CONTRACTS VS REGULATORS: WHO WINS?

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LNG supply contracts are private contracts between a buyer and a seller. However, regulators are intervening more actively in these contracts. This can seriously upset the bargain made between the parties and, importantly, the security that both parties intend to achieve with these contracts.

This paper will look at two case studies. The first case study pertains to destination clauses in LNG contracts. Japan’s Fair Trade Commission has found that destination clauses distort competition. South Korea’s Fair Trade Commission may be following that example. In Europe, the European Commission has been very successful in banning destination clauses from gas and LNG contracts. Will this result be replicated by Japan and South Korea?

The second case study pertains to pricing and is an example of indirect intervention by regulators. Japan is liberalising its gas market, which may result in pressure on Japanese buyers to reduce LNG prices. In China, LNG import prices are affected by China’s regulation of city gate prices. Similar issues have in Europe led to numerous price reviews under long-term supply contract. Will Asia be able to escape that experience?

On the basis of these two case studies, the paper will discuss what happens when the world of private commercial contracts clashes with the reality of regulatory intervention. Contracts are designed to offer often long-term security of the terms of the LNG supply to buyers and sellers. That security can in any event no longer be taken for granted.
CONTRACTS VS. REGULATORS: WHO WINS?

1. INTRODUCTION

The traditional contracting model between LNG sellers and buyers is centered around contracting supplies for the long-term. LNG producers (sellers under LNG contracts) are required to make significant investments into production facilities and infrastructure and, therefore, need security in that the LNG will indeed be sold for a good price, resulting in a solid and secure cash flow for years to come. For the same reason, financiers of LNG projects typically require long-term contracts to be in place prior to the investments being made. Similarly, LNG buyers require security of LNG supply, so that they can be certain to sell-on LNG to its own customers and thus itself generate a good and steady cash flow. That cash flow is required for such LNG buyer to be able to make its own investments in required infrastructure, such as LNG terminals and distribution network. Through long-term supply contracts, both the seller and the buyer of LNG thus achieve long-term security on key elements of the LNG supply. This relates not only to pricing but also to other important aspects affecting their operations and related financials, such as the country in which the LNG is to be delivered.

Long-term contracts continue to be concluded, next to shorter contracts and spot trades that are also seen in the LNG market these days. Furthermore, many long-term contracts that have been concluded by Asian players in the past are still in place at present. For the reasons above, long-term supply contracts remain a key fundament to the investment and business models of both sellers and buyers of LNG.

However, regulators are intervening more actively in these contracts. This can seriously upset the bargain made between the parties and, importantly, the security that both parties intend to achieve with these contracts. Recent years have shown an increasingly active stance by Asian regulators, resulting in both direct interferences with LNG supply contracts, as well as interference with the market as a whole by imposing measures that significantly change market conditions. As a result, such measures also indirectly affect the conditions under which the parties to LNG supply contracts operate and which they have reflected in their contract.

On the basis of two case studies, the paper will discuss what happens when the world of private commercial contracts clashes with the reality of regulatory intervention.

2. REGULATORS ATTACK DESTINATION CLAUSES

2.1 Introduction

The first case study pertains to destination clauses in LNG supply contracts. These clauses restrict the territorial scope for the delivery of LNG under the contract, often limiting the destination to a certain country. Such destination clauses have been a focal point of regulators in Europe for the past two decades. They have recently attracted similar attention from Asian regulators. Will the Asian regulators replicate the results achieved by the European Commission?

2.1 EU: Two decades of actively banning clauses with territorial restrictions

*Several investigations lead to a ban on destination clauses*

At the outset of the millennium, the European Commission conducted several notable investigations into, amongst others, destination clauses included in LNG supply contracts. The first of these investigations related to contracts between Nigerian gas company Nigeria LNG Ltd. and European LNG importing companies.¹ The Commission considered that the destination clause (as well as a profit-sharing clause with similar effects) included in a particular contract constituted a breach of European competition law, as it prevented cross-border trade and undermined the ongoing creation of a European single gas market. The investigation ultimately resulted in a settlement under which NLNG released its customer of the destination clause and committed to exclude such clauses in future contracts with European gas companies.

