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Territorial Restrictions in Gas Supply Contracts in Japan—Antitrust Implications and Experience From the European Union

Japan, the world's biggest buyer of liquefied natural gas ("LNG"), is currently investigating the potential anticompetitive effects of territorial restrictions in LNG supply contracts. Historically, LNG suppliers have used long-term contracts that incorporate territorial restrictions to prevent Japanese buyers from on-selling the LNG outside Japan. The effect of such clauses is to ban exports of LNG bought by Japanese customers. While this may have increased Japanese energy security, LNG suppliers have benefited from the absence of price arbitrage between Japan and neighbouring markets. This contractual framework eliminates the buyers' scope to trade LNG with other countries. The concern is that such territorial restrictions could now be resulting in a reduction in trading volumes, liquidity and increasing buy-side risk.

Background

Japan's Ministry of Economy, Trade and Industry ("METI"), states that it will work to eliminate in their entirety or reduce the scope/effectiveness of territorial restriction clauses in new LNG supply contracts. In its report entitled *Strategy for LNG Market Development*, METI highlights that "[i]n order to develop a flexible and liquid LNG market, these [territorial] restrictions need to be eliminated to the greatest extent possible to increase the number of market players as well as trade volumes and frequencies to a level exceeding a certain critical mass."¹ The Japanese antitrust agency, the Japanese Fair Trade Commission ("JFTC") is also understood to have launched an investigation in 2016 to determine to what extent the export bans in LNG supply contracts adversely affect competition. Given that LNG is supplied to Japan under long-term contracts with a typical duration of 25 years, antitrust enforcement is the only tool available to challenge the export bans in existing LNG supply agreements. Prohibiting the use of territorial restrictions could lead to the renegotiation of approximately \$600 billion worth of LNG supply contracts already in place.² With this reform on the horizon, key Japanese buyers of LNG such as Jera Co. and Osaka Gas Co. have refused to sign new LNG supply contracts containing export bans.³

¹ *Strategy for LNG Market Development – Creating flexible LNG Market and Developing an LNG Trading Hub in Japan*, Ministry of Economy, Trade and Industry, Government of Japan, 2 May 2016, p. 7.

² *Japan Said to Review If LNG Contracts Barring Resale Violate Law*, Bloomberg, 14 July 2016, available at <https://www.bloomberg.com/news/articles/2016-07-14/japan-said-to-review-if-lng-contracts-barring-resale-violate-law-iqlr1xu7>.

³ *Another Buyer in World's No. 1 LNG User Resists Resale Curbs*, Bloomberg, 12 September 2016, available at <https://www.bloomberg.com/news/articles/2016-09-12/osaka-gas-in-talks-to-ease-lng-contract-terms-barring-resale>.

Antitrust Challenges

Territorial restrictions in contracts for the supply of gas have been found to infringe antitrust rules in other jurisdictions, notably the European Union (“EU”). There are strong differences in the structures of the European and Japanese gas markets, which means EU antitrust law has developed using theories of harm that cannot be easily transposed to the Japanese market. A series of decisions from the European Commission (“EC”) concerning contracts for the supply of gas between (1) undertakings in different Member States; and (2) undertakings importing gas into the EU, reveal how territorial restrictions have been examined under EU competition law.

The first step the EU took against export bans related to intra-EU supply contracts. The EC held that territorial restriction clauses contained in a transportation and a service contract between Gas de France (“GDF”), Eni S.p.A (“ENI”) and Enel S.p.A (“ENEL”), which prohibited ENI and ENEL from selling in France the natural gas which GDF transported on their behalf, infringed EU competition law.⁴

The latter category concerned primarily investigations by the EC into supply contracts concluded between Gazprom and European energy companies such as E.ON Ruhrgas,⁵ ENI⁶ and OMV.⁷ The agreements reached between the parties and the EC concluded in the elimination of the territorial restriction that prevented the European energy companies from selling the gas supplied by Gazprom to other Member States.

In both cases, the EC considered that territorial restrictions were a restriction of competition by ‘object’. Object restrictions in the EU are effectively equivalent to per-se violations of section 1 of the Sherman Act, a federal antitrust statute in the United States, and can be assumed to be harmful without needing to prove any actual anti-competitive effect. The specific harm assumed was that the operation of territorial restrictions would allow suppliers to maintain different price areas for the same product, thus undermining the integration of a single European gas market.

Using antitrust enforcement to encourage integration of the EU single market – sometimes called the “single market imperative,” is a peculiar feature of the EU. It does not generally apply to antitrust regimes elsewhere in the world, including in Japan. Further, the investigation the JFTC is undertaking is different from the previous cases in the EU. The equivalent case in the EU would be a situation where a gas supplier prevented an EU buyer from exporting the gas *outside* of the EU itself—not between Member States of the EU.

Under EU competition law, clauses prohibiting onward sales outside the single market would not be an object restriction. However, these restrictions could in theory be challenged if it could be shown there was an anti-competitive effect. In practice such cases are very rare. The EC would take into consideration whether, in the

⁴ Commission Press Release, ‘Commission confirms that territorial restriction clauses in the gas sector restrict competition,’ (IP/04/1310), 26 October 2004.

