Model Diversion Clause for LNG Sale and Purchase Contracts

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Introduction

Global liquefied natural gas ("LNG") markets are in transition. This transition is driven by factors including (but certainly not limited to):

- Increasing number of players, including new types of players such as portfolio players that support the growing liquidity and allow the buyers to look for cargoes outside their traditional long-term contractual relationships.
- Technological innovation in areas such as floating LNG liquefaction and regasification facilities as well as others.
- Entry of new exporting countries like the United States ("US") into the LNG market. Also the list of importing countries is in flux. China has become the second largest LNG importer overtaking South Korea, European Union is increasing its imports and new EU Member States have become players in the LNG markets (Lithuania and Poland for instance) and so on.
- The LNG world has moved from 11 importing countries for 12 exporting countries in 2000 to 40 importing countries for 19 exporting countries in 2017. Similarly, spot LNG markets have grown exponentially: from 8 spot importers and 6 spot exports in 2000 to 33 end markets and 29 exporting countries (inc re-exports) in 2017.
- Move towards shorter contracts and spot trades, driven partly by the more and more liberalized markets and the emergence of trading platforms for natural gas.

All these developments have also contributed towards both increasing availability of "free" non-committed LNG and growth in liquidity in international LNG markets. In this respect and for the purposes of this article, it is necessary to note that the impact of the entry of US

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exports to liquidity of international LNG markets exceeds its volumetric significance as it has fundamentally changed the targeted structure of contracts used by sellers as well as non-US buyers, most importantly those in Asia. Examples would be 1) the emphasis on Henry Hub as a marker price for gas vs. indexing to oil, 2) the truncation of the term of long-term purchase agreements, 3) the suppression of destination clauses, and 4) the potential for inclusion of client equity positions in the natural gas fields as well as in the LNG liquefaction plants.

While the transition is driven primarily by technological as well as real world market developments, there is a role for lawyers in this transition. Law, regulation and contracts can, and must, support this transition and for their part, move the markets towards increasing efficiency and liquidity. One ongoing project, initiated by European Commission and Japanese Ministry for Economy, Trade and Industry, is a series of workshops intended to foster the development of a global transparent, reliable and liquid LNG market. In the frame of this project, the work of an expert group was supported, resulting in a model diversion clause. The present author drafted the model clause, assisted by the other members of the expert group[2]. The group believes that the model clause can meet the antitrust requirements of both Japan and European Union[3].

This projects has now resulted in contractual provisions that may be used by parties to an LNG sale and purchase transaction. It is designed to be incorporated into a separately negotiated LNG sale and purchase agreement ("LNG SPA"). This model diversion clause and guidance note to accompany the model clause are available at: https://www.ogel.org/legal-and-regulatory-detail.asp?key=21040.

Brief background to the model diversion clause

[2] The model provision for a diversion clause and the related guidance notice was drafted by Professor Kim Talus (Tulane Law School). He was assisted by an international group of legal experts. Members of the group have provided input on both contractual matters relating to LNG contracting and on compliance with recommendations of the JFTC's report and past settlement cases in the EU on geographical restrictions in LNG trade. The expert group consisted of seven members, including Hiroyasu Konno, Peter Roberts, Harry Sullivan, Mark Tudor, Gunnar Steck and James Atkin.

[3] Neither the EU Commission nor METI formally endorses or are in any way bound by the model clause or accompanying explanatory memorandum.

This model "diversion" clause with a profit-sharing element, has been drafted so as to comply with the antitrust laws of European Union ("EU") and Japan.[4] The background rationale is that parties to an LNG sale and purchase agreement ("LNG SPA") may adopt this model clause as a part of their LNG SPA. The model clause is not a standalone clause but requires that it be integrated into a more comprehensive LNG SPA. In particular, this requires that parties include appropriate definitions in the contract and in doing so take the applicable law and its implications into account.[5]

In order to create a model clause that meets the requirements of both legislative systems and guidance from the respective antitrust authorities in EU and Japan, the model clause is designed to meet requirements of both systems. This means that in some details the model clause can be more specific than would be required by the applicable law of just one jurisdiction. It is not the intention of the model clause to restrict the parties' ability to agree on less restrictive terms, as long as these will not violate applicable antitrust laws, if parties so choose. It is also necessary to reiterate that neither European Commission nor Japanese authorities (including the JFTC) formally endorse this model clause nor the accompanying guidance notice.

