As efforts to liberalise Asia's gas markets make for a more competitive arena, **WilmerHale** counsel **Sabrina Lee** examines disputes that may arise relating to pricing formulas under long-term supply contracts

Asia: The new battleground for gas price reviews?

The Asia-Pacific region is the largest importer of liquefied natural gas (LNG), comprising 53.6% of global supply in 2016. Japan is the world's largest LNG importer (83.3MT imported in 2016), followed by South Korea (33.7MT in 2016).

Given the high volume of imports, it is highly likely that LNG-related disputes will arise because Asian gas markets are undergoing a similar transition to the one European gas markets went through over the past two decades, which triggered significant numbers of gas price reviews. There is therefore reason to believe that the European experience with gas price reviews may be repeated in Asia over the coming years.

The European experience

The majority of gas sold to European buyers is sold through long-term supply contracts with take-or-pay obligations that require the buyer to pay for an agreed volume of gas. Until recently, the prices under most of those contracts were indexed to the prices of alternative fuels (usually oil prices), and most contracts include a price review clause, allowing parties to seek revision of the pricing formulae at periodic intervals (for example, every three years) in certain circumstances as specified in the contract.

There have been a large number of gas price review arbitrations relating to long-term supply contracts to Europe, particularly in the last 10 years. A number of factors led to these disputes, a few of which are discussed below:

- **gas markets** in European Union (EU) member states were liberalised to introduce more competition. Before liberalisation, there were no competing sources of gas in most markets, and gas therefore was competing with other fuels. This changed after liberalisation, when gas importers began to compete to gain market share, and there was increasing gas-to-gas competition.
- **gas hubs**, trading points where gas is purchased and sold, were developed in Europe and began to mature. By the end of the 2000s, there were significant trading volumes and transparent pricing on several gas hubs in Europe, such that some parties began to regard hub prices to be reliable and liquid.

Liberalisation and the development of gas hubs, along with other factors, led to what many refer to as a 'decoupling' of oil and gas prices, which prompted many buyers to request price reviews in an effort to change pricing formulas in their contracts to incorporate gas prices.

- **buyers of LNG** increasingly sought to take advantage of the ability to transport LNG to other markets, by selling LNG cargoes to markets outside their home markets. This could be achieved, for example, through the use of diversions (where cargoes that were initially bound for the buyer's home market were diverted to alternative destinations) or by re-exporting gas that had already arrived in the buyer's home port by loading gas onto ships bound for destinations outside the buyer's home market. European buyers were able to undertake such activities in part because, following several investigations by the European Commission, destination restriction clauses were no longer used in contracts with European buyers.

LNG contracts in Asia

Many of the key gas markets in Asia, including Japan, Korea and Taiwan, are supplied through LNG, as they lack access to pipeline gas and have limited domestic gas production. LNG contracts involving Asian buyers resemble in many respects the gas contracts found in Europe. Like in Europe, the majority of LNG sold to Asian buyers is sold pursuant to long-term supply contracts with take-or-pay obligations. Prior to 2010, these contracts were mostly oil-indexed and priced to Japanese Crude Cocktail (JCC).

Unlike in Europe, price review clauses were not included in most long-term LNG contracts in Asia until the 1990s. Since then, contracts with Japanese buyers have generally included price review clauses providing for periodic reviews (typically every five years).

Asian long-term LNG supply contracts have also typically included destination clauses, particularly in Japan, Korea and Taiwan. Buyers in these countries were willing to accept destination clauses because their primary consideration was ensuring secure LNG supplies for their countries, which was of the utmost importance given Japan, Korea and Taiwan's near-total dependence on imported LNG. Buyers were less concerned with ensuring that they had flexibility to sell LNG to other markets.

The future of Asian price disputes

The lack of price review clauses in some older Asian LNG contracts limits the pool of contracts on which price reviews may be sought. In this respect, the situation in Asia is somewhat different from the situation in Europe. However, there is still a sizeable pool of more recent Asian contracts that do include price review clauses. Gas price reviews relating to these contracts may arise over the coming years, as the Asian gas markets become more competitive, with liquid market prices, just as the European gas markets have done.

