

Splitting hairs? Profit-sharing mechanisms in gas contracts under EC Competition Law

Leigh Hancher^(*)

University of Tilburg, the Netherlands,
Allen & Overy, WRR,
Member Academic Council EEI

Key words: gas, LNG, competition, long-term contracts, price or profit-sharing clauses, exchange of information

^(*) Prof. Dr. Leigh Hancher (Kilbarchan, Scotland, 1956) studied law at the universities of Glasgow and Sheffield. In 1989 she obtained her doctorate (cum laude) at the University of Leiden, the Netherlands, with a thesis on "Regulations for competition: government, law and the pharmaceutical industry in the United Kingdom and France". She is Professor of European Law at the University of Tilburg, the Netherlands and Of Counsel to Allen & Overy, Amsterdam.

Previously, from 1988 till 1991, she was part of the academic staff at the University of Leiden. From 1991-1997 she was professor European Law in the Erasmus University Rotterdam. In 1996 she was visiting professor "natural resources law" in the University of Calgary, Canada. Between 1997 and 1999 she was Head of Legal Services at the Energy Charter Secretariat, Brussels. Furthermore, on a regular basis, she gives lectures abroad, amongst others at the University of Leuven, University of Stockholm and the European Academy Trier. She also lectures at various Dutch universities. She gained broad experience in matters relating to competition notifications to the European Commission and national regulatory authorities and advising on state aid complaints to the European Commission. Her expertise is in the changing role of the government at stimulating the liberalization of traditionally heavy regulated sectors.

Leigh.Hancher@Amsterdam.AllenOvery.com

1. Introduction

In this short article I will focus on the potential competition law risks posed by various types of profit splitting mechanism clauses and the potential competition law risks associated with the drafting and enforcement of such clauses, and in particular the possible risks attached to any sharing of sensitive commercial information. These types of clauses are not uncommon in long-term LNG contracts. LNG is of course transported over long distances by ships, from a liquefaction plant to a re-gasification terminal. Profit-splitting mechanisms could however also be – and indeed have been – applied to pipeline sales. LNG transport permits greater flexibility as regards delivery – a cargo can easily be diverted to a more attractive market before it reaches its destination. Further it is easier to monitor the destination of the cargo whereas pipeline gas is often impossible to track to a final destination once the gas has been delivered. Hence sellers may attempt to maximise their returns on sales of LNG to different markets by incorporating some form of profit sharing mechanisms into their contracts in order to benefit from the proceeds of any diversion of the cargo to a higher priced market elsewhere in the European Union.

Although this type of arrangement may make commercial sense for the seller, and indeed the seller's financial backers, seeking to maximise the returns on their investments, profit-splitting and price-sharing clauses can raise concerns under European competition law. In particular both the Commission and the European Courts have been concerned that any types of contracts may amount to a restriction on resale could either divide or partition the various national markets, thus frustrating the objective of ensuring undistorted competition throughout the internal market. Furthermore, European competition law has traditionally taken a tough line on resale price maintenance restrictions – contractual clauses that require a buyer to impose a certain price in its own contracts with customers further down the contractual chain. In both cases, clauses which partition markets or impose different prices for different territories, are usually deemed to be hard-core restrictions.¹ However not every measure impeding sales outside one market infringes competition rules. The Commission has also recognised that it may be justified to grant special rebates to distributors when they sell into another market if the rebate is granted in return for additional efforts to sell the product into a new territory, which is less developed, for example. It is recognised that this type of rebate does not

¹ See the Commission's Guidelines on Vertical Restrictions. O.J. 2000, C291/1 paragraphs 34 and 49.

have as its object the restriction of trade but rather its promotion. In accordance with the more economics-based analysis of European competition law it is always necessary to analyse the alleged restrictive clauses in the light of the underlying facts and circumstances in order to determine their objective purpose.²

2. Background

The European Commission's Directorate for Competition has recently turned its attention to profit sharing or profit-pass over clauses and price splitting mechanisms in long term LNG supply contracts. The Commission has indicated in a number of press releases and articles published in its Competition Policy Newsletter as well as in contributions by Commission officials to academic publications that it views certain types of profit-sharing mechanisms with suspicion. In an article of the Competition Policy Newsletter two Commission officials from the unit in DG-Competition specialising in energy matters stated that the starting point of the Commission's analysis is to regard these types of clauses as likely to infringe Community anti-trust law.³ The authors based their opinion on the Commission's standpoint in the (unpublished) Nigerian LNG case of 2002 where it is stated it has ensured that such clauses would not be inserted into contracts.⁴

