GAS AND LNG: TERRITORIAL RESTRICTIONS, DESTINATION CLAUSES AND PROFIT SHARE MECHANISMS

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A note reviewing the application of EU competition law to the use of territorial restrictions, destination clauses and profit sharing mechanisms in gas and liquefied natural gas (LNG) supply contracts. The note considers the implications of the European Commission's enforcement of competition regulations for companies wishing to enter into gas and LNG supply agreements.

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SCOPE OF THIS NOTE

The European Commission (Commission) has long maintained an interest in territorial restrictions or "destination clauses" that prevent a wholesale buyer of gas from selling the gas outside a specific geographic area.

The Commission has also raised concerns that certain forms of profit-sharing mechanisms (PSMs) (where the buyer must share a proportion of the profit with the supplier if the gas is sold to a customer outside the agreed territory or for another purpose) may infringe EU competition law.

The Commission has concluded various settlements and understandings with companies in the gas sector requiring them to remove territorial and equivalent restrictions from their supply arrangements.

With renewed interest, and echoing themes in previous investigations, in July 2018 the Commission opened a formal investigation into whether supply agreements between Qatar Petroleum companies and European importers restrict the free flow of liquefied natural gas (LNG) throughout the EEA (see *Legal update: Commission opens investigation into Qatar Petroleum supply agreements*). The investigation follows the Commission's *Gazprom* decision in which it secured binding commitments in relation to the distribution of gas in Central and Eastern Europe (CEE).

Against this background, this note:

- Sets in its legal and policy context the EU competition law and regulatory treatment of territorial restrictions, destination clauses and PSMs in gas and LNG supply arrangements.
- Identifies the implications of the Commission's enforcement practice for concluding gas and LNG supply agreements.

TREATMENT OF RESTRICTIVE BUSINESS PRACTICES IN THE GAS AND LNG SECTOR UNDER EU COMPETITION LAW

EU regulatory and policy background

EU competition law and territorial restrictions

The Commission has traditionally treated territorial restrictions and destination clauses as "hardcore restrictions" in vertical arrangements between a producer and a buyer. This thinking informs the Commission's Vertical Restraints Block Exemption (*Regulation 330/2010*), where the inclusion of such a provision would prevent the "safe harbour" in the block exemption applying. The inclusion of a hardcore restriction in an agreement would prevent the block exemption applying meaning that the agreement would need to be "self-assessed" for compliance with competition law. However, hardcore restrictions such as territorial restrictions would be justifiable in limited circumstances.

Specifically, the following is considered a hardcore restriction of EU competition law:

> "the restriction of the territory into which, or of the customers to whom, a buyer party to the agreement, without prejudice to a restriction on its place of establishment, may sell the contract goods or services" (*Article 4(b), Vertical Restraints Block Exemption*).

There are some exceptions.

For more information, see *Practice note, EU Vertical agreements.*

EU energy liberalisation

The Commission's thinking on territorial and similar restrictions is influenced by the principle of the single market imperative and ongoing liberalisation of a borderless EU energy market.

EU energy sector inquiry

The Commission's Energy Sector Inquiry identified a number of practices which it considered indicated that the EU gas markets were not functioning as well as they should. The Final Report was published in January 2007 (see *Legal update, Commission publishes final report on energy sector inquiry*). Given the Commission's evident hostile stance to restrictions on territory, use and destination, it can be assumed that the Commission would be prepared to sanction serious infringements with fines in appropriate cases in the future.

Destination clauses

Destination clauses have been criticised by the Commission as market partitioning mechanisms to the extent that they forbid or discourage the buyer from selling outside the traditional or allocated territories.

There need not be an overt ban on selling outside a specific EU territory or territories for the arrangement to infringe EU competition law. Any provision which has the effect of discouraging buyers from selling gas to customers in other EU markets would be considered an implicit territorial restriction.

Profit-sharing mechanisms

PSMs are mechanisms which oblige the buyer to pass over to the producer a share of the profits made when selling outside the traditional destination provided for in the contract.

While overt territorial restrictions are generally considered to be hardcore restrictions, PSMs require a more complex analysis of their effect in practice. The Commission has been concerned about this type of clause where its effect is tantamount to a territorial restriction because it discourages the buyer selling outside the traditional destination.

