Territorial restrictions and profit sharing mechanisms in the gas sector: the Algerian case

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Introduction

With the recent conclusion of the territorial restrictions case relating to the import of Algerian gas into Europe, the Commission successfully closed all previously pending cases on this issue. The Commission had started to investigate territorial restriction clauses in gas contracts in 2000, with the aim to increase supply competition. Numerous contracts concluded between external suppliers and the European importers were examined and a number of cases were opened. Some of these cases could be closed, once the upstream suppliers had agreed to delete territorial restrictions (and comparable provisions) from their contracts and not to introduce them in new contracts. Commitments were received gradually in July 2002 from Norwegian Statoil and Norsk Hydro (2); in December 2002 from NLNG, the Nigerian gas company supplying liquefied natural gas (3); and in 2003 and 2005 from Italian ENI (4), Austrian OMV (5) and German E.ON Ruhrgas (6) with respect to their supply agreements with Gazprom (7). Moreover, in 2004, the Commission provided clear guidance on its legal assessment of territorial restriction clauses with the adoption of a decision in the GDF case (8).

Discussions with the Algerian Government representatives and the Algerian national supply company Sonatrach were to take longer, as Sonatrach was keen to replace territorial restriction clauses with alternative mechanisms, most prominently so-called profit sharing mechanisms, on which a common understanding needed to be reached. On 9 July 2007, Commissioner Kroes and the Algerian Minister for Energy and Mines Dr Chakib Khelil had the final discussions in this matter. In this context the Algerian party committed to delete territorial restrictions from existing contracts and not to introduce such clauses in new contracts (9). A common understanding was also found on profit sharing mechanisms.

The substance of the common understanding has only been made public via a press release by the Commission and the Algerian Government (10), as agreed by the parties. The aim of this article is to provide further information to stakeholders and other interested parties.

Territorial restrictions and profit sharing mechanisms

In gas supply contracts between a gas producer and a European gas wholesaler, territorial restriction clauses, also called destination clauses, undermine the creation of a common energy market by preventing the buyer from reselling the gas outside a defined geographic area, normally a Member State. The clauses impede arbitrage between low price areas and high price areas.

Profit sharing mechanisms (hereafter “PSMs”) have been used as an alternative to territorial restrictions. PSMs oblige the buyer to share a certain part of the profit with the supplier/producer if the gas is resold by the buyer to a customer outside the agreed territory or to a customer using the gas for another purpose than the one agreed upon. Typically the contracts provide for a 50/50 split of the additional profits, however often not clarifying how these “additional” profits are calculated.

(1) Formerly Directorate-General for Competition, unit B-1. The content of this article does not necessarily reflect the official position of the European Communities. Responsibility for the information and views expressed lies entirely with the author.

(2) Press release IP/02/1084 of 17 July 2002, «Commission successfully settles GFU case with Norwegian gas producers». This case concerned a joint selling agreement between producers from the Norwegian continental shelf, but incidentally the abolition of territorial restrictions was also achieved.

(3) Press release IP/02/1869 of 12 December 2002, «Commission settles investigation into territorial sales restrictions with Nigerian gas company NLNG».

(4) Press release IP/03/1345 of 6 October 2003, «Commission reaches breakthrough with Gazprom and ENI on territorial restriction clauses».

(5) Press release IP/05/195 of 17 February 2005, «Commission secures improvements to gas supply contracts between OMV and Gazprom».

(6) Press release IP/05/710 of 10 June 2005, «Commission secures changes to gas supply contracts between E.ON Ruhrgas and Gazprom».


(9) This is valid for any contract by which gas is supplied to the European Union, even where gas transits via another Member State before reaching the Member State for which it is initially bought. It should be noted that the common understanding does not cover contractual relationships relating to sales of gas in Algeria’s neighbouring countries, namely Morocco and Tunisia.

Whilst territorial restrictions are generally considered hardcore restrictions of competition, the situation as regards PSMs is more complex. By requiring the importer to share part of the profit gained through the deviation of the gas to a more profitable destination, the PSM may have an anti-competitive effect, if it removes or reduces the importer’s incentive to deviate the gas. In practice, the effect of the PSM would then be equivalent to that of a territorial restriction clause. In addition, PSMs raise concerns as they tend to include reporting obligations for the buyer. It is argued that the supplier must know the final destination of its gas to calculate the profit to be shared. However in this way, commercially sensitive information could be communicated between the upstream supplier and its European buyer.

Gas can be supplied either via pipeline or as liquefied natural gas (“LNG”). Historically and generally, territorial restrictions have been included in pipeline contracts, whereas PSMs have been inserted in LNG contracts.

Algeria as a gas supplier

In 2006 (11), Algeria produced 84.5 billion cubic meters (hereafter “BCM”) of natural gas and internally consumed 23.7 BCM thereof. Of its production, 35.6 BCM were supplied to the European Union via pipeline, namely 24.4 BCM to Italy, 8.6 BCM to Spain, 2.1 BCM to Portugal, and 0.4 BCM to Slovenia. Algeria also supplies 1.3 BCM to neighbouring Tunisia. LNG allows diversifying the countries supplied. In 2006, Algeria shipped LNG tankers to the European Union for about 19 BCM, of which 7.3 BCM to France, 3.3 BCM to Belgium, 3 BCM to Italy, 2.8 BCM to Spain, 2 BCM to the UK and 0.4 BCM to Greece. Outside the EU, Algeria sells 4.6 BCM to Turkey, 0.5 BCM to the U.S.A., 0.3 BCM to South Korea, 0.2 BCM to Japan and 0.08 BCM to India.