The rather bold statement that profit sharing clauses are likely to infringe Article 81(1) EC on the prohibition of restrictive agreements and practices should perhaps be seen in the context of the case in question. The Commission's primary concern had been to ensure that this mechanism does not allow parties to an LNG agreement to achieve essentially the same results as they would have been able to do through the enforcement of so-called destination clauses. These types of clauses effectively prohibit a buyer

² Commission Guidelines on the Application of Article 81(3) O.J. 2004, C101/97 at paragraph 22.

³ H. Nyssens and I. Osborne, *Profit splitting in a liberalised gas market: the devil lies in the detail*, Competition Newsletter 2005, Spring (1) p. 25.

⁴ A short press notice – IP/02/1869 of December 12, 2002 and a reference in the Commission's annual Competition Report, 2002, at page 286, are some of the only documents in the public domain. The Commission had also invited other gas producers to state that they are not using, nor intending to use, territorial sales restrictions in their contracts while the case against the destination clause was running, see press release IP/02/1084 of 17.07.2002. This was apparently intended, as this press statement and the previously mentioned statement IP/02/1869 indicated, to persuade the producers concerned that these devices are not necessary to market gas at profitable terms inside the European Union.

from selling its offtake into markets other than those stipulated in the contract.⁵ Such clauses have the effect of segmenting or partitioning the Community gas market, making it difficult for new entrants to obtain gas and for established players to sell outside their traditional supply zones. Contractual clauses which have as their object or effect, market portioning within the European Union are usually referred to and dealt with as ‘hard core’ restrictions, and as such are rarely held to be justified on the basis of Article 81(3) EC. The Commission has challenged destination clauses in a number of cases in the last five years and has obtained their adjustment and removal.⁶ The Commission’s primary concern is that profit-sharing mechanisms are in fact nothing more than sophisticated means of achieving the same objective – market segmentation or partitioning – so that buyers are in effect compelled to sell their offtake in a particular territory and are therefore unable to use their LNG supplies to compete in other markets within the European Union. It is important to bear in mind that the Commission has not condemned profit sharing mechanisms per se – it has rather concentrated in its limited precedent up to 2007 on the effects of these clauses as a form of market segmentation. Its recent decision in the Sonatrach case⁷, however, may suggest that it might take a stricter approach. Before turning to this latest development it is useful to review the different types of contractual clauses.

3. Types of profit-sharing mechanisms

The Commission has in its published reports and in related publications, distinguished between two types of mechanism: price-splitting and profit-splitting. Price-splitting usually involves an agreement between seller and buyer to split the entire difference between the lower price usually obtained in the home market of the importer and the higher price actually obtained from a buyer in another market. This mechanism is also referred to as a ‘raw’ profit sharing mechanism as it in effects amounts to an agreement to split the gross price difference between the upstream price and the downstream price in the new territory. Profit splitting (or net PSMs) involves an agreement between the parties to split the incremental profit obtained from the sale in another downstream market after deducting all the

⁵ These types of clauses are discussed in greater deal in the chapter by M. van der Woude, *Recent Developments in Competition Law*, European Energy Law Report, III.

⁶ See C Jones, et al, 2nd edition, 2007, chapter 3, para. 3.2.

⁷ IP/07/1074 of September, 11, 2007.

costs incurred with the marketing and delivery of the gas in that market. In the latter case it is argued that the importer will still have the assurance that it can retain some of the profit it would not have made from a sale on the home market. Hence the purchaser/importer will still have some incentive to sell outside the original market. The mere splitting of a real incremental profit will always lead to a higher margin, also for the buyer, in the new territory.