First, there is a move in some Asian countries towards liberalisation of their gas markets, similar to that which took place in the European Union over the course of the first decade of the 2000s. Most notable of these is Japan, which has set a timetable for liberalisation of its gas market. Many of the milestones set by the government have already been achieved. These include the passage of legislation in 2015 liberalising the Japanese wholesale gas market and reinforcing access rights to LNG terminals and pipelines. That was followed in 2017 with liberalisation of the gas retail market and legislation mandating access to LNG terminals for third parties. In April 2020, legislation is expected to be passed that will separate pipeline operations from supply.

Similar efforts to liberalise the gas markets in Korea and China are also underway. Korea has announced that, beginning in 2025, third parties will be allowed to import their own LNG independently of the current monopoly distributor **Korean Gas Corp.** (KOGAS). China is also in the midst of efforts to liberalise its gas market.

Liberalisation of these Asian gas markets will introduce or increase competition in these markets, including introducing gas-to-gas competition, where previously only gas-to-alternative-fuel (such as oil) competition existed. That may prompt buyers to request price reviews in an effort to change the pricing formulas in contracts currently priced to oil products.

Second, the continuing development of gas hubs in Asia may eventually result in liquid gas hubs similar to those found in Europe. Several countries in Asia are actively encouraging the development of gas hubs: for example, the Japanese Ministry of Economy, Trade and Industry published in May 2016 a strategy setting out a roadmap to create an LNG hub in the early 2020s. Meanwhile, many commentators believe that Singapore is likely to have the first gas hub in Asia. While gas hubs in Asia are not yet liquid enough to be reliable benchmarks, some commentators believe that an Asian hub with sufficient liquidity to become a credible price reference for Asian LNG trade is likely to emerge in the next five to 10 years.

As happened in Europe, the emergence of liquid gas hubs in Asia may prompt Asian buyers to seek price reviews to change from oil-indexed pricing formulas to formulas incorporating gas prices. This can be done by, for example, indexing to gas hub prices. Already, some Asian buyers have signed agreements for LNG supplied from the US which is indexed to **Henry Hub** prices. Alternatively, buyers may seek to base price formulas on published spot price indices such as JKM (the Japan/Korea marker from **Platts**), if they become sufficiently liquid. Such spot price indices have already begun to be used in some short-term and medium-term agreements, although it does not yet appear that they are being used in long-term agreements.

Third, many commentators anticipate that there will be a surplus of LNG supply in Asia in the coming years, at the same time that gas demand is slowing. As a result, Asian LNG

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buyers in Japan and South Korea are potentially overcommitted in the near term, and they may be looking for opportunities to sell those excess volumes in markets other than their home markets. Such activities may give rise to disputes with suppliers, who may wish to revise the pricing formulae to reflect prices in those new destination markets.

While some Asian buyers are prohibited from engaging in such activities by the destination clauses in their contracts, such destination clauses may be gradually phased out of Asian contracts in the future (or, alternatively, terms may be added to contracts giving the buyer additional flexibility, such as clauses permitting the buyer to engage in a certain number of diversions to certain specified markets).

Indeed, the **Japan Fair Trade Commission** has recently stated that it is "highly likely" that destination restriction clauses are anti-competitive, and it concluded that such clauses should not be included in new LNG contracts. It also advised parties to existing contracts to "review competition-restraining business practices which lead to restrictions of resale".

This has been interpreted by many as a call for parties to review and potentially re-negotiate the destination restrictions in their existing contracts. It therefore seems likely that, going forward, destination restriction clauses may disappear even from existing contracts with Japanese buyers, thereby freeing them to sell their excess LNG volumes to markets other than their home markets. Such efforts, as noted above, may lead to disputes as suppliers seek to revise the pricing formula under the contract to match prices in those new markets.

Conclusion

The Asian gas markets are in the midst of a transition that mirrors that taken by Europe. There are therefore good reasons to anticipate a wave of gas price review disputes in Asia similar to those that have taken place in Europe. It remains to be seen whether those disputes will result in litigation or arbitration. Many commentators have noted that traditionally, Asian parties have had a strong preference to mediate or negotiate, instead of engaging in litigation or arbitration. However, this may be changing, as shown by KOGAS' recent commencement of an arbitration against its Australian supplier, which is the first public arbitration relating to an Asian LNG contract. The outcome of this dispute could set an important precedent and prompt other Asian parties to seek contractual renegotiations and price reviews.

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