In those early years of the 2000s, the Commission also launched multiple other investigations on destination clauses and clauses with similar effects. Another landmark concerned the settlement between the European Commission, Gazprom and ENI in which these energy companies agreed to remove the destination clause included in that contract, consequently allowing ENI to resell the gas outside of its home country of Italy as well as allowing Gazprom to also sell to other customers in Italy.²

After having concluded these settlements, the European Commission in 2004 finally confirmed by means of a formal decision that territorial restriction clauses violate European competition law. This decision concerned two contracts in which Gaz de France (GDF) included clauses to that effect. One contract was with ENEL and included a clause that the gas was destined for Italy. The other contract was with ENI and under that contract ENI was allowed to market the gas anywhere but in France, which was GDF’s home turf. Particularly the Commission’s decision on the latter decision shows its strict approach towards territorial restrictions in gas contracts. In its decision the Commission elaborated on how it perceives such clauses to cause segmentation within the European gas market and contribute to a lack of fluidity in the market.³

In 2005, Neelie Kroes, the European Commissioner for Competition, stated: “I intend to use our competition tools actively to speed up the liberalisation process in gas and electricity markets.”⁴ The Commission was of the view that “wholesaling or arbitraging could significantly contribute to the creation of a more integrated European gas market fostering both competition and security of supply.”⁵ Indeed the implementation of this approach was noticed in practice, as destination clauses and clauses with similar effects continued to be targeted by the European Commission, including in contracts between OMV and Gazprom⁶ and E.ON Ruhrgas and Gazprom⁷.

At present, the European Commission continues to take up an active role in ensuring the absence of territorial elements that may negatively affect the single European gas market. In a more recent decision of May 2018, the European Commission has shown that it not only imposes negative obligations on LNG suppliers, such as an obligation to refrain from the inclusion of destination clauses, but also imposes positive obligations. In its decision, the European Commission required Gazprom to take proactive steps in integrating gas markets in Central and Eastern Europe, which lacked the proper infrastructure for gas to flow freely.⁸ Furthermore, Gazprom was not only obliged to remove any territorial restrictions placed on its Central and Eastern European customers to resell gas, but also to grant its (existing and new) customers the right to obtain a lower price if the price would diverge too much from competitive Western European price benchmarks, at the risk of a fine of 10% of its global turnover.⁹

In June 2018, the European Commission launched an investigation into LNG contracts between Qatar Petroleum and European importers for the inclusion of “direct and/or indirect” territorial restrictions.¹⁰ Qatar Petroleum is the

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largest exporter of LNG globally and to Europe, controlling several companies that produce and export LNG to Europe under long-term agreements (typically for a term of 20 to 25 years). This investigation is expected to take some years and may result in an agreement as concluded with other LNG suppliers in the past, or a formal decision as was given in respect of GDF and Gazprom previously.

These recent developments confirm that the European Commission is not adopting a more reticent attitude towards LNG supply contracts between two private parties, if it feels that its interference could further improve competition and support the internal gas market within Europe.

2.2 Japan: JFTC sends a clear warning

Meanwhile, also in Asia the liberalization of gas markets seems to be high on the agenda of certain countries. Japan has taken the lead in this respect. Japan has a particular interest in striking down destination clauses since LNG counts for more than 40% of its total power generation after the Fukushima accident in 2011. As a result of the liberalization of the gas market, combined with an over-commitment in long-term LNG supply contracts and the return of nuclear power supply, Japan is expected to be over-supplied. In response, many Japanese companies have already indicated they will swap out or resell cargoes. However, to be able to do so, their LNG supply contracts must not include destination clauses. It appears that the regulator got this message loud and clear.