PSMs take various forms. A distinction can be made between:

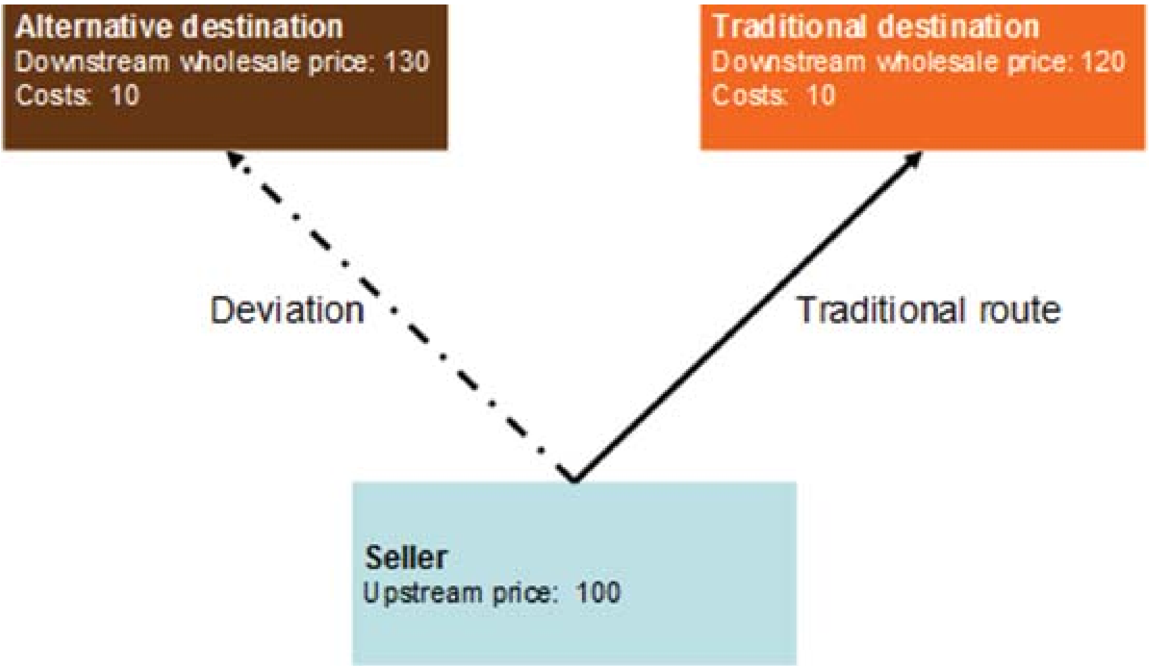
- **Raw profit share.** Splits between the supplier and the buyer the entire difference between the upstream price and the price obtained by the buyer when reselling in an alternative destination.
- **Net profit share.** Splits the incremental profits to be made by the buyer when reselling in the alternative destination **after deduction of costs** associated with delivery of gas to the alternative destination.

The difference between raw PSM and net PSM can have significant effects on the incentives of the buyer to change the destination of the cargo, as illustrated in *Example of raw and net profit share mechanisms* below.

Commentators have suggested that net PSMs should not be viewed as anti-competitive, since they do not deter the buyer from selling into an alternative destination as the buyer will always tend to make a positive margin from diverting the gas (see *Profit splitting mechanisms in a liberalised gas market: the devil lies in the detail, Competition Policy Newsletter, Spring 2005*).

However, recent case experience of the Commission suggests that the Commission draws no such distinction (see *Review of EU case law on territorial restrictions and profit-sharing in the gas sector*).

Example of raw and net profit share mechanisms



Source: Based on illustrative schema in *Profit splitting mechanisms in a liberalised gas market: the devil lies in the detail, Competition Policy Newsletter, Spring 2005.*

Assuming that the PSM provides for a 50:50 share between the seller and the buyer, the difference in the effects of raw and net PSMs are as follows:

- **Raw PSM:** in the alternative destination, the difference in the final price (130) and the initial price (100) is 30, so the seller gets 15 (30/2). The buyer gets 5 (after initial costs of 10 are deducted). This compares with the buyer's realisable margin of 10 in the traditional destination (120 - 100 -10).
- **Net PSM:** the incremental profit as a result of the deviation is 10 (a margin of 20 in the alternative destination compared to only 10 in the traditional destination after costs are deducted). The application of the net PSM leaves the buyer with a profit of 15 when selling in the alternative destination (20 less 5 given to the seller as representing 50% of the incremental profit from selling in the alternative destination).

STATE OF PLAY: REVIEW OF CASE EXPERIENCE

Gas and LNG contracts containing territorial restrictions concluded with external producers and EU importers have been closely examined by the Commission. Some of these cases have been closed once the parties agreed to delete territorial restrictions and comparable provisions.

For a review of key cases see *Review of EU case law on territorial restrictions and profit-sharing in the gas sector.*

A question arises as to whether PSMs or similar provisions could ever be allowed in gas or LNG contracts. An example concerns discussions with Sonatrach and the Algerian government when Sonatrach wanted to replace territorial restrictions with PSMs (see *Commission and Algeria reach agreement on territorial restrictions and alternative clauses in gas supply contracts*).