Antitrust Concerns with Various Destination or Diversion Clauses and Profit-Sharing Mechanisms

This section will now examine the basic antitrust concerns raised by various diversion clauses. The main concern of antitrust authorities in both EU and Japan and the guidance they provide can be summarized as follows:

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[4] In referring to any kind of clause restricting or affecting the buyers right to change the agreed unloading terminal of a cargo, this document talks about "diversion clauses".

[5] An example of this is the concept of "Reasonable and Prudent Operator", which may be interpreted differently under the laws of England than the laws of New York. This needs to be taken into consideration and there is a need to provide a detailed definition in the LNG SPA.

(1) Under FOB contracts, the ownership and the risk over the cargo are transferred to the buyer at the loading port. As such, destination clauses, diversion clauses and profit-sharing mechanisms under FOB LNG SPAs, or where a destination is changed only after title and risk have been transferred to the buyer, may be argued to have anticompetitive effects and, in cases where the EU or Japanese antitrust laws are applicable, are likely to violate the antitrust rules of both EU and Japan.

EU antitrust law prohibits agreements and practices between companies which may affect trade between EU member states and which have the object or effect of preventing, restricting or distorting competition within the internal market. In this context, EU antitrust law views the use of diversion clauses and profit-sharing mechanisms in FOB LNG SPAs as a disincentive for the buyer to divert a cargo from one EU member state to another EU member state, thereby potentially distorting competition within the internal market.

JFTC's anti-trust guidance does not work with the concept of title transfer. Instead it uses the concept of "reasonableness" and "fair necessity" for a seller to restrict a destination change: In general, it allows diversion clauses as long as the buyer's diversion request cannot be unnecessarily or unreasonably withheld by the seller. According to the JFTC, FOB contracts do not provide room for any such reasonable or necessary restriction. Diversion clauses in FOB contracts are therefore highly likely to be anti-competitive.

Another key consideration in this respect is the extra-territorial applicability of the respective laws in international situations where the primary contract relates to cargos from and to third countries and the link to EU or Japan is a diversion by buyer to either EU or Japan, subject to a profit-sharing mechanism. It would appear that the extra-territorial scope of the Japanese antitrust laws would be wider than those of EU.

(2) A DES[6] contract requires a specified delivery destination. However, diversion to an alternative delivery destination can be necessary or desirable. As such, under a DES contract, the requirement of a consent for diversion from the seller is necessary where the seller has title and risk for the LNG cargo up to the designated regasification terminal.

EU antitrust law does not prevent the use of diversion clauses in DES LNG SPAs. Where the LNG is still owned by the seller, the present approach of EU antitrust law is that diversion clauses do not restrict resale. The EU antitrust law would furthermore consider the diversion to amount to a new contractual arrangement.

Japanese antitrust law allows diversion clauses in DES contracts as long as the seller is entitled to reject a diversion request only if it does not meet "requirements of fairly necessity and reasonableness." In DES contracts there is a variety of issues perceptible, that would make a seller's refusal to divert a cargo from its originally agreed destination necessary and reasonable (making vice versa the request not meeting the JFTC's requirements): inter alia operational safety, ship-shore compatibility, or additional costs due to, for example, increased distance without the buyer being willing to mitigate or compensate those. In this sense, the JFTC report explicitly states that a diversion request meets the "requirements of fairly necessity and reasonableness" if (i) "compatibility and safety of a receiving terminal at the destination (ship-shore compatibility) is confirmed"; (ii) "buyer bears all additional costs out of diversion (transportation costs, boil off gas equivalent fees, charter fees, various port charges, insurance fee, etc.)", and (iii) "a seller can correspond to Annual Delivery Program (does not disturb Annual Delivery Program)."