In June 2017, the Japan Fair Trade Commission (JFTC) completed an investigation on destination clauses in LNG supply contracts, concluding that destination clauses are "likely" to violate Japanese antitrust laws, and considered profit-sharing clauses, as well as combinations of destination clauses and diversion restrictions, "highly likely" to do so. The JFTC explicitly indicated that new LNG contracts should not include such clauses, nor should LNG sellers otherwise take business practices which lead to restrictions of resale. At the same time, the JFTC encouraged LNG sellers to revisit their current contracts if they contained such clauses. In the words of the JFTC itself: "As for the existing contracts before the expiration, LNG sellers should at least review the competition-restraining business practices". The decision of the JFTC seems set to shake up the Asian market in the same way as the European Commission's actions have done in Europe.

The market quickly responded to this development, with major Japanese gas importers committing not to enter into new contracts with destination clauses and indeed also to renegotiate existing contracts in this respect. Tokyo Gas, Japan's second largest LNG importer, in October 2017 publicly confirmed that it will refrain from entering into new LNG contracts with such clauses, and it renewed a long-term LNG contract with Malaysia LNG, a subsidiary of Petronas, with destination flexibility "on good terms". Similarly, JERA, the world's largest LNG importer, renewed its LNG contract with Malaysia LNG in October 2017 and indicated that it considered the destination clause included in the contract, for which the delivery method is both FOB (free on board) and DES (delivery ex ship), to be "in line" with the JFTC ruling of June 2017. JERA has been pushing to drop destination clauses from existing long-term contracts since the JFTC publication. JERA furthermore indicated that it had been renegotiating

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existing contracts with the aim to revise profit-sharing clauses. In August 2018, JERA signed a three-year-deal with Abu Dhabi's Adnoc LNG for deliveries beginning April 2019. Also for that deal, JERA indicated that the contract was "in line with the JFTC’s findings of June 2017, which seems to relate to the fact that the delivery mode under this contract is (only) DES. In its report of June 2017 the JFTC acknowledged that in DES contracts destination clauses are necessary to specify the unloading terminal where the property and risk passes to the buyer and, consequently, that "necessary and reasonable" destination restrictions under DES contracts are "not basically harmful" under the Antimonopoly Act.

Although JERA indicated in October 2017 that in its view LNG sellers appeared willing to remove destination clauses, the common perception has since been that sellers on the Japanese market have generally been less inclined to make any changes. Yet, the buyers’ active response is met with a continued proactive stance from the Japan government. In October 2018, a model diversion clause was published that was developed by experts during workshops that were organised by the Japanese Trade Ministry and the European Commission Directorate-General for Energy. The model clause is aimed at boosting renegotiations between parties to long-term LNG contracts and is tailored to replace existing destination clauses with contractual arrangements for cargo diversions, including delivery specifications and profit sharing or compensation arrangements. The introduction of this model clause was apparently triggered by a perceived lack of active engagement on the side of LNG sellers to revise existing contracts with Japanese importers.

2.3 South Korea: Following in Japan’s footsteps

Developments similar to those in Japan were expected for South Korea. Shortly after the JFTC report, the Korean Fair Trade Commission (KFTC) referred to the developments in Japan and also publicly indicated that it is examining the legality of the destination clauses of LNG import contracts concluded by South Korean gas importers. The KFTC indicated that it was in the stage of monitoring the situation and had not decided yet whether to conduct an official investigation. The significance of such contracts – and thus of restrictive clauses in them – appear to be increasing for South Korea, as the government is looking to further increase the ratio of LNG-based power generation and reduce those of thermal and nuclear power generation. South Korea is currently already the third largest importer of LNG behind China (second largest) and Japan. In light of the already high LNG demand and the anticipated growth of such demand in South Korea, the government emphasized that the country was keen on having LNG contracts that offer more flexibility, including the removal of (stringent) destination clauses.

The response of the South Korean market has been quite similar to that of the Japanese market. KOGAS, South Korea’s largest gas importer, confirmed that it intends to remove restrictive clauses, such as destination clauses, from its contracts in renegotiations, explicitly mentioning to aim at increasing solidarity with other East Asian importers. However, since the KFTC’s notification of October 2017, little further developments have taken place.

