

Destination Restriction and Profit Sharing Clauses in LNG Supply Contracts

By

Nisha Kaur Uberoi

Partner & National Head, Competition Law Practice

Trilegal

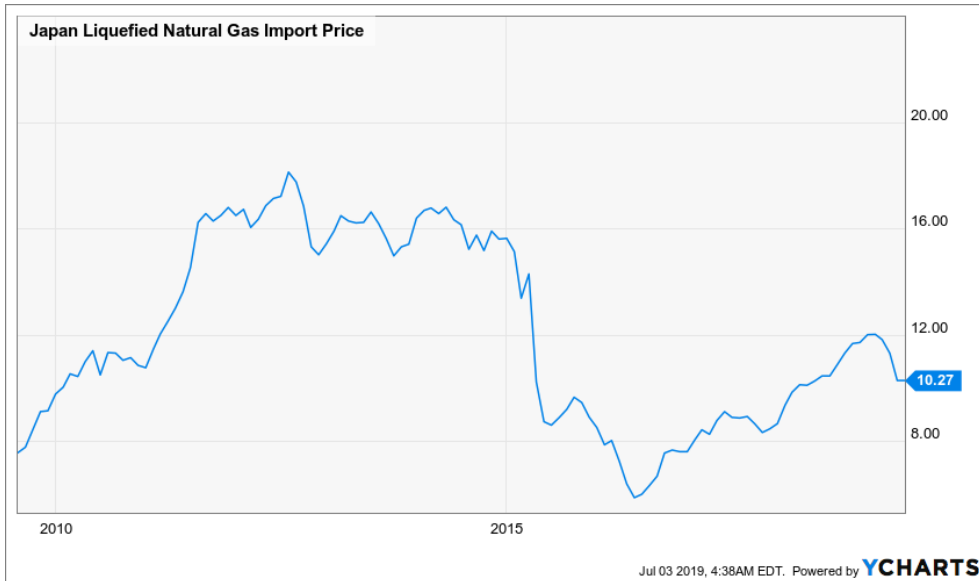
9 July 2019

The Gas Market

The Global Gas Market

- Gas, unlike oil, remains a fractured market, dominated by regional and local forces.
- Only 30 per cent. of gas consumed crosses an international border compared to 70 per cent. for oil.
- Gas is traded through long term contracts, faces higher infrastructure costs and transportation costs.
- Gas market is not integrated, prices can vary between North America, E.U-Africa and Asia.

Gas Market is maturing

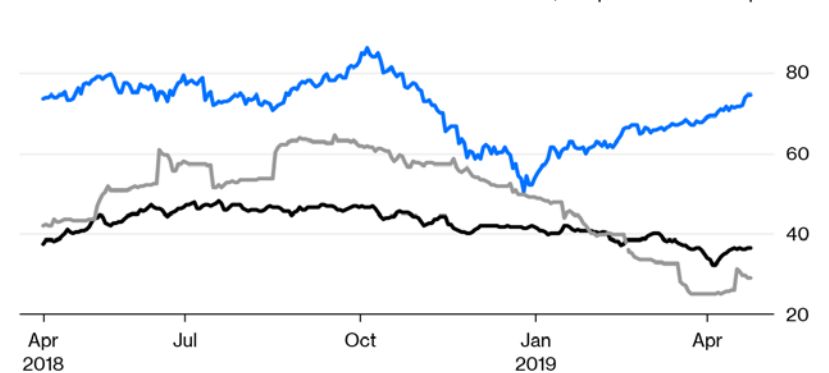


Gas Under Coal

Oil, coal and spot liquefied natural gas prices

/ Brent oil
 / Newcastle coal
 / Japan Korea Marker spot LNG

\$100 per barrel of oil equivalent



Source: Bloomberg calculations of ICE, CME

BloombergOpinion

- There is a considerable push to create a unified global gas market which is lowering prices.
- The liquefied natural gas (LNG) trade is expanding rapidly, connecting hitherto disparate markets.
- The barriers to entry have fallen, leading more countries to import LNG.
- Growing market for buying and selling LNG on a short-term basis, resulting in more flexibility and liquidity.
- Gas prices are set increasingly on their own terms, weakening a historical link to oil.

Indo-Japanese co-operation in the Gas Market

Memorandum of Cooperation on Establishing a Liquid, Flexible and Global Liquefied Natural Gas Market (MOC)

- On October 18, 2017, Mr. Hiroshige Seko, Minister of Economy, Trade and Industry of Japan, and Mr. Debendra Pradhan, Minister of State for Petroleum and Natural Gas of India, signed the MoC
- The MoC aims to expand cooperation between Japan and India to establish a **liquid, flexible and global LNG market**.

MOC (Contd.)

The MoC provides a framework to cooperate in facilitating flexibility in LNG contracts, abolition of Destination Restriction Clause and to explore possibilities of cooperation in establishing reliable LNG spot price indices reflecting true LNG demand and supply

The intention of the parties in the MoC includes:

“accelerate efforts in facilitating more flexible LNG contracts noting that destination restrictions should be abolished”

Glossary of the restrictive clauses

Destination Clauses

- Destination clauses mean clauses that designate a list of unloading terminals as destination ports of LNG ships.

