Vertical and horizontal restraints in the European gas sector – lessons learnt from the DONG/DUC case

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1. Introduction

On 23 April 2003 the Commission services closed their investigation into the DONG/DUC case relating to the Danish gas market (1). This case as well as some other cases recently concluded (2) demonstrate the way in which the European Commission applies its competition policy in the European gas sector. All cases complement the liberalisation process in the energy sector promoted by the European Commission (3).

This article provides an overview over the essential findings of the Commission services in the DONG/DUC case, which relates to joint marketing activities of gas producers as well as certain restrictive provisions contained in the gas supply contracts concluded between these gas producers and the Danish incumbent company DONG.

This article also summarises the experiences gained in the other recent cases relating to the European gas sector (4). In this respect it appears appropriate to distinguish between vertical and horizontal restraints. Vertical restraints are those found in vertical supply relationships, e.g. between gas producers and European wholesalers. Horizontal restraints on the other hand relate to the relationship between companies acting on the same level of trade, e.g. gas producers.

2. The facts of the DONG/DUC case

In the year 2000, gas produced for sale at the Danish continental shelf amounted to approximately 7 BCM. The DUC partners (Shell, AP Møller/Maersk and ChevronTexaco) accounted for 90% of this production. The gas produced by the DUC partners is sold under three large Gas Supply Agreements (GSA 1979, GSA 1990 and GSA 1993) to the Danish incumbent gas supplier DONG. The gas consumption in Denmark was approximately 4 BCM in 2000, the remaining volumes were exported by DONG to Sweden and Germany.

The Gas Supply Agreements between the DUC partners and DONG were negotiated jointly by the DUC partners and DONG, but subsequently entered into separately by each of the DUC partners and DONG. The contracts contain provisions, by means of which the DUC partners grant DONG certain priority rights when it comes to the sale of ‘additional’ (newly discovered) gas volumes. The contracts also introduced price formulas depending on the customer to whom DONG resells the gas. Finally the contracts contain a mechanism, which was interpreted as providing a right to ask inter alia for adjustments to the gas volumes purchased from the DUC partners, if the DUC partners start selling into Denmark.

3. Horizontal restraints

The first aspect addressed in the DONG/DUC case was that of joint marketing by the gas producers. The DUC partners had negotiated their Gas Supply Agreements with DONG jointly and only when it came to the conclusion of the contracts had entered into separate contracts. In this respect the Commission services took the view that the joint marketing activities reduce the possibilities of customers to choose between suppliers/producers and thus appreciably restrict competition contrary to Article 81 (1) EC. The Commission services also argued that joint marketing does not improve the production or distribution of goods within the

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(1) IP/03/566.
(4) This article does not cover cases relating to access to pipelines etc. In this respect reference is however made to the recent settlement of the Marathon case with the Dutch company Gasunie, IP/03/547 of 16 April 2003.
meaning of Article 81 (3) EC and can therefore not be exempted.

The DUC partners claimed however, inter alia, that their joint marketing activities were covered by ‘Commission Regulation (EC) No 2658/2000 of 29 November 2000 on the application of Article 81 (3) of the Treaty to categories of specialisation agreements’ (1) (Specialisation Block Exemption). Article 3 (b) of this Regulation does allow – under certain circumstances – for ‘joint distribution’ of goods produced jointly.

The Commission services did not agree with this reasoning. The joint marketing of the DUC parties provided for ‘joint co-ordination of sales’ between independent operators as opposed to ‘joint distribution’ under the Specialisation Block Exemption. In addition the Commission services drew the attention of the parties to the 8th recital of the Specialisation Block Exemption, which sets out that one of the effects of specialisation should be that ‘the undertakings concerned can concentrate on the manufacture of certain products and thus operate more efficiently and supply the products more cheaply’. According to the Commission services this will hardly ever be the case for the forms of joint production of gas as known today.

Whilst reserving their legal position the DUC partners agreed to discontinue joint marketing activities for un-contracted gas produced on the Danish continental shelf. They agreed in particular to market all new gas individually in future. They also undertook to individually carry out negotiations concerning existing contracts when prices are renegotiated. Finally they promised to offer for sale 7 billion cubic meters of gas to interested third parties. Taking into account that DONG promised not to buy these volumes, the Commission services agreed to close their investigation relating to the joint marketing of gas in the past.

The DONG/DUC case follows the example set in the GFU case of last year (2). In this case the Norwegian gas producers had committed to discontinue their joint marketing activities relating to all gas produced in Norway. The case confirms the Commission’s reasoning in the GFU case (i.e. the need for individual marketing) and develops it further as the Danish case no longer relates to all gas produced in one country, but only to gas produced in one or more gas fields (3). The case thus shows that joint marketing activities of gas producers will – under normal circumstances – not be accepted by the Commission as these joint activities limit the consumers’ choice to negotiate with different supplier.

4. Vertical restraints

Apart from the horizontal aspects, the DONG/DUC case also raised a number of issues relating to the supply relationship between the DUC partners and DONG (vertical restraints) (4). In this respect it appears possible to distinguish between a) restraints imposed on the DUC partners in their function as suppliers (here in form of a ‘reduction clause’) and b) restraints imposed on DONG in its function as buyer/customer (here in form of a use restriction) (5). Taking into account that the Commission recently concluded some other cases relating to similar issues, the subsequent chapters also make reference to these cases.

a) Reduction clauses

The gas supply agreement between the DUC partners and DONG of 1993 contained a so called ‘necessary adjustment mechanism’. This clause was interpreted as providing that the DUC partners and DONG have to agree on adjustments to the gas supply agreements, e.g. the take-or-pay obligations of DONG, if the DUC partners start selling gas into Denmark. The mechanism is seen by the Commission services to have the same effect as the so called ‘reduction clause’, identified in an earlier case as potentially anti-competitive (6).