In its early decisions and publications, the Commission indicated that price-splitting mechanisms or ‘raw PSMs’ are likely to be viewed as having the object of restricting competition as the mechanism does not guarantee the buyer/importer a profit from cross-border sales. There might even be a risk, depending on the buyer/importer’s costs that it could even make a loss. In comparison, a ‘net PSM’ should not necessarily have this object or even this effect, as the buyer should still be able to realise some profit and is not deprived of its incentive to sell outside the home territory. However this may presuppose that all costs are taken into account and are accurately calculated. If not, diversion to another market could be discouraged. Similarly, the Commission indicated that if the terms of the contract were not clear and to enable the buyer to determine in advance and without the need for ad hoc renegotiation with the seller what share of the profit will be payable to the latter, then this could have the purposes of obliging the buyer to seek permission from the seller to divert. Hence vague ‘net’ PSM clauses could be considered to restrict competition in the same manner as ‘raw’ PSMs.

The Commission has further expressed its concerns that FOB (‘free on board’) contracts may raise less justifications for profit-splitting than CIF (‘cost, insurance and freight) contracts or DES (Delivery ex ship) contracts. If a PSM is included in an FOB contract this appears unjustified as the risk and property in the goods in question has already passed to the buyer. A PSM in an FOB contract is therefore an unjustified restriction on the buyer’s commercial freedom. This can, in the Commission’s view be considered, *prima facie*, to be a restriction of competition and as such, a violation of Article 81(1)EC. Hence the Commission officials have stated in its Competition Policy Newsletter ‘that from a policy point of view’ only FOB contracts providing for the freedom of the buyer to deviate ships – without prior approval of the seller – containing the mere limitation that an incremental profit will be shared can be considered as not being appreciably restrictive (at page 29). In a CIF contract however the seller is considered

to deliver the goods when they pass the ship's rail at the port of shipment but the seller must pay the costs and freight necessary to bring the goods to a named port of destination and must pay the insurance against the buyer's risk of loss or damage to the goods during carriage. However the risk of loss of or damage to the goods, as well as any additional costs due to events occurring after delivery, are transferred from the seller to the buyer in the port of shipment. Lastly the Commission noted that in a DES contract the seller delivers the contract goods when those goods are placed at the disposal of the buyer on board the ship at the named port of destination. The seller has to bear all costs and risks in bringing the goods to the designated port of destination.

Unlike the FOB contract, the Commission had originally reasoned that in the CIF and DES type contracts, the seller would always have to agree to deviation under the contractual terms. Hence, in this sense, a PSM included in these types of contracts did not interfere with the buyer's freedom, since the deviation of the cargo takes place before the ownership and/or risk of the gas has passed. In general, the Commission reasoned, it was unlikely that PSMs in CIF or DES contracts would constitute an infringement of European competition law, so long as they apply to what happens to the gas before its delivery. On the other hand PSMs that oblige the buyer to pay an amount to the seller in view of the use made by the buyer of the gas after it has been delivered would clearly restrict the buyer's freedom. This would occur even in a CIF or a DES contract if such a contract contained a clause restricting use of the gas after its re-gassification. For example, restriction on use of the gas for electricity generation only would under certain conditions, also raise antitrust concerns.⁸

It is important to note that these earlier Commission publications did not indicate whether in the Commission's view, and under what circumstances, either form of PSM - and in particular the combination of 'raw' PSMs and FOB contracts could be justified under Article 81(3) EC. The Commission seems to infer that because this type of combination is likely to lead to market segmentation in the European Union, it is a hardcore restriction, which has, if not the object, then the effect of restricting competition and therefore is unlikely to be justifiable. It is of course for parties claiming the benefit of Article 81(3) to provide the necessary justification but the

⁸ See in this respect the Commission's decision on Gas Naturel, IP/00/297 and M. Fernandez Salas, 'Long term supply agreements in the context of gas market liberalisation', Competition Policy Newsletter 2/2000, p.55.

Commission must also assess the arguments and evidence put forward and weigh up the advantages and the disadvantages. In this respect the Commission has acknowledged that destination deviations can cause both technical and commercial difficulties for both parties and hence, that contractual terms to deal with the conditions for deviations are agreed (Competition Policy Newsletter, at page 27).