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22 The model clause is available at: https://www.jurists.co.jp/sites/default/files/news_pdf/ja/13676.pdf
New developments may be catalysed by the recent Japan-EU initiatives, with South Korea following Japan's moves closely in this respect.

2.4 Anticipating future developments: valuable lessons learned from Europe
Observing these developments on the Asian markets, particularly the JFTC seems to be following in the footsteps of the European Commission to a certain extent, by placing the liberalization of its gas market high on its agenda. This could result in increasing (and increasingly intrusive) regulatory action. As was the case in Europe, Japan first seems to have limited itself to investigating and, subsequently, monitoring the situation and market developments, with the report of June 2017 not yet constituting a formal decision nor imposing binding obligations on market participants. However, as witnessed in the EU in the past two decades, a next step may be a straightforward formal decision holding a ban on destination clauses and clauses with a similar effect. Therefore, these developments prompt market participants to reflect on the lessons learned in Europe over the past two decades in order to anticipate upcoming developments, regulatory measures and their potential implications.

While such lessons from Europe indeed allow markets participants to adapt their business practices in advance, there seem to be some differences between regulatory action taken by the European Commission and actions that may be taken by regulators of single Asian countries. A primary difference seems to relate to the fact that in Europe the (legal) justification for investigations and measures relating to destination clauses seems readily apparent with the internal market as a core principle of the EU. Destination clauses in LNG contracts (with a FOB delivery method) constitute a rather straightforward violation of such principle. Absent a single internal market such as in the EU, the situation in Asia seems to be different and, consequently, similar investigations and measures into destination clauses by individual Asian countries may require different (legal) justifications.

3. LIBERALIZATION AND THE EFFECTS ON PRICING
3.1 Introduction
Besides direct interventions in LNG supply contracts by regulators, other public policy measures by governments may indirectly affect existing (and future) LNG supply contracts. The Asian gas market is rapidly changing; players such as China, India, Thailand, Pakistan and Bangladesh are increasingly participating, whilst traditional large importers of LNG, such as South Korea, Japan and Taiwan Region of China, are trying to liberalize their LNG markets and striving to further increase competition.\(^{28}\) The effects of this regional market transition and liberalization on existing contracts may be significant and can cause concerns particularly for parties to long-term LNG contracts.

3.2. Europe: liberalization led to a wave of gas price reviews in arbitration
Similar developments were experienced in Europe in the 2000's and onwards. In 1998, the European Commission started gas-market reform by enacting new legislation aimed at liberalizing the market.\(^{29}\) It allowed new participants to enter the market and increase competition, in order to increase European energy-security and lower prices for consumers.\(^{30}\) In 2009, the effects of the liberalization were felt in particular when the gas demand in Europe dropped as a result of the economic downturn and an excess of previously contracted gas flooded the market. The increased competition on the gas markets that had resulted from the liberalization, led to significant drops in energy prices to consumers and business, whilst energy companies were tied to the pricing agreed in long-term supply contracts. In order to address the outlook of large losses under these contracts, energy companies resorted to renegotiations under these contracts, which led to multiple disputes being brought in arbitration throughout

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Europe. Similar situations may be on the horizon in Asia due to changing regulations, shifting markets and an increasing focus on liberalization of gas markets.

3.3 Liberalization of the Japanese markets
Japan formally liberalized its gas market in April 2017 by implementing the Revised Gas Business Act. Increased third party access and improvement in infrastructure will further the Japanese government's goal of achieving liberalization of the gas market. Japan accounts for more than one third of the LNG imports worldwide, and therefore the liberalization is expected to have effects on an international scale as well.

Most of Japan's current LNG imports are still under long-term contracts with foreign suppliers that will only expire by the end of next decade. In the face of the liberalization of the market and related increased unpredictability, Japanese energy companies currently appear to be more hesitant to enter into long-term commitments. The effect of actual liberalization of the Japanese gas market, aided by further improved third-party access, may lead to increased competition on a market that is already expected to have an oversupply of LNG for the coming 5 years. In such a situation, LNG buyers may attempt to mitigate the effects of a resulting pressure on pricing, either through renegotiations or, if failed, possibly arbitrations over their long-term LNG supply contracts.

