Contracts vs. Regulators: Who Wins?

Edward van Geuns
Partner
De Brauw Blackstone Westbroek Singapore
Introduction

• Long-term contracts: certainty of price and cash flow
• Producers/sellers: investments in production facilities and infrastructure
• Buyers: security of supply to customers, investments in infrastructure and distribution network
• Increasing *direct* and *indirect* interventions by Asian regulators
• Lessons learned in Europe may prove valuable
First case study: Destination clauses

Source: Orchard Energy
EU developments as from 2000s

EC conducts multiple investigations into destination clauses in LNG supply contracts

Settlement between European Commission and Nigeria LNG relating to contracts with European importers

Another EC investigation leads to settlement with Gazprom and ENI

2000s

2002

2003
EU developments as from 2000s

• 2004: Binding decision concerning two contracts concluded by GDF (with ENEL and ENI)

Commission confirms that territorial restriction clauses in the gas sector restrict competition

The Commission has confirmed, by two formal decisions, the first on this subject in the gas sector, that territorial restriction clauses infringe Article 81 of the Treaty. The clauses in question were contained until recently in two contracts, one a transportation and the other a service contract, concluded by GDF (Gaz de France) with ENI and ENEL respectively. The two clauses prohibited ENI and ENEL from selling in France the natural gas which GDF transported on their behalf. The clauses prevented French consumers therefore from obtaining their supplies from the two Italian operators and constituted a sizeable obstacle to the creation of a genuinely competitive and integrated gas market at European level.
Current EU developments

- EU still targeting geographical restrictions
- June 2018: EC launched investigation into contracts between Qatar Petroleum and European importers regarding "direct and/or indirect" territorial restrictions
Current EU developments

• May 2018: Gazprom decision imposing both negative and positive obligations

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EUROPEAN COMMISSION
Press Release Database

Brussels, 24 May 2018

The European Commission has adopted a decision imposing on Gazprom a set of obligations that address the Commission’s competition concerns and enable the free flow of gas at competitive prices in Central and Eastern European gas markets, to the benefit of European consumers and businesses.
LNG accounts for 40% of total power generation

Over-commitment in long term LNG supply contracts results in over-supply

Results in a desire with LNG importers to swap out and resell cargoes

Requires ban on destination clauses

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

Based on this report, when LNG sellers conclude a new contract or revise a contract after the expiration, LNG sellers (including sellers who were users) should not provide competition-restraining clauses nor take business practices which lead to the restrictions of resale and so on. Also, as for the existing contracts before the expiration, LNG sellers, at least, should review competition-restraining business practices which lead to restrictions of resale and so on.
Japan: Market responses

Tokyo Gas will not accept destination clauses in new LNG contracts - president

JERA Strikes ADNOC Deal

GLNG - Global LNG
09 August 2018, Week 31, Issue 530

Crucially, the deal is "in line with the Japan Fair Trade Commission ruling, issued in June 2017", the statement said. The commission’s ruling found that new LNG contracts should not have destination clauses, restricting where buyers could deliver gas.

Petronas, JERA ink LNG supply deal

JERA noted in its statement that the destination clause in the deal is "in line with the survey on LNG trades report released by the Japan Fair Trade Commission in June 2017."
MODEL DIVERSION CLAUSE FOR LNG SALE AND PURCHASE CONTRACT

This document contains two sections:

1. A guidance note to accompany the proposed model diversion clause
2. Model provisions for diversion clause

MODEL PROVISION

1. Without prejudice to [provisions on compliance and sanctions if the language in the SPA is not inclusive] and [Buyer’s obligation to take], Buyer shall have the right to request Seller to direct any Cargo scheduled for delivery in the Annual Delivery Programme or Ninety Day Schedule to an Alternate Unloading Port ("Diversion").

2. If Buyer elects to request a Diversion, Buyer shall provide a Notice of the Alternate Unloading Port and the other operational details concerning the Diversion included in this section 2 to Seller, and Seller shall promptly approve such Diversion provided that:

(1) Buyer has provided Seller with a copy of and Seller, acting as a Reasonable and Prudent Operator, (i) has accepted the Terminal Rules, and (ii) has accepted the Conditions of Use for the Alternate Unloading Port;
(2) Seller, acting as a Reasonable and Prudent Operator, has obtained all required Approvals;
(3) the LNG Specification corresponds with requirements of the Alternate Unloading Port;
(4) the LNG Tanker is or, with the Parties’ reasonable endeavors and at Buyer’s costs, can be made compatible with the Alternate Unloading Port;
(5) such Diversion will not cause Seller to be in breach any obligation it has accrued under the contract of the Harbors of Delivery.
South Korea

The Korea Fair Trade Commission (KFTC) is examining the illegality of the destination clauses of LNG import contracts between South Korean gas companies and foreign suppliers. At present, the KFTC and LNG importers in South Korea are regarding the clauses as a kind of poison pill.