It may be noted in this respect that the Commission's policy on PSMs is closely modelled on its approach to cases where suppliers of certain products seek to limit so called parallel trade – or unofficial exports – from low-priced to high-priced markets. The Commission has not only condemned contractual arrangements which ban exports but also agreements and practices which make export less commercially attractive or even uneconomic. The Commission has tended to assume that these types of practices have as their very object, market segmentation and has condemned them without thorough-going analysis of their effects and without taking into serious consideration the arguments put forward by the parties to such arrangements that they could in fact be justified on efficiency grounds. The Court of First Instance's (CFI) latest ruling in Case T-168/01 GlaxoSmithKline Services, of September 27th 2006 has proved a timely reminder to the Commission that the Courts will not accept either a formalistic approach to labelling particular types of arrangements as hard core or a mere superficial economic analysis of the alleged anti-competitive effects, in these types of cases. In order to justify its decision condemning such arrangements, the Commission has to demonstrate in full that such arrangements do restrict competition and cannot be justified under Article 81(3) EC. This judgement is now under appeal.

It seems to follow that the Commission's unpublished decisions as well as its policy statements on PSMs should not be taken out of their context, and one should also bear in mind the Commission's concern that destination clauses in historic (that is existing) long term gas contracts would be replaced by more sophisticated clauses having essentially the same impact and effect. In other words PSMs could be seen as a form of indirect destination or territorial restriction. Furthermore, before reaching a final conclusion, it is necessary to examine the actual detailed contractual clauses, and the PSM mechanisms chosen, and their potential effect on the relevant market. Nevertheless even although the Commission has stressed that as a general policy, it will take a more economics based approach to the application of Article 81(1) EC, its recent decision in the Sonatrach case

seems to indicate that an element of formalism in its approach is still present.

4. The Sonatrach decision

Under this settlement, reached in September 2007, and after protracted discussions with the Commission, Sonatrach commits to abstain from including any profit-sharing mechanisms in LNG and pipeline contracts that apply after title and risk has passed to the buyer. Until title and risk pass to the buyer, it cannot be resold by the buyer, in the Commission's view. In this situation a PSM would define the price at which the goods will be delivered at the modified delivery point. Hence as delivery has not taken place, and risk and title have not passed, it would be difficult to term the mechanism as a form of resale restriction. The good remains the property of the seller. The only competition concern which might arise here is the exchange of commercially sensitive information, discussed below. In effect this means, if Sonatrach is to be taken as a precedent, that only the combination of a DES regime and a net PSM would appear to be permissible, and only on the condition that the buyer would still have a sufficient incentive to divert the goods from the original destination to another, more profitable one. Furthermore, this conclusion would only apply as long as the contract imposed no further restrictions on use.

5. Future considerations

In its recent Energy Sector Inquiry Report, the Commission devotes a short chapter to the LNG sector.⁹ However as the Commission itself stresses, this part of the Report reflects its attempt to improve its understand of the current state and likely development of demand and supply for LNG in the EU. It does not, as other chapters relating to the electricity and gas market do, seek to highlight the main competition issues which will require follow-up action. Hence this short chapter on LNG is more indicative of future policy directions for competition and regulation in relation to certain aspects of the market, in particular infrastructural investment and eventual

⁹ DG Competition Report on the Energy Sector Inquiry, SEC (2006) 1724, January 10, 2007 at p.261 et seq.

access rules. There is no explicit mention made of the use of profit sharing mechanisms for example, nor are any related issues, such as destination clauses singled out for further treatment. Nevertheless there are some useful insights into how the market for LNG is developing in Europe which could provide useful contours for a better understanding of the role of these types of clauses in the future. Although the Commission has not undertaken to compare the price of LNG in the seven different European markets which currently have functioning LNG import facilities, it devotes some attention to a simulation exercise comparing the cost of LNG with gas from long-distance pipelines. This simulation is of a purely indicative value (see para. 900, at p. 273) but serves to illustrate the importance of the economics of transportation and how this strongly influences the ability of LNG to compete with pipeline-delivered gas. In this respect it notes that although an important factor, transport costs will not be the only factor for the producer in deciding the best transport-suited mode. Considerations such as the increased flexibility of LNG which it notes, can also bring increased value to the producer, can also play a role. In this respect it would be useful to bear in mind that a balanced profit-sharing mechanisms can contribute to enhanced flexibility and with it increased value for the producer. Furthermore the Commission examines changes in the shipping market. It notes that not only has the recent increase in LNG demand resulted in the expansion of the LNG shipping industry and the number of tankers being built (a growth of 35 % between 2003 and 2006) but also an increase in transportation capacity of about 57%. This is in part due to the fact that whereas in the past, LNG tankers were built for specific (very) long-term contacts and routes, tending to be rather small in size, recent trends are towards even larger ships being build for charter contracts of shorter duration or even without a specific contract link (see para 884 and Figure 86 at p.267) Finally, in this respect the Commission also observes a growing trend towards vertical integration, either between producers and ship owners or between importers, particularly large incumbents, who operate directly in the transportation segment, directly managing LNG tankers, or by means of a controlled shipping company (see para 887 at p 268). Obviously a strict formalistic approach to condemning balanced PSM mechanisms might act as a further incentive for companies to engage in vertical integration, making it harder for new entrants to access the downstream markets. Against this background, it may well be that the Commission should encourage PSM mechanisms as both an equitable way of securing added value for the producer and at the same time ensuring that diversion can take place to different markets where new entrants - i.e.