Antitrust Concerns over Profit-sharing Mechanisms

[6] While this document uses DES agreements in its explanations, it needs to be noted that DES term was eliminated from Incoterms 2010 and it has been replaced by 'delivered at terminal' (DAT) terms. In both options, the title and the risk is transferred from the seller to the buyer at unloading port and seller is responsible for shipping costs. LNG contracts of today still usually employ the DES – FOB distinction and do not use the Incoterms DAT terms.

(3) While certain types of profit-sharing clauses can be acceptable, subject to careful analysis, there are specific conditions attached to the profit-sharing clauses that raise antitrust concerns. In this respect both EU and Japanese antitrust authorities have indicated that the following elements, or lack of any provision on the respective element, may raise antitrust concerns:

   a. Excessive part of the profit is allocated to the seller under the contract and this removes or reduces the buyer's incentive for diversion.
   b. Profit allocated to the seller goes beyond the additional costs and risks the seller has accrued due to the diversion.
   c. Contract that does not clearly specify how additional profit is shared raises similar concerns as one allocating an excessive part of the profit to the seller.
   d. The sharing of profit requires that commercially sensitive information is shared.

Based on such considerations, Japanese antitrust laws do not justify profit-sharing, except where the objective of the profit-sharing mechanism is to account for additional unquantifiable costs and risks taken by the seller. Also, the other anti-trust requirements for profit-sharing mechanisms need to be met. As such additional costs and risks cannot be caused by diversion in the context of FOB contracts, diversion clauses and profit-sharing mechanisms in FOB contracts are likely to be considered to be in violation of Japanese antitrust laws. In practice, this leads to the same result as the EU approach.

It is against this background that the model clause should be examined.

Certain Details in Relation to the Proposed Model

The model clause provides for a diversion clause that has been drafted so as to be compatible with the requirements of both Japanese and EU antitrust laws, as they are currently

interpreted. As the Japanese antitrust law is more specific, the model clause draws primarily on the JFTC guidance on the topic.

Key elements of the model clause include:

The model clause provides the parties to the contract with flexibility for the buyer to give notice of a diversion request to the seller. When deciding on the exact time for the notice, the parties need to ensure sufficient time to execute the diversion, considering shipping times to the alternative delivery destination and return of the ship to join the rotation and other similar factors.

While the profit-sharing mechanism should reflect the additional costs and risks incurred by the seller and the buyer due to the diversion, in some instances the quantification of each cost and risk is time consuming and might therefore make the diversion much less likely to take place. In other cases, there can be unquantifiable risks, which are unique to each project. As such, in order to enable the contractual flexibility needed for a timely diversion and in order to increase the liquidity of the international LNG markets, the model clause adopts an approach where the parties to the contract have an option to either quantifying each cost and risk or, alternatively, choose to use a profit-sharing mechanism to encompass these costs and risks, whether known or unknown.
Where the parties opt for the profit-sharing mechanism, the provision on the profit-sharing mechanism provides clarity of the profit-share. The Japanese antitrust guidance notes in this respect that the profit-sharing should be clear from the beginning and that this can be achieved by defining a calculation method and/or a percentage of sharing resale profit in the LNG contract. This model clause has taken an approach where parties agree on a mutually acceptable percentage. In agreeing on the percentage, the parties should keep in mind that the share of the profits allocated to the seller should be premised to cover additional costs and risks the seller has to incur.

Both EU and Japanese antitrust laws also recognize the potentially anticompetitive effect of a requirement to share commercially sensitive information in connection with the diversion or in the details of the profit-sharing. This model clause includes provisions that, in order to be relevant in practice, require exchange of data. The proposed wording aims at ensuring that such data exchange is as much as possible restricted to what is necessary but also that where commercially sensitive information is shared, the confidentiality of such data is preserved. As such, the model clause includes provisions for a third-party expert appointment. It is emphasized that this verification by a third-party expert might not be necessary in all situations.

The model clause also aims to restrict the power of the seller to refuse a requested diversion. To this end, provisions noting that refusal must be based on technical difficulties or pre-existing obligations to third parties have been included in the model clause. Also, an obligation on the seller to provide reasoning for any refusal has been added and this has been combined with a third-party expert mechanism to protect against arbitrary refusals.