Commission and Algeria reach agreement on territorial restrictions and alternative clauses in gas supply contracts

A common understanding was reached between the Commission and the Algerian government as follows:

- Deletion of territorial restriction from all existing contracts and no insertion in future contracts.
- PSMs only to be applied in LNG contracts under which the title of the gas remains with the seller until the ship is unloaded (in practice, sales under "delivered ex-ship" terms (for more detail, see *Incoterms: DES*)). Consequently, Sonatrach was understood to be transforming its existing FOB and CIF LNG contracts to sales under DES terms.
- No PSMs in future LNG contracts under which the title of the gas passes to the purchaser at the port of loading (in practice, sales under FOB and CIF terms).
- No PSMs in existing or future pipeline gas supply contracts.

Regarding pipeline gas, the case does not contain anything new.

Regarding LNG, there are some interesting points. It had previously been thought that PSMs in both CIF and DES LNG supply agreements would tend not to infringe EU competition law on the basis that both involve the supplier arranging shipment to a named destination and any destination deviation involves mutual agreement to amend the contract. However, the understanding with the Algerian government appears to suggest that the key consideration is the transfer of title rather than the responsibility for shipment. It is worth noting that DES was a trade term that required a seller to deliver goods to a buyer at an agreed port of arrival and assume the full cost and risk involved in getting the goods to that point. Now that DES terms have been removed from the 2010 version of Incoterms it remains to be considered how relevant this distinction is in today's commercial environment. It is suggested that a similar reasoning could apply to contracts on *DAT* or *DAP* terms or in other arrangements where the seller bears the risk up to the point of delivery to the buyer's destination.

For more detail, see *EC: Commission and Algeria reach agreement on territorial restrictions and alternative clauses in gas supply contracts (11 July 2007).*

OTHER CONTRACTUAL AND COMMERCIAL CONSIDERATIONS

The practical operation of PSMs and other clauses in gas and LNG supply contracts may raise indirect effects which need to be scrutinised for competition law purposes.

Information and cost sharing

- An application of a PSM could present a risk of sharing confidential information between actual or potential competitors. This would be the case where the price offered by the buyer to its final customers is used for computing the profit to be shared by the parties.
- The passing of commercially sensitive information between competitors in the context of such arrangements should be examined for competition law compliance.

Construction of contracts

- It is important that the contractual terms are sufficiently clear with regard to costs determination and comparators when calculating the profit share. If there is a lack of clarity on the obligations of the parties, the arrangements may tend to have the effect of obliging the buyer to seek permission before any transaction is entered into outside the traditional destination. The risk is that such ambiguity may operate to restrict competition in the same way as a blatant territorial restriction.

Long-term contracts

- While the Commission has taken a hard line towards territorial restrictions and provisions having a similar effect, there is a recognition of the need to support long-term contracts in the gas sector given the risks involved and security of supply considerations. However, given the risks involved any gas producer or buyer will want to assess the duration and terms of their long-term contracts for compatibility with EU competition law.

WHEN MIGHT A DESTINATION CLAUSE OR PSM BREACH COMPETITION LAW?

The Commission maintains a tough stance towards territorial restrictions and other more sophisticated risk and reward sharing provisions where these have the object or effect of partitioning EU markets.

Case law to date suggests that infringements will be almost certain in the case of the equivalent to FOB and CIF arrangements, but that LNG supply arrangements where risk/title passes to the buyer at the agreed destination could be structured to avoid a competition law violation. However, this needs to be seen in the context of the overall framework of EU competition law which triumphs **substance** over **form**. Accordingly, whether the arrangements in fact appreciably restrict competition requires a detailed analysis of the contractual mechanisms and the incentives on the buyer to sell outside the traditional destination.