If one adds pipeline gas and LNG, Algeria supplied in total 54.6 BCM to the European Union in 2006. This is equivalent to 11% of the EU’s total consumption (483 BCM) in 2006 and makes Algeria the third largest external supplier after Russia (127 BCM in 2006) and Norway (84 BCM in 2006). However, in some Member States, Algerian supplies represent a much higher share of national consumption. In particular, Algerian supplies represent 35% of Italy’s total gas consumption and 34% of Spain’s total gas consumption (12).

The common understanding reached with Algeria

Whilst accepting the need to delete territorial restriction clauses from gas supply contracts concluded with European importers, Sonatrach and the Algerian Government insisted — as indicated above — on replacing such clauses with PSMs. The possible drafting of the PSM clauses was discussed at length between the Commission and the Algerian side, but no solution could be found, as the Commission insisted that it was essentially for the commercial partners (i.e. Sonatrach and the European importers) to agree on contractual terms acceptable to them. The Commission could only express itself on the compatibility of concrete proposals with EC competition law. In this respect, the Commission noted that the proposals submitted to it could not be considered compatible with EC competition law.

Typically, LNG supplies are contracted under three Incoterms, or international commercial terms, DES, CIF and FOB. Incoterms are standard trade definitions most commonly used in international sales contracts. They are devised and published by the International Chamber of Commerce (13).

DES (“delivery ex ship”) means that the seller fulfils its contractual obligations when the goods are placed at the disposal of the buyer (title and risk) on board the ship at the named port of destination. The seller bears all the costs and risks involved in bringing the goods to the named port of destination. In other words, the LNG remains the property of the seller until handed over to the buyer in the port of destination.

CIF (“cost insurance and freight”) means that the seller fulfils its contractual obligations when the goods pass the ship’s rail in the port of shipment. The seller must pay the costs and freight necessary to bring the goods to the named port of destination, but the risk of loss of or of damage to the goods, as well as any additional costs due to events occurring after the time of delivery, are transferred from the seller to the buyer. However,


(12) BP Statistical Review of World Energy 2007. In 2006, Italy consumed 77.1 BCM; 24.46 BCM were imported from Algeria by pipeline and 3 BCM as LNG. The same year, Spain had a total gas consumption of 33.4 BCM; 8.62 BCM were imported from Algeria by pipeline and 2.8 BCM as LNG.

(13) http://www.iccwbo.org/incoterms/id3042/index.html
in CIF the seller also has to procure marine insurance against the buyer’s risk of loss of or damage to the goods during the carriage. In brief, CIF contracts provide that the goods are delivered to the buyer at the port of shipment (title and risk), but the seller bears the costs of the insurance and the freight.

FOB (“free on board”) means that the seller has fulfilled its contractual obligations when the goods pass the ship’s rail at the named port of shipment. This means that the buyer bears all costs and risks of loss of or damage to the goods from the port of shipment. FOB contracts therefore transfer the title and risks of the good at the port of shipment.

A key factor in distinguishing the different types of contracts in which PSMs may be applied is the transfer of title and risk. As soon as the buyer takes title to and bears the risks for the gas, he should be entitled to take the gas to another destination, i.e. divert the ship. The Commission took the view that to restrict this freedom through the application of a PSM would amount to a restriction of competition contrary to Article 81 EC Treaty. The application of the PSMs proposed by Sonatrach would likely have reduced or possibly even eliminated the buyers’ incentive to resell the gas in another geographical area.

In the framework of the common understanding, the Algerian Government and Sonatrach accepted not to insert PSMs in new LNG contracts under FOB and CIF conditions, when the contracts are related to the supply of the European Union. On the other hand, under the common understanding PSMs can be applied in DES contracts. In DES contracts, title and risk pass to the buyer at the port of destination. Should the gas be diverted from its initial destination while still underway a change of contract would be required. Moreover, as the gas still belongs to the seller, it is difficult to speak of a resale restriction in such circumstances.

The Algerian party is also going to remove PSMs from existing pipeline contracts and will not insert them in future pipeline contracts, also for transit contracts where the gas runs through another Member State prior to arriving at its final destination. While not expressly stated in the press release, the underlying rationale is the same. Once title and risk pass to the buyer the PSMs should not be applied.

Be it for territorial restriction clauses or for PSMs, the common understanding with the Algerian party does not foresee any type of compensation or renegotiation of contract following the deletion of the contested clauses.

The common understanding reached with Sonatrach and the Algerian Government covers only contracts relating to the supply to the European Union. This means that the contractual regime of Algerian gas sales outside the EU is not affected by the common understanding. The Algerian party underlined in particular gas sales in Morocco and Tunisia.

Conclusion

The common understanding reached with the Algerian side on territorial restrictions and PSMs concludes seven years of at times difficult discussions and further contributes to the development of a positive relationship between the European Union and Algeria. It was important to reach a solution for this specific competition issue, considering the broader context of the development of the European neighbourhood policy and in particular the negotiation of the Memorandum of Understanding on strategic partnership between the EU and Algeria in the field of energy. It is now expected that the commercial parties adapt their contracts to make them compatible with European competition law. In this respect it is important to underline that the Commission will not interfere with the commercial negotiations between Sonatrach and the European importers. The commercial parties remain free to negotiate what is for them the best suited solution, as long as it is ensured that the gas can be effectively sold across borders.