

# JFTC questions the validity of destination clauses in LNG SPAs

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Japan Fair Trade Commission Issues Report on LNG Trading Identifying Provisions in LNG Contracts that may Violate Antimonopoly Act

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On 28 June 2017, the Japan Fair Trade Commission (“JFTC”) issued a report regarding its “Survey on LNG Trades” based on questionnaires and interviews with Japanese and non-Japanese buyers and sellers of LNG (the “Report”). This survey was conducted with the JFTC’s compulsory investigation authority, which is rare. Such approach implies the seriousness of the JFTC’s policy on this matter. The Report identified certain provisions commonly included in LNG SPAs as potentially violating the Act on Prohibition of Private Monopolization and Maintenance of Fair Trade (Act No. 54 of April 14, 1947) (“Antimonopoly Act”) as exclusive dealings in some cases.

The JFTC is the Japanese regulatory body charged, inter alia, with enforcing the Antimonopoly Act and has the power to initiate investigations for alleged violations of the Antimonopoly Act. The Report’s key findings regarding LNG SPAs are summarized below.

## Destination Restrictions and Profit Sharing Provisions in FOB LNG SPAs

Under FOB (Free On Board) LNG SPAs, the sale and purchase of LNG takes place at the loading port. Under such agreements, the buyer is responsible for transportation of the LNG after the point of sale.

### 1) Destination restrictions

The JFTC found that most fixed term FOB LNG SPAs have clauses which limit the destinations to which the buyer may transport and unload the LNG. The JFTC found that such destination clauses are “likely” to be in violation of the Antimonopoly Act. In addition, the JFTC found that the combination of destination clauses together with restrictions on “diversions” to other destinations, is “highly likely” to be in violation of the Antimonopoly Act.

### 2) Profit sharing provisions

The JFTC found that some LNG SPAs include provisions under which the buyer is required to share with the seller the profits derived from diversions. The JFTC found that, in the context of FOB LNG SPAs, such profit sharing clauses are “highly likely” to be in violation of the Antimonopoly Act.

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## Destination Restrictions and Profit Sharing Provisions in DES LNG SPAs

Under DES (Delivered Ex-Ship) LNG SPAs, the sale and purchase of LNG takes place at the unloading port. Under such agreements, the seller is responsible for transportation of the LNG from the loading port to the unloading port.

### 1) Destination restrictions

The JFTC found that all DES LNG SPAs have destination clauses. The JFTC recognized that specifying destinations is necessary in DES LNG SPAs. Furthermore, the JFTC found that requiring a seller's consent for any diversions from such destinations "is not in itself problematic" under the Antimonopoly Act.

However, in practice, a seller withholding consent to a requested diversion would be "likely" to be in violation of the Antimonopoly Act if the requested diversion meets necessary or reasonable conditions such as: (i) there being no increased transportation costs or the buyer agreeing to bear any such increased transportation costs; (ii) the diversion terminal being safe and compatible with the seller's LNG vessel; and (iii) the delivery to the diversion terminal fitting within the LNG vessel's overall scheduled uses.

Furthermore, the JFTC found that in some cases the seller's consent to diversions is made subject to conditions intended to restrain competition. Examples of such conditions identified by the JFTC are that the diversion: (i) be only for the buyer's operational reasons; (ii) not be for the buyer's commercial reasons (such as to capture arbitrage profits); (iii) not involve the buyer reselling the LNG to the seller's customers; and (iv) must be for a direct sale by the seller to the owner or operator of the diversion terminal. The JFTC found that imposition by a seller of these types of "competition restraining" conditions, whether through contractual provisions or in practice, is "highly likely" to be in violation of the Antimonopoly Act.

### 2) Profit sharing provisions

The JFTC found that inclusion of a diversion profit sharing mechanism in a DES LNG SPA "is not in itself problematic" under the Antimonopoly Act.

However, such profit sharing mechanisms would be "likely" to be in violation of the Antimonopoly Act when: (i) the seller's required share of profit is "unreasonable"; or (ii) when the buyer is required to provide commercially sensitive information to the seller in respect of the profit calculation and such requirement "has some effects" of preventing the buyer from reselling the LNG. While the JFTC recognized that "most long-term contracts with profit share clauses specify the percentage of the profit to sellers as 50%", it did not expressly opine on whether or not a 50% share is "unreasonable."

In addition, the JFTC found that profit sharing clauses that lack clear methods for calculating the profit and/or do not specify the seller's share of profit are "more likely" to be in violation of the Antimonopoly Act than clear clauses. The JFTC stated that it is therefore "desirable" for the parties to state the matters clearly in the contract in advance.

## Take-Or-Pay Clauses

Take or pay is a common feature of term LNG SPAs. The JFTC found that inclusion of take or pay mechanisms in LNG SPAs "is not in itself problematic" under the Antimonopoly Act. However, the JFTC stated that take or pay clauses in combination with "strict" minimum purchase obligations are considered "likely" to violate the Antimonopoly Act 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."

## Application

The JFTC made clear that LNG sellers should observe the findings expressed in the Report when they conclude a new contract or revise a contract after expiration of its initial term. As regards, existing contracts that have not expired, the JFTC stated that "LNG sellers, at least, should review competition-restraining business practices which lead to restrictions of resale and so on."

While the JFTC's findings expressed in the Report are not legally dispositive, they should be given considerable weight by LNG sellers and buyers, and other participants in the LNG industry. The findings will

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need to be considered carefully not only in the context of new LNG SPAs but also practices under existing LNG SPAs.

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