REVIEW OF EU CASE LAW ON TERRITORIAL RESTRICTIONS AND PROFIT-SHARING IN THE GAS SECTOR

Case report/date	Parties	Case summary
24 May 2018 *Antitrust: Commission imposes binding obligations on Gazprom to enable free flow of gas at competitive prices in Central and Eastern European gas markets (IP/18/3921)*	Gazprom	The final commitments require Gazprom to remove any restrictions placed on customers to resell gas cross-border. In addition: • Gazprom must enable gas flows to and from parts of the CEE member states that are still isolated from other member states due to the lack of interconnectors. • Relevant Gazprom customers are given an effective tool to make sure their gas price reflects the price level in competitive Western European gas markets, especially at liquid gas hubs. • Gazprom cannot act on any advantages concerning gas infrastructure, which it may have obtained from customers by having leveraged its market position in gas supply. For more information, see *CaseTracker, Gazprom* and *Legal update, Commission decides to accept binding commitments given by Gazprom to address concerns about abuse of dominance in wholesale gas supplies in Central and Eastern Europe.*
11 July 2007 *Commission and Algeria reach agreement on territorial restrictions and alternative clauses in gas supply contracts (IP/07/1074)*	Algerian government and Sonatrach	The common understanding reached between the Commission and the Algerian government is summarised in the Commission's press release as follows: • Deletion of territorial restriction from all existing contracts and no insertion in future contracts. • PSMs only to be applied in LNG contracts under which the title of the gas remains with the seller until the ship is unloaded (in practice, sales under DES terms). • No PSMs in future LNG contracts under which the title of the gas passes to the purchaser at the port of loading (in practice, for sales under FOB and CIF terms). • No PSMs in existing or future pipeline gas supply contracts. For more information, see *CaseTracker, Sonatrach.*
26 October 2004 *Commission confirms that territorial restriction clauses in the gas sector restrict competition (IP/04/1310)*	GDF and ENI GDF and ENEL	The Commission confirmed by two formal decisions (the first on this subject in the gas sector) that territorial restriction clauses infringe Article 101 of the Treaty on the Functioning of the EU. The clauses in question were contained in two contracts: • The GDF-ENI contract concerned the transportation of natural gas purchased by ENI in northern Europe. GDF transported the natural gas across French territory to the border with Switzerland. The contract contained a clause obliging ENI to market the gas exclusively "downstream of the redelivery point", that is, after leaving France. • The GDF-ENEL contract concerned the swap of LNG purchased by ENEL in Nigeria. It contained a clause which required ENEL to use the gas only in Italy. Although the parties terminated the infringements when the Commission issued its decision, the Commission thought it useful to confirm that the two clauses as originally drafted restricted the territory into which the parties could use the gas and were aimed to partition national markets in the EU. For more information, see *CaseTracker, Gaz de France/ENI/ENEL.*

Case report/date	Parties	Case summary
10 June 2005 *Competition: Commission secures improvements to gas supply contracts between OMV and Gazprom (IP/05/195)*	Gazprom and E.ON Ruhrgas	The parties committed that: • Ruhrgas will no longer be contractually prevented from reselling outside Germany the gas it buys from Gazprom. • Gazprom will no longer be bound by a "most favoured customer" provision with Ruhrgas. For more information, see *Legal update, Territorial restrictions: E.ON Ruhrgas/Gazprom.*
17 February 2005 *IP/05/195 (Competition: Commission secures improvements to gas supply contracts between OMV and Gazprom)]*	Gazprom and OMV	The Commission reached a settlement with Austrian oil and gas company OMV on similar terms to the Gazprom/ENI settlement of 6 October 2003. For more information, see *Legal update: archive, Territorial restrictions: OMV/Gazprom.*
6 October 2003 *Commission reaches breakthrough with Gazprom and ENI on territorial restriction clauses (IP/03/1345)*	Gazprom and ENI	The parties agreed to: • Delete the territorial sales restrictions imposed on ENI from all existing gas supply contracts. • Increase the delivery points for Russian gas from one to two. • Allow ENI to take gas to destinations of its choice. • Refrain from introducing the contested clauses or clauses with similar effect in new supply contracts. • Delete a consent clause in the contract obliging Gazprom to obtain ENI's consent when selling gas to other customers in Italy. In addition, ENI agreed to offer significant gas volumes to customers located outside Italy for five years and to promote third party access to its TAG pipeline. For more information, see *CaseTracker, Gazprom/ENI* and *Legal update, Territorial restrictions: Gazprom/ENI.*
12 December 2002 *Commission settles investigation into territorial sales restrictions with Nigerian gas company NLNG (IP/02/1869)*	NLNG and ENEL	NLNG committed: • To delete a territorial sales restriction which prevented its customer (ENEL) from reselling the gas outside Italy. • To not introduce territorial restriction clauses or use such restrictions in its future supply contracts. That none of its existing gas supply contracts contained PSMs affecting the EU and that it would not introduce such mechanisms in the future.
17 July 2002 *Commission successfully settles GFU case with Norwegian gas producers (IP/02/1084)*	Statoil and Norsk Hydro	Although not being part of the GFU case (COMP 36.702), which was the subject of the Commission's inquiry, when the Commission concluded its inquiry Statoil and Norsk Hydro confirmed that they would not introduce territorial sales restrictions or use restrictions in their gas supply contracts. Both types of clauses were considered by the Commission to be incompatible with EU competition law as they prevented the creation of a single market. The Commission stated that it welcomed Statoil and Norsk Hydro's position as it "demonstrates that gas can indeed be marketed in the Community without these anti-competitive clauses".