Source: Business Korea
South Korea: Market response

South Korea's KOGAS to seek more flexible LNG contracts: CEO

Korea Gas Corp (KOGAS), the world's second-biggest liquefied natural gas (LNG) buyer, will seek flexible contracts to have more leeway to trade its LNG cargoes down the road, its chief executive told Reuters on Friday. The changes would follow similar efforts by LNG buyers in Japan, the world's top LNG importer. Companies there have been vocal about the removal of destination clauses in their long-term import contract that restrict a buyer's ability to resell cargoes it does not need.

But KOGAS will have to wait until 2025, its long-term contracts expire, before it can start to adjust its import terms.

Source: Business Recorder
Anticipating future developments

- Liberalization of gas markets is on the agenda in Asian countries
- Regulatory actions may increase: investigating and monitoring may develop into more intrusive actions
- Similarities with events in Europe as from 2000s (although perhaps different justifications)
- Reflecting on European lessons learned may allow market participants to anticipate upcoming developments
Conclusion on destination clauses

- *Direct* regulatory intervention in LNG supply contracts
- Regulatory action can significantly interfere with the bargain made by the parties
- Negative and positive obligations can be imposed; implications may be serious, as witnessed in Europe
- Japan seems to be on the same path; South Korea possibly trailing close behind
Second case study: Liberalization and effects on pricing

Source: Shutterstock
Europe

Liberalization and effects on pricing (I)

New market participants and increased competition → lower gas prices

Combined with economic downturn and contracted oversupply → significant price drop

1998

EC enacts new legislation aimed at liberalization of gas markets

2000s

Market participants tied to long-term contracts → renegotiations and price reviews in arbitration

2009

2009 >>

Source: Anthony Melling
Japan

- April 2017: Revised Gas Business Act
- Further improvement of infrastructure and third-party access may result in increased competition
- Most of its LNG imports is under long-term contracts; over-supply expected for upcoming 5 years
- Recipe for potential pressure on pricing
- LNG buyers may attempt to mitigate potential pressure through renegotiations or arbitration
China: Third-party access

• Moderate liberalization thus far, but some notable recent developments

Third-party access to Asian LNG import terminals making slow but sure headway

Wed 11 Apr 2018 by Mike Corkhill

Third-party access to Asian LNG receiving facilities holds the promise of a more efficient use of available infrastructure, but there are challenges to its implementation

A number of Asian LNG import terminals are currently being opened up for third-party access (TPA) as part of drives towards gas market liberalisation in the region’s leading gas-buying nations and optimising use of the gas processing and distribution infrastructure currently in place.

Source: LNG World Shipping
China: City-gate prices

Recent years show two contrasting developments

- 2015 and 2017: multiple price decreases by Chinese government
- Increased pressure on Chinese LNG importers under international LNG supply contracts
- Several disputes arose under such contracts
- June 2018: unification of prices
- June 2019: more flexibility, allowing 20% upward adjustment compared to city-gate benchmark
- Might relieve some pressure on LNG importers, but residential is only 20% of total Chinese gas demand
Impact of liberalization on long-term LNG supply contracts

- Further liberalization may result in increased competition and market volatility
- Traditional LNG contract model becomes more risky, but remains necessary for investments and supply security
- Renegotiations or gas price reviews in arbitration; experiences in Europe show that these are real options
- February 2018: KOGAS v. North West Shelf; other Asian market participants may follow suit?
Conclusion on liberalization and effects on pricing

- *Indirect* effects on LNG supply contracts
- May lead to (increased) disparity between market price and contract price
- Price can only be amended by the parties in renegotiations or by a Tribunal in arbitration
- Effects of regulatory intervention will need to addressed within the contractual boundaries
Contracts vs. Regulators: Who Wins?

• Result: a draw
• In any case, security under long-term LNG supply contracts can no longer be taken for granted
Thank you for your attention!

Edward van Geuns
De Brauw Blackstone Westbroek Singapore

Tel       +65 6809 5017
Fax       +65 6809 5276
Mobile   +65 8376 4141
E-mail    edward.vangeuns@debrauw.com