DES Term

- DES term means that the term of delivery that designates the destination port in an importing country as the delivery point. Sellers bear the risk.

FOB Term

- FOB term means the term of delivery that designates the shipment port in an exporting country as the delivery point. Buyers bear the risk.

Diversion Clauses

- Diversion means operational redirect to an alternative unloading terminal, not in the list designated by the destination clauses in a contract.
- Diversion clauses means clauses providing the requirements and the procedure of such diversion.

Profit-sharing Clauses

- Profit-sharing clauses mean those that impose an obligation on buyers to share a part of resale profit with sellers when a buyer resells LNG to third parties by means of diversion.

Take-or-pay Clauses

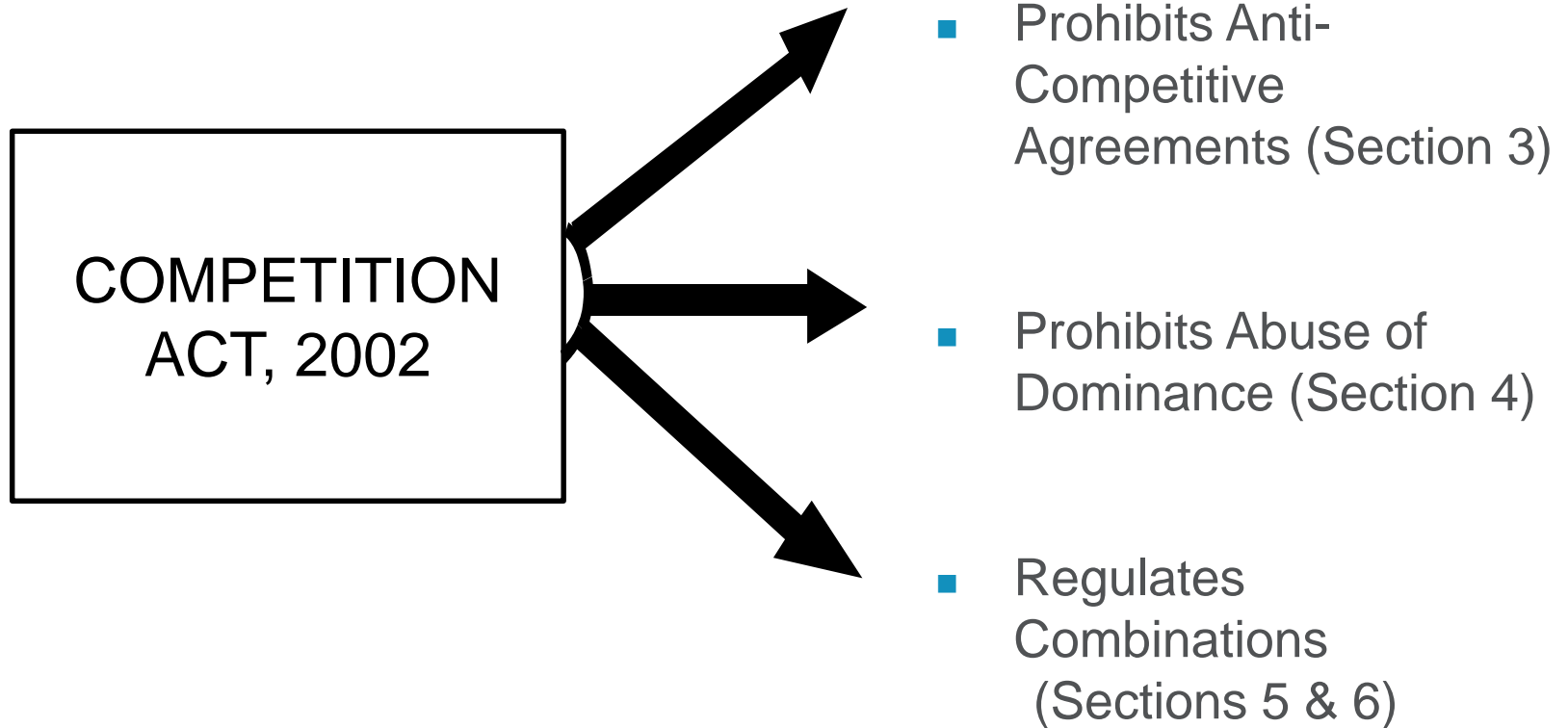
- Found in fixed-term contracts, take-or-pay clauses impose an obligation to pay for all the contracted volume, including the volume buyers do not actually receive.