These potential developments show many similarities to the developments on the European market in the 2000’s, which indeed led to renegotiations and a large number of gas-price reviews in arbitration.

3.4 China: moderate liberalization thus far
China has also been reforming its gas market on several fronts in recent years, by encouraging third-party access to LNG terminals and by amending its city-gas pricing regime. Yet, the process of liberalization has been relatively slow.

Like in Japan, China is allowing and increasing third-party access. However, this process has been convoluted due to high market concentration; China's biggest LNG import terminals are owned by the three state-owned energy companies – Sinopec, China National Offshore Oil Corp (CNOOC) and PetroChina. Although these parties have initially been reluctant to grant third party access, movement has occurred on the markets in this respect as well, and third parties are increasingly able to access the LNG terminals. PetroChina took the lead in fee-based access for third parties, and CNOOC has followed suit recently to allow third parties to access Yuedong's LNG import terminal, receiving LNG sourced from Australia for the first time in October 2018.

Another area of notable development is China's city-gate pricing regime. City-gate prices – the regulated cost at which downstream gas distributors in China purchase natural gas – were traditionally set by the government per province. City-gate prices thus refer to the price that downstream distributors of gas pay to gas wholesalers. The city-gate prices used to be split up in two sections: residential (small-user) and non-residential.

In 2015 and 2017 the Chinese government lowered the non-residential city-gate prices several times. This resulted in pressure on Chinese LNG importers under international LNG supply contracts, as a discrepancy was created between, on the one hand, the lowered city-gate prices that LNG importers were able to charge to gas distributors and, on the other hand, the price that they had been previously agreed under long-term supply contracts. Several disputes have consequently arisen under such contracts.

In the spirit of liberalization, China has recently taken on reform of the city-gate pricing regime. In June 2018, the Chinese government ordered a unification of (lower) residential prices and non-residential prices, thereby allowing for a significant price increase for residential users. Starting June 2019, the Chinese government will also introduce more flexibility for wholesale energy companies to adjust prices for gas based on the benchmark city-gate price, but within certain government-set margins: an upward adjustment of 20% is allowed, whilst there is no limitation for any downward adjustment. These most recent reforms may provide some relief for Chinese LNG importers from the pressure that follows from the 2015 and 2017 lowering of non-residential prices. However, such mitigating effects may be limited as the demand for residential gas makes up only 20% of the total Chinese gas demand. At the same time, further liberalization of the Chinese gas markets might result in increased competition and, thus, bring in new pressure on prices from a different angle.

It is clear that the Chinese gas markets are undergoing continuous developments as a result of government initiatives. It will be interesting to see how LNG importers will deal with these developments and the resulting pressure on pricing. As we have seen in Europe – and in China in the past few years already – this may lead to disputes with foreign LNG suppliers, ultimately boiling down to the question to which extent their long-term supply contract should accommodate for these developments – and, primarily, the resulting discrepancy between the market price for LNG and the price agreed between the parties in the long-term contract. That question is to be answered by the parties themselves in renegotiations or, if they do not succeed to do so, by arbitrators in arbitration proceedings.

3.5 Impact on long-term LNG supply contracts

Clearly, the continued developments on the liberalization of the Asian gas markets, as discussed in the foregoing, will continue to result in changing market conditions and will thus impact the current players on these markets. In face of more competition and concurrent increasing volatility, the traditional LNG model of long-term contracts with pricing against commodities such as oil, becomes more risky due to the possible emergence of disparities between the contractual price and the economic value of the LNG at the time of delivery. As such, these moderate liberalization measures have already resulted in a move away from the traditional LNG model based on long-term contracts, towards more flexible contracts for shorter periods. Prices are now sometimes also being linked to market prices for gas, instead of only to related commodities such as oil. This was the case, for example, in a contract signed in 2018 between China National Petroleum Corporation (CNPC) and US-based Cheniere Energy worth 1.2 million MT/year, in which the price is linked to US Henry Hub rather than to oil or other related products. However, LNG importers that are tied to long-term LNG supply contracts will need to find a way to address the risks posed by these developments within the boundaries of their existing contracts and the mechanisms that those contracts include. If markets liberalize and competition increases, significantly changed prices may be a reason for both buyers and sellers renegotiate contracts or have the prices under their contracts reviewed in arbitration. The experience from Europe over the past two decades has shown that this is not only a possibility on paper, but indeed that many parties have attempted at least serious renegotiations, often ultimately resorting to arbitration. The interests at stake with long-term LNG supply contracts are a reason to expect that renegotiations will be