In the course of the settlement discussions it was argued that the adjustment mechanism (i.e. the reduction clause) is necessary to counterbalance

(1) OJ L 304, 5.12.2000, p. 3. It should be noted that the predecessors of Regulation 2658/2000 (Regulation 417/85 as amended by Regulation 151/93 on specialisation agreements) did not apply due to the turnover threshold mentioned in Article 3 (1) (b) of the Regulation.
(3) CF. in this sense also IP/01/578 of 20 April 2001 – Corrib, Report on Competition Policy 2001, p. 206.
(4) In this respect it should be noted that the DUC partners and DONG are potential competitors for certain gas customers leading to the conclusion that their vertical supply relationship also had horizontal effects.
(5) The investigation also confirmed that DONG enjoyed certain priority rights when the DUC partners had additional gas to offer. For the purpose of this article is was deemed appropriate not to deal with this issue in detail. For further information reference is made to the press release.
the ‘take-or-pay’ obligations imposed on the buyer. Otherwise, the producer/seller could sell its gas twice, once to the buyer (even if not taken) and once again to former customers of the buyer. It was argued that the elimination of the adjustment mechanism would undermine the commercial equilibrium of the contracts, even after new gas pipelines to neighbouring countries are commissioned providing for new—however commercially less attractive—marketing outlets.

The Commission services did not agree with this reasoning. They argued that reduction clauses have similar effects as exclusivity clauses—from which they usually derive—, namely to prevent the supplier (here the DUC partners) from entering the downstream markets or at least rendering the supplier’s direct sales on that market less attractive. This could not be accepted as the buyer (here DONG) holds a dominant position on the Danish markets concerned. The Commission services maintained in particular that in the post liberalisation period a protection of the home markets is no longer warranted when new pipelines linking Denmark with other continental European markets are commissioned.

The solution agreed upon between the Commission services and DONG consists in the elimination of the adjustment mechanism. DONG—whilst maintaining its legal position—clarified in the first place that it will not invoke the adjustment mechanism for gas originating from sources other than the DUC gas fields. Thus gas imports from Germany are allowed without the possibility to invoke the clause. DONG also committed to waive the adjustment mechanism once a new pipeline is commissioned linking the gas fields on the Danish continental shelf with other continental European countries (2). In this respect the Commission services accepted a six months transitional period. Thus the DUC partners will be free to sell DUC gas into the Danish market six months after the commissioning of this new pipeline without the possibility that the adjustment mechanism can be invoked.

The solution found in the DONG/DUC case confirms the earlier case EdF Trading/WINGAS and develops the Commission’s practice further. The German gas company WINGAS had agreed not to invoke the reduction clause in its supply contracts with EdF Trading in so far as this company sells gas to other wholesalers in Germany (3). The elimination of the adjustment mechanism in the DONG/DUC case also concerns sales to customers other than wholesalers, i.e. most prominently industrial users.

b) Use restrictions

Another important aspect of the DONG/DUC case relates to a specific form of a use restriction identified in the gas supply agreements between the DUC partners and DONG. The contracts provided that DONG had to report to the DUC partners the volumes sold to certain customer groups in order to benefit from special price formulas for these customers.

The Commission services argued that these reporting obligations amount to a ‘use restriction’, as DONG is not free to sell the gas to whichever customer without losing the benefit of the specific price formula. In this respect the Commission services explained that use restrictions are hardcore restrictions in as far as they relate to the territory into which, or the customers to whom the buyer may sell the contractual goods or services (4). Applied to gas sales, they lead to market partitioning, which is incompatible with EC competition law and the creation of a common gas market.

Reserving their legal position, the DUC partners and DONG agreed to amend their supply contracts also in this regard. The Commission services welcomed this decision as it will allow DONG to sell the gas wherever and to whomever it deems appropriate, and in particular without informing the DUC partners about any of these sales.

The solution agreed upon in the DONG/DUC case presents some similarities with the solution found in the case relating to the Nigerian gas company NLNG (5). In this case the Commission services had established that NLNG had entered into a gas supply contract with a European customer containing a territorial restriction clause. Thus the customer was prevented from reselling the gas outside a certain territory (here a Member State).

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(1) Take-or-pay obligation means that DONG has to pay for a defined quantity of gas even if not taken. Generally the take-or-pay obligation do not relate to the full annual gas quantity that could be delivered, but only to a large part thereof.
(2) The construction of such a new pipeline is planned. It is envisaged that the pipeline is commissioned not later than 1 January 2005.
(5) IP/02/1869 of 12 December 2002 – Nigeria LNG.
This case could be closed after NLNG had deleted the contested clause from the supply contract and had committed not to introduce territorial sales restrictions and use restrictions into its future gas supply agreements relating to the European Community. NLNG also confirmed that it will not introduce so called ‘profit-splitting mechanisms’ into its future gas supply contracts. Such clauses foresee that the customer has to pass over a certain part of its profit to the supplier, if it sells the goods outside an agreed territory or to customers using the gas for other purposes. In this respect the Commission services take the view that profit-splitting mechanism are incompatible with European competition law as they have similar effects as territorial sales restrictions and use restrictions (¹).

5. Conclusion

The settlement reached in the DONG/DUC case contains important clarifications for the application of EC competition law in the European gas sector. It confirms again that joint marketing of gas by gas producers is under normal circumstances no longer acceptable in the liberalised gas markets.

It also develops the Commission’s practice as regards vertical restraints in the gas sector and clarifies that reduction clauses and use restrictions (here in form of reporting obligations) are no longer tolerable in a liberalised gas environment.

The case is thus a good example of how competition cases can contribute to the liberalisation process of the European energy markets.