Indian Competition Act, 2002

Competition Act, 2002 – An Introduction

Adjudicating authority:	Competition Commission of India (“ CCI ”)
Investigating authority:	Director General (“ DG ”)
Appeals from CCI	National Company Law Appellate Tribunal (“ NCLAT ”)
Appeals from the NCLAT	Supreme Court of India (“ Supreme Court ”)

Scheme of the Act



Anti-Competitive Agreements (Section 3)

Vertical Agreements: Section 3(4)

- Entered into by enterprises operating at different levels of the production and distribution chain in different markets
- Agreements with distributors/ customers etc., which includes:
 - Exclusive Distribution Agreements
 - Exclusive Supply Agreements
 - Tie-in Arrangements
 - Refusal to deal
 - Resale price maintenance
 - (List of agreements is not exhaustive)
- Vertical agreements causing an appreciable adverse effect on competition in India (AAEC) void.
- CCI is required to establish that the vertical restriction causes or is likely to cause an AAEC in India

Exclusive Distribution Agreement

‘Exclusive Distribution Agreement’ has been defined to include any agreement to limit, restrict or withhold the output or supply of any goods or allocate any area or market for the disposal or sale of the goods.

Destination restriction clauses may, in certain scenarios, contravene Section 3(4) of the Competition Act, 2002 if it causes or is likely to cause an appreciable adverse effect on competition in India

AAEC is likely if the market share of the seller in the upstream market for supply of LNG in India is typically more than 15% (no market share threshold specified under the laws)

Destination Restrictions (FOB Terms)

Destination restrictions in LNG supply contracts on FOB terms may violate the competition laws if such clause causes or is likely to cause an AAEC in India

Restricting or limiting the purchaser's resale ability, i.e., the ability to sell the LNG/gas after the purchaser acquires ownership and assumes all risk at the port of shipment may be considered to be anti-competitive

Case by case analysis will be required to determine whether AAEC

JFTC's View: These restrictions are neither necessary nor reasonable. Since liabilities and title have already been passed to buyer at the loading port, it would be difficult to justify an FOB contract provision that requires LNG to be unloaded at only certain designated terminals.

Destination Restrictions (DES Terms)

Destination restrictions in LNG supply contracts on DES terms are unlikely to violate the competition laws

Considering that the title and risk of the goods during transportation till the destination port rests with the seller, such destination restrictions are justifiable

Pursuant to transfer of title to the purchaser, there should not be an restriction in the resale ability of the purchaser

JFTC's View: In line with the view stated above.

Profit Sharing Clauses

Profit sharing clause in contracts with FOB delivery terms may raise concerns under the competition laws as it restricts the resale ability of the purchaser

Destination restrictions in LNG supply contracts with DES delivery terms are unlikely to raise concerns under the competition laws

A profit sharing clause in supply contracts with DES delivery terms will be considered as a compensation for the seller in case of any diversion mutually agreed by the parties

JFTC's View: In line with the view stated above.

Abuse of Dominance (Section 4)

Abuse of Dominant Position

Section 4(2)(a)(i) provides that there shall be an **abuse of a dominant position** by an enterprise or group:

- (a) Directly or indirectly, **imposes unfair** or discriminatory -
- (i) **Condition** in purchase or sale of goods or services.

Imposition of ‘destination clauses’ and ‘profit sharing clauses’ in supply contracts on FOB delivery terms by a dominant LNG supplier are likely to be held to amount to abuse of dominant position as it unfairly restricts the resale ability of the buyer

Profit Sharing clauses in contracts with a dominant LNG supplier

Even though profit sharing clauses in LNG supply contracts with DES delivery terms are unlikely to violate the competition laws, however, such clauses should be fair and reasonable.

- Share of the profits allocated to seller should not be excessive but adequate to compensate the seller for the additional costs and risks in case of diversion
- Profit sharing clause should be fair and clearly set out without ambiguity or uncertainty
- The buyer should not be forced to share commercially price sensitive information
- The profit sharing clause should be applied consistently without any discrimination among the Indian buyers

Take or Pay Clauses

While adjudicating a matter between state owned gas supplier GAIL to industrial customers, the CCI noted that the suppliers are in fact bound to these long terms contracts and are forced into enter into one-sided contracts as their margins selling imported gas from RasGas is very limited.

The CCI ruled in favour of the Gas supplier (who imports the gas) against the industrial customers, not being convinced that there was supra-normal profits being made by the supplier and the industrial customers have several other suppliers to choose from.

The CCI considered the views of US Supreme Court and the EU AND stated: *“The long-term ‘Take or Pay’ contracts are considered the key risk covering mechanism in natural gas trade and have been traditionally viewed as essential for security of steady supply.”*

JFTC’s View: Take-or-Pay clauses guarantee sustainable and full payment from LNG users/buyers, which is imperative to any LNG project investment decision. They are not themselves problematic, and the relative bargaining power of the LNG buyer and seller on a case-by-case basis must be analysed. .

Extra Territorial Jurisdiction of the CCI

- Section 32 provides that the CCI shall have extra-territorial jurisdiction to inquire into agreements or abuse of dominant position if such agreement/conduct causes or is likely to cause an AAEC in the relevant market in India, notwithstanding:
 - The agreement was entered into outside India.
 - Any party to such an agreement is outside India.
 - Any party abusing its dominant position is outside India.

Thank You

nishakaur.uberoid@trilegal.com

Partner & National Head, Competition Law Practice

TRILEGAL

+91 – 91671 27599