The Model Diversion Clause

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 prior to the provision of the Notice of Diversion;

(6) Seller (acting as a Reasonable and Prudent Operator) is satisfied that the Diversion can be carried out in a safe manner; and

(7) performance of the Diversion will not cause the Seller to be in breach of any applicable laws.

3) *In respect of each Diversion, the Parties agree on either a compensation mechanism or a profit-sharing mechanism for the Alternate Unloading Port as contemplated below.*

(1) In the case of a compensation mechanism, it will:

Compensate Seller for all the actual documented net costs (including costs and savings related to transportation, terminal fees, canal transit fees and third-party costs) and risks incurred by Seller to complete such Diversion to the Alternate Unloading Port.

(2) In the case of a Profit-sharing mechanism, it will:

Allocate all net incremental profit, if any, realized by Buyer as a result of the Diversion in a reasonable manner premised on additional risks, both quantifiable and unquantifiable, and costs incurred by the Seller due to the Diversion. Due to the difficulty of precisely quantifying all of the additional

risks and costs incurred by the Seller associated with a Diversion, the parties have agreed to the allocation of net incremental profit on the basis of [ ] percent for Seller and [ ] percent for Buyer, which allocation the parties believe is reasonable in light of the risks associated with a Diversion. Buyer shall no later than [ ] days after Delivery notify Seller as to the net incremental profit realized with the specific Diversion. Should either Party deem it necessary to verify the incremental profit calculation, it shall request that Parties exchange the necessary and appropriate data. The Parties shall agree on third party expert verification of such data so as to protect the confidentiality of the data. All additional costs relating to the third-party verification shall be shared equally by the Parties, except where the auditor concludes that the incremental profit calculation is incorrect in which event the party providing inaccurate information shall bear the costs.

4) Upon Seller's approval of a Diversion, the Alternate Unloading Port in such Diversion shall be considered the Unloading Port for all purposes with respect to such Cargo.

5) *Seller shall not unreasonably withhold or delay its consent for a Diversion. Seller's refusal to consent to a Diversion must be duly reasoned and justified, with the reasoning communicated in writing to Buyer. Should the Buyer deem it necessary to verify data supporting the reasonableness of Seller's refusal to a Diversion, a third-party expert shall be appointed to verify the reasonableness of Seller's refusal to consent. The third-party expert shall keep all Seller's data confidential. All costs relating to the third-party verification shall be borne by the Buyer, except where the third-party expert concludes that the Seller has unreasonably withheld its consent, in which case the Seller shall bear the costs of the third-party expert.*

Concluding note

Finally, it is also necessary to note that the model clause reflects the EU guidance as it can be seen to exist in 2018. It is possible that new developments lead the interpretation of EU

antitrust provisions (Articles 101 and 102 of the Treaty on the Functioning of the European Union) to new directions. The ongoing antitrust investigation to assess whether supply agreements between Qatar Petroleum companies exporting LNG and European importers have hindered the free flow of gas within the European Economic Area (EEA) in breach of EU antitrust rules[7], is an example of developments that may affect the current guidance in these matters. In this case the Commission is investigating whether Qatar Petroleum's long-term agreements (typically 20 or 25 years) for the supply of LNG into the EEA contain direct and/or indirect territorial restrictions. In particular, certain clauses contained in these agreements appear to, directly or indirectly, restrict the EEA importers' freedom to sell the LNG in alternative destinations within the EEA. For example, some contractual clauses prevent any diversion of cargoes to another destination or restrict the territories to which diversion can take place or the volumes that can be diverted. As a result, these clauses may unduly limit the free flow of LNG sold by Qatar Petroleum in the EEA, segmenting the EU's internal gas market.[8] However, at the time of drafting the model diversion clause or writing this article, the impact of this Qatar investigations are not known and therefore not considered as part of the analysis.

The model clause presented and explained in this document is free for contractual parties to adapt as a part of their LNG SPA. While I believe that this clause complies with antitrust requirements of EU and Japan today, care must be taken to ensure that future developments do not change the interpretation of these laws in a way that has an impact on this compliance.

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[7] http://europa.eu/rapid/press-release_IP-18-4239_en.htm.

[8] http://europa.eu/rapid/press-release_IP-18-4239_en.htm.