difficult and may not succeed. At the same time, those interests may then be a sufficient reason to proceed to arbitration, rather than accepting that failed renegotiations mean the end of it. European practice has shown that, if negotiations fail, market players faced with significantly changing conditions will ultimately request the view of an arbitral tribunal to obtain changes to the contract that accommodate market developments.

Despite Asian energy companies thus far having been somewhat hesitant to initiate arbitration proceedings for a gas price review, preferring renegotiations over a direct confrontation before a tribunal, it is not a given that this will remain the case. For instance, in February 2018, South Korean state-owned Korea Gas Corporation (KOGAS) claimed a price adjustment in arbitration proceedings against Australia’s North West Shelf joint venture. In light of the experiences in Europe after gas market liberalization, as margins may be increasingly pressured there is a chance that more market participants will follow suit and attempt to renegotiate the terms of their contract or seek the guidance of an arbitral tribunal as to the existing terms.

4. CONCLUSION

The focus of Asian regulators on destination clauses, and other clauses with the effect of territorial restriction, directly affects the bargain made between LNG buyers and sellers in existing contracts. JFTC appears to be unhappy with the progress made by market participants with regard to the removal of destination clauses since its report of June 2017, especially when it comes to existing contracts. South Korea is following Japan’s example and is watching closely how matters unfold. A parallel with the European situation is apparent, in which the European Commission, after having adopted a somewhat careful and observing approach initially, acted with increasing force in subsequent years, taking matters in its own hands in order to effect actual change. JFTC has now allowed the market some time to make the desired change in business practices itself. Perhaps 2019 and following years will see JFTC taking a more active approach towards the removal of destination clauses and clauses with similar effects. In that case, coming back to the main question of this paper, the winner is clear: by effectuating measures that directly interfere with contracts between private parties, the regulator wins.

With regard to the liberalization of Asian LNG markets and the regulatory actions in that respect, some key questions as to current long-term LNG supply contracts are likely to be answered in the near future. How will the different Asian market players approach the challenges to the profitability under their long-term contracts as a result of regulatory measures being taken on the gas markets? What responses may we expect as the markets continue to be liberalized and increased competition will out-market the current long-term LNG supply contracts? Are these changes cause for gas-price reviews or renegotiations of current contracts? Regulatory actions may cause the market conditions to change, resulting in a potentially significant disparity between market prices for LNG and the price that an LNG seller and buyer have agreed in a long-term LNG supply contract. However, the regulatory actions do not have a direct effect on the contractually agreed price. That price can only be amended by the parties themselves, either through renegotiations or if a price review arrangement has been included in the contract, and then only in accordance with the specific conditions and stipulations of such arrangement. Thus, the contract itself is decisive in determining if and to which extent there should be a change in pricing under the existing contract as a result of market conditions or a market price influenced by regulatory actions. In other words: the contract wins.

The result is a draw, which may perhaps best fit the current state of affairs on the Asian LNG markets: regulatory intervention has begun but is not yet as intrusive as witnessed in Europe over the past decades, and at the same time the market players have started to explore renegotiations and gas price reviews as means to ensure alignment of their contracts, and specifically the prices under their contracts, with market developments. The match has only just kicked off.

It is clear that these developments – all the consequence of either direct or indirect regulatory interference – create considerable uncertainties for private parties that have entered into long-term LNG supply contracts. Those contracts were designed to offer long-term security of the terms of LNG supply to buyers and to sellers. That security can in any event no longer be taken for granted.