⁵ Commission Press Release, ‘Commission secures changes to gas supply contracts between E.ON Ruhrgas and Gazprom,’ (IP/05/710), 10 June 2005.

⁶ Commission Press Release, ‘Commission reaches breakthrough with Gazprom and ENI on territorial restriction clauses,’ (IP/03/1345), 6 October 2003.

⁷ Commission Press Release, ‘Commission secures improvements to gas supply contracts between OMV and Gazprom,’ (IP/05/195), 17 February 2005.

absence of the export ban, there would be a realistic possibility of re-import of the products into the EU.⁸ If such were the case, banning exports could lead to a softening of competition in the internal market.

The Approach of the Japan Fair Trade Commission

Japanese antitrust legislation does not automatically prohibit the use of territorial restrictions. The use of territorial restrictions will constitute a violation of Japanese antitrust law only if they have an anticompetitive effect. There has not been a finding by the JFTC that such clauses are an object restriction of competition or that they necessarily lead to anticompetitive effects in the market. Conversely, there is also no antitrust legislation or finding by the JFTC concluding that territorial restrictions are permissible or compatible with Japanese antitrust law.

Whilst it is clear that METI considers it indispensable to eliminate territorial restrictions to create a more flexible LNG market in Japan⁹ and bolster Japan's role as a regional trading hub for LNG, we consider it unlikely that the JFTC could immediately challenge export bans in LNG supply contracts on the basis of illegality. Given the EU's single market objective, territorial restrictions within the EU have long been considered object restrictions. However, export bans in long-term LNG supply agreements to Japan do not present such an obvious anti-competitive effect; indeed it would be odd if they did since provisions have been a well understood basis for LNG contracting for decades without attracting prior enforcement effort. Consequently, the JFTC would need to embark on an effects analysis. This involves comparing the state of the market with territorial restrictions against the state of the market absent the territorial restrictions. Using accepted economic tools it would then need to prove empirically that the restrictions distort competition.

There are a number of significant problems in doing this. In particular, the Japanese LNG market is highly fragmented on the supply side.¹⁰ It would be practically impossible for the JFTC to prove that a single long-term LNG supply contract containing an export ban has an adverse effect on competition, since the supplier in question would have no market power. This contrasts with the market structure in the EU, where Russia, Norway and Algerian national oil companies each have significant shares, although even here the EC did not attempt an effects analysis.

Given this issue, to successfully tackle the challenges posed by territorial restriction clauses, the JFTC would have to establish that all LNG supply contracts containing these clauses constitute a network of similar agreements and study the anticompetitive effect that they collectively present. EU competition law also recognises that the existence of a network of similar agreements reinforce their individual adverse effects on the market, and therefore a factor to consider by antitrust authorities.¹¹

In addition, there is a jurisdiction hurdle for the JFTC in tackling territorial restriction clauses as they prohibit the Japanese buyers only from selling the LNG outside of Japan and not from selling to their customers in Japan. However, territorial restriction clauses will reduce trading volumes and liquidity and increase the buy-side risk

⁸ Commission Decision, *SABA (No. 1)*, OJ 1976 L28/19, [1976] 1 CMLR D61.

⁹ See above at 2, p. 10.

¹⁰ In addition to Australia, Qatar and Malaysia, the USA and Brunei have also penetrated the Japanese LNG market.

¹¹ See judgment of the General Court in Case T-65/98 *Van den Bergh Foods v Commission* [2003] ECR II-4653; see also judgment of European Court of Justice in Case C-234/89 *Delimitis v Henninger Bräu* [1991] ECR I-935.

that can increase the LNG's price level in the Japanese market. The jurisdiction of Japanese antitrust law can be established as long as the conduct has an anticompetitive effect in Japanese market, and if the JFTC would succeed in establishing the collective anticompetitive effect in the Japanese market, that could mean that the JFTC would have overcome the jurisdictional challenge.

Points for LNG Traders / Sellers to Consider

- Territorial restriction clauses in new long-term LNG supply contracts to Japan are unlikely to be a sound basis to plan for new liquefaction projects.
- Consider whether existing projects supplying LNG to Japan are adversely affected by this reform. In particular, as a matter of contract whether the change to territorial restriction affects the buyer's obligations to purchase gas at the agreed price. These supply contracts typically support limited recourse project financing of liquefaction projects.
- Territorial restrictions in LNG supply contracts are unlikely to be removed abruptly. Nevertheless, suppliers are encouraged to engage with the JFTC at an early stage to provide evidence of the disruptive effects that a sudden change in the LNG supply contracts could have for consumers and market stability. Whilst METI is exerting pressure on suppliers to remove export bans, there should be a transition period to allow the parties to renegotiate their contractual arrangements. Parties should consider how long this needs to be.
- This renegotiation period will only be efficient if coupled by clear guidance issued by the JFTC explaining exactly what territorial restrictions would breach the antitrust provisions and in which circumstances. Parties and their advisers should consider what sensible thresholds or filters could be used in this guidance.

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