EU to Punish Restrictive Business Practices in LNG Contracts

Whilst the second European gas directive, adopted on June 26, 2003, seeks to provide freedom of choice of supplier for industrial and domestic gas customers, the European regulatory authorities are busy trying to bring down the remaining barriers to an effective liberalised energy market.

On an inter-regional scale, this means the end of clauses in gas contracts prohibiting buyers onselling gas outside their national territory. Here, Laura Guttuso, Associate at Herbert Smith, together with Jonathan Scott and Stephen Murray, Partners at Herbert Smith, assesses the resolve of the European Commission to end these arrangements, which has so far caused both pipeline and LNG contracts to be renegotiated.

European Union (EU) competition rules seek to overcome impediments to trade between Member States, be they structural – such as mergers which strengthen the dominant position of a former monopoly – or contractual, such as destination clauses. The approach of the European Commission (Commission) to destination clauses has been developed in a number of recent settlements with non-EU gas producers.

The Commission's regulatory attacks on destination clauses have to be seen in the context of a three-pronged liberalisation strategy, which aims to set in place a structure that is favourable to competition in the gas and electricity markets: by increasing supply competition; by ensuring effective access to energy networks; and by guaranteeing free consumer choice by challenging consumer lock-in.

An open model which efficiently allows for independent competitive offerings at various levels of the supply chain is in almost direct contrast to the traditional pattern of LNG project development, where nearly all buyers were either government monopolies or franchised utility companies. The traditional LNG market model was based on long-term sales contracts into defined markets, often of 20 years or more in duration.

In order to be able to successfully operate in this new liberalised environment, buyers and sellers are looking for new ways of sharing and absorbing risks to enhance the efficiency of the industry and achieve a satisfactory allocation of these risks. For the regulatory authorities, there is therefore an underlying tension between reconciling the perceived benefits of liberalisation with the need to guarantee security of supply for the EU.

Destination clauses are clauses in long-term commodity supply contracts which have the effect of forbidding wholesalers from re-selling the commodity outside the countries where they are established, thereby guaranteeing the seller a form of protection. This practice helps to maintain price differentials across different national markets and for this reason destination clauses have been criticised by the Commission as constituting market partitioning devices.

Destination clauses can take various shapes and forms and the restriction need not be as explicit as an outright resale ban. Anything which has the effect of discouraging buyers from selling LNG or gas to customers in other countries in the EU may be considered an implicit territorial restriction.

For example, profit-splitting mechanisms are clauses obliging the buyer to pass over to the producer a share of the profits made when reselling the gas across borders.

Use restrictions prevent the buyer from using the gas for purposes other than those agreed upon, whereas consent clauses oblige one party to obtain prior consent from the other when selling gas to third parties. In the view of the Commission, all these clauses can be similar to express destination clauses in terms of their effects and are therefore considered to belong in the same overall category of territorial sales restrictions. The Commission is concerned by the effect of the clause, not its form.

In the case of the supply of gas from LNG projects, the Commission has been investigating for some time suspected territorial restrictions in gas supply contracts between non-EU producers and European companies. The Nigeria LNG (NLNG) investigation provides a useful illustration of these principles and demonstrates how the Commission is showing an increased interest in imports of gas sourced from LNG projects.

One of the many European contracts entered into by NLNG contained a territorial sales restriction, which prevented the customer, in this case the Italian utility company ENEL, from re-selling the gas outside Italy. In the discussions and subsequent settlement with the Commission, NLNG agreed in October 2002 to delete the destination clause from its contract with ENEL and also undertook not to introduce territorial restriction clauses or use restrictions into its future supply contracts. It further confirmed that none of its existing gas supply contracts contained profit-splitting mechanisms affecting the EU markets and that it would not introduce these in future contracts. ▶

The Commission has also been looking into gas supply contracts concluded between Algeria's Sonatrach and its principal European customers. Sonatrach recently undertook to discuss modifications to its existing contracts with European customers and to submit revised supply contracts.

Recent cases involving Gaz de France (GdF) showed that the Commission intends to continue to treat destination restrictions and other anticompetitive clauses very seriously. On October 27, 2004 it confirmed that territorial restriction clauses contained in two contracts, between GdF and ENI and GdF and ENEL respectively, infringe Article 81 of the Treaty.

The GdF-ENI contract concerned the transportation of gas purchased by ENI from GdF in northern Europe. GdF transports the gas across French territory to the border with Switzerland and the contract contained a clause obliging ENI to market the gas exclusively "downstream of the redelivery point" i.e. after leaving France.

The GdF-ENEL contract concerned the swap of LNG purchased by ENEL in Nigeria. The offending clause required ENEL to use the gas only in Italy.

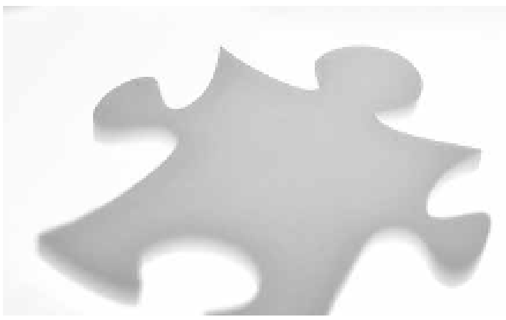
Although the parties had already terminated the infringements, the Commission thought it useful nevertheless to confirm that the two clauses as originally drafted restricted the territory in which the parties could use the gas and were designed to partition national markets: They were depriving French gas consumers of the benefit of obtaining supplies from ENEL and ENI.

The Commission made it clear that it wanted to clarify the law for the benefit of all companies operating in the sector. It expressly warned that if it should find restrictions of the same type in other gas contracts, it would show much less clemency.

If it finds that there has been an infringement of Article 81, the Commission may impose any remedies which are proportionate to the infringement committed and if necessary to bring it effectively to an end. The Commission would no doubt want to make sure that the offending clauses are deleted from the agreements and may seek an undertaking from the parties not to introduce any similar provisions in future contracts.

However, the Commission may also impose fines on companies that infringe competition law. The size of the fine is at the Commission's discretion and, in theory, it has the power to impose fines up to a maximum of 10% of the company's total turnover in the preceding year.

Given its recent very public warning in the GdF cases, we can assume that the Commission may well be prepared to issue fines in any future infringements.



Another by-product of the liberalisation process is that LNG receiving terminals are open to third party access (TPA), subject to exemptions being obtained by the project developers. LNG producers and project developers need therefore to be aware of both the evolving contractual requirements and the changing regulatory framework when engaging in LNG projects and trade directed towards European markets.

It is worth noting that the Office of Gas and Electricity Markets (Ofgem), the UK's regulator dealing with applications for TPA exemptions, has made it clear in its responses that it welcomes the project developers' assurances that the contractual arrangements negotiated will not contain any resale or destination restrictions.

It is still too early to determine how significant the impact of market liberalisation will be on the supply of gas and LNG in the EU. Former European Commissioner for Competition Policy, Mario Monti believes: "Liberalisation of the energy markets has become irreversible." It is also clear that liberalisation has, to a degree, altered the balance between risk and reward for buyers and sellers of gas.

However, there is also growing acceptance by the competition authorities of the need to maintain and support long-term contracts. Monti was keen to point out, when announcing the ENI/Gazprom settlement in October 2003, that the Commission's action on destination clauses "has no impact on the producer's ability to sell their gas in the Union under long-term contracts".

Looking ahead, the challenge for the regulators will be to strike the right balance between accommodating the main supply conditions that matter to the producing countries and the key market opening principles that are at the heart of the liberalisation programme. ■