buyers can also profit from the flexibility which these types of mechanisms offer.

6. Information sharing

Finally, a separate concern which must always be borne in mind by parties to contracts containing PSM mechanisms is whether the information to be exchanged in calculating the incremental profits and diversion proceeds could lead to the exchange of sensitive commercial information between competitors. Resorts to independent auditors are possible mechanisms to address these concerns. As indicated in the short discussion of the Sonatrach settlement above, the Commission may be concerned that a PSM in a DES (delivery ex ship) contract might still lead to sensitive information sharing if the clause required the buyer to communicate information about its resales to the original seller. Similar concerns could also arise even in a DES contract if the terms under which diversion could take place are not clear, causing the buyer and the seller to enter into ad hoc but direct negotiations. This would be especially problematic if the buyer and seller are actual or potential competitors.

However if the information was audited by an independent third party, so that only aggregated information on the buyer's resale revenues was passed on to the seller, this may remove these concerns.

7. Conclusion

It is frequently argued that profit-sharing mechanisms should be seen as a valid means of maintaining a commercial equilibrium between the different parties to an LNG contract, given that the production, transportation and re-gasification of LNG requires a complex series of transactions which must be well co-ordinated. Deviations from a pre-planned delivery schedule can cause problems for the seller, who must then re-arrange its production process as well as for the buyer, who has to re-arrange its supply portfolio. Moreover sellers developing complex upstream facilities do not always have the know-how or the commercial resources to engage in downstream marketing. At the same time they want to be assured a fair share of the returns in the growing European LNG markets. Buyers however want the

freedom to be able to arrange and re-arrange their delivery schedules to take advantage of both variations in demand and in prices. A net PSM may seem an equitable means of achieving the necessary commercial equilibrium as both buyer and seller share the eventual gains. This is all the more true for long-term contracts where price evolution is hard to predict. Furthermore, as the Commission itself has noted in its Report on the Sector Inquiry, liquid hubs have not yet developed to a sufficient extent in the various national markets to yield a reliable index or reference price. Many gas and LNG contracts must therefore rely either on Henry Hub in the USA for indexation or must be based on an alternative pricing principle (e.g. the competing fuels principle, or the market price principle, or the net-back principle). As the Report itself notes, these types of pricing principles may also raise competition issues, and the Commission has announced that it will seek to use its powers under competition law to try to prevent the automatic linking of gas prices with crude oil prices. Net PSM clauses may then be a useful way forward, allowing for linkage to be made to hubs as they develop in different markets, and it seems a pity to discourage their use on the basis of an excessively formalistic application of the competition rules alone.

At the same time, it may also be necessary to bear in mind that the *Sonatrach* case, as discussed above, might be regarded as exception, given the apparent difficulties the parties and the Commission encountered in trying to find a formula that would satisfy the Commission that the incentive for the buyers to engage in arbitrage would be preserved.¹⁰ If a PSM clause can still be drafted in such a way that it is clear to the Commission, national competition authorities and the courts that they do not create a disincentive for the buyer to engage in arbitrage then there may be scope to argue that PSMs are not caught by Article 81(1) at all. Finally it should not be forgotten that restrictions on resale between a third country and the European Union are only caught by Article 81(1) when they have appreciable restrictive effects on competition inside the European Union.¹¹

¹⁰ See further, Lars Kjolbye, Part 3 in Jones et al, *EU Competition Law and Energy Markets*, vol II, p.250.

¹¹ Case C-306/96 *Javico*, [1998] ECR I-1983.