on Japan ,2015, page 10.
[7]2016 IGU World Gas LNG Report, page 4.
[8]*See* historical data for the Japan Liquefied Natural Gas Import Price at https://ycharts.com/indicators/japan_liquefied_natural_gas_import_price.
[9]*Global natural gas markets: Prospects for US exports?*, presentation by Donald D. Ripple at the 2015 EIA Energy Conference, https://www.eia.gov/conference/2015/pdf/presentations/ripple.pdf, slide 17.
10*Japan's spot LNG contracted in October rebounds*, LNG World News, 10 November 2016.
[11]Only a few years ago, the difference between Henry Hub and the Asian price was around $12/MMBtu. This significant difference far exceeds the costs required to move gas from the U.S. Gulf Coast to North East Asia.
[12]The Platts JKM is an LNG benchmark price for spot physical cargoes delivered ex-ship into Japan and South Korea; it is a month-ahead delivered price. JKM, along with the ICIS East Asia Spot LNG Index, are attempts by price reporting agencies to find a credible pricing mechanism for the short-term LNG market.
[13]*Japan plans to launch LNG trading hub by early 2020s, LNG World News, 2 May 2016 and Strategy for LNG market development. Creating flexible LNG market and developing an LNG trading hub in Japan*, METI, May 2016, page 15.
[14]*Challenges to JCC Pricing in Asian LNG Markets*, Howard V Rogers and Jonathan Stern, The Oxford Institute for Energy Studies, February 2014.
[15]GIIGNL annual reports. GIIGNL generally considers short term contracts to have a duration of 1-4 years.
[16]*EIA: Japan's electricity price up despite drop in LNG, coal price*, LNG World News, 12 September 2016.
172016 GIIGNL annual report, page 21. Based on the International Association for Natural Gas' (CEDIGAZ) statistics, LNG imports in Japan dropped by 3.9%, from 88.5 Mt in 2014 to 85 Mt in 2015, see Cedigaz: Eastern Asian LNG imports down 3.9 pct in 2015 and Japan's 2015/16 LNG imports down 6.2 %, LNG World News, 20 April and 12 February 2016.
[18]*Established Asian markets for LNG – Japan, Korea, Taiwan*, FGE, The 16th Pacific Gas Insiders 2016.
[19]The already restarted reactors are the Sendai 1 and 2, Takahama 3 and Ikata 3 reactors. Although Takahama 3 resumed operations at the beginning of 2016, it is currently not operational following a court injunction requested by opponents of nuclear energy.
[20]*Established Asian markets for LNG - Japan, Korea, Taiwan*, FGE, The 16th Pacific Gas Insiders 2016.
[21]*Strategy for LNG market development. Creating flexible LNG market and developing an*

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November 2016.
[26]*Japan to seek LNG contract details amid resale probe*, Bloomberg, November 2016.
[27]Fair Trade Commission Public Notice on Designation of Unfair Trade Practices no. 15 of 1982, at para. 12.

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