Profit splitting mechanisms in a liberalised gas market:
the devil lies in the detail

Harold NYSSSENS and Iain OSBORNE,
Directorate-General Competition, unit B-1

Introduction

Liberalisation of energy markets is a key element in the Lisbon agenda to improve European competitiveness. Recent years have therefore seen a range of actions at European and Member State level to open markets for competition, most prominently through the adoption of European legislation liberalising electricity and gas markets (1).

In parallel, the Commission has pursued a series of anti-trust cases to remove, amongst others, commercial practices that entrench market segmentation (2). In view of the high costs of entry into energy markets, established players' efforts to sell outside their traditional supply zones are likely to be, at least in the medium term, a crucial catalyst for competitive markets to develop in this sector. A number of cases challenging territorial restriction clauses found in upstream gas contracts were described in a recent article in this Newsletter (3).

The present article discusses further how other, more sophisticated, mechanisms might similarly have the effect of segmenting the European gas market. In particular, it reviews the compatibility with article 81 of the EC Treaty of so-called 'profit-sharing mechanisms', also dubbed 'profit splitting mechanisms' or PSMs, in contracts between gas producers and wholesalers.

The importance to consumers of cross-border trade

Although gas has been internationally traded to a far greater extent than electricity, gas markets in most of Europe have nevertheless historically been sharply segmented by national legislation, commercial practice and contract terms. Prices paid by customers in different national markets and end-use sectors have varied markedly, due to these factors amongst others. One important reason probably lies in the different gas prices in upstream long-term gas contracts signed by national incumbents with upstream producers. Indeed, upstream prices have tended to be set according to three main principles:

The first principle is the 'competing fuels principle'. This principle means that the evolution of the gas price is linked to the price of crude oil and its derivatives. It arose historically from gas being marketed predominantly in competition with heavy and light fuel oils.

The second principle is the 'market value principle'. This principle indicates that the gas price is negotiated separately for each target market (generally the territory of a Member State), taking into account the mix of competing fuels in this market. In this regard, it should be noted that the fuel mix naturally varies from country to country, leading to different price levels for each Member State.

The third principle is the so-called 'net-back principle'. This principle implies that, whatever price would be the result of the previous principles is then adjusted taking into account transport costs between the agreed delivery point and the point when the gas enters the importer's sales area. The net-back principle generally has the effect of lowering gas prices for those importers whose sales area is further away from the delivery point.

These, together with other relevant factors like local transport costs and margins, lead to price differentials between market prices and thus to a natural pressure for arbitrage between markets. The effect of such 'gas-to-gas' arbitrage should be, in the first instance, to equalise prices between markets. Competition between suppliers — of gas from the same and from different sources — should also create pressure for gas prices to fall towards costs. This is of particular importance within the areas of Europe that have historically relied heavily on a single source of gas (Russian, Algerian or North Sea gas).


(2) For an overview, see MEMO/03/159 of 29.7.2003.

It is therefore of prime importance for competition that wholesalers who buy gas from producers are free to sell this gas outside their historic area of operation. It is in this perspective that legal monopolies for gas supply, import and/or export that were granted in the past by a large number of Member States are gradually being abolished by the liberalisation Directives. However, some contractual practices can achieve a similar effect as legal monopolies from the point of view of competition or the consumer.

Further barriers to free movement: profit sharing mechanisms

An earlier article on territorial restrictions described the progress achieved by the Commission in securing the removal of territorial restriction clauses from some upstream gas supply contracts. Since then, the Commission services have continued to work on this theme. For instance, in October 2004 the Commission adopted two decisions, the first on this subject in the gas sector, which formally confirm that territorial restriction clauses infringe Article 81 of the Treaty (1).

However, the Commission's work on this theme has not only addressed contract clauses that explicitly forbid resale outside a particular territory. It has also covered a number of contractual mechanisms that have equivalent effects to a territorial restriction, by making resale economically unfeasible or at least less attractive. In particular, producers have sometimes replaced territorial restriction clauses with PSMs.

That effects similar to territorial restrictions might be achieved as effectively indirectly, by more sophisticated means, has long been recognised by the Commission. Paragraph 49 of the Commission Guidelines on Vertical Restraints (2) indeed states:

‘The hardcore restriction set out in Article 4(b) of the Block Exemption Regulation [...] relates to market partitioning by territory or by customer. That may be the result of direct obligations, such as the obligation not to sell [...] to customers in certain territories [...]. It may also result from indirect measures aimed at inducing the distributor not to sell to such customers, such as [...] profit pass-over obligations [...]’.

This position has been reflected in a number of Commission decisions. For example, in the JCB decision (3), relating to construction and earth-moving equipment, the Commission dealt with a system of service fees payable when goods had been exported by a distributor to a destination outside its own territory. These fees were paid by the distributor of the country of origin, and paid to the distributor in the destination country. The fee supposedly related to the cost of after-sales services provided in the destination country for re-exported goods. The Commission argued that, given that the fee amounted to a substantial part of the potential gross margin from such exports, the fee acted as a de facto profit pass-over clause and that this deterred export sales and thus reinforced the territorial protection of other official distributors.

Similarly, in the Volkswagen (4) case, an antitrust infringement arose because a limit, imposed on the volume of sales outside the contract territory that could be taken into account for the purpose of calculating a bonus, was liable to induce dealers to remain within their own territory, and thus restricted consumers' and overseas dealers' ability to acquire vehicles in Italy.

The starting point is therefore to regard profit-sharing or profit pass-over mechanisms (PSMs) as likely to infringe Community anti-trust law. In recent territorial restriction cases the Commission has equally paid close attention to profit-sharing clauses. For instance, in the Nigerian LNG case (5) it ensured such clauses would not be inserted into contracts.

Do profit-sharing mechanisms always restrict competition?

However, the antitrust effects of a PSM depend on what concrete mechanism is being applied. The rest of this article examines the application of profit-sharing in liquefied natural gas (LNG (6)) supply contracts. Some operators have indeed argued that profit-sharing mechanisms can provide a valid means of maintaining a commer-

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(1) See Commission press release IP/04/1310. [See the article on the GDF case in this Newsletter on page 45].
(5) Commission press release IP/02/1869. See also Commission press release IP/02/1048 concerning the GFU case.
(6) LNG is gas that has been super-cooled at the port of departure. It is piped aboard an insulated tanker and can then be transported long distances before being piped ashore and regasified, and then injected into onshore transportation pipelines.
cial equilibrium between the parties to an LNG contract. LNG involves co-ordinating and time-tabling a complex chain of technical facilities, including upstream production sites, cooling facilities, tankers, re-gasification terminals and the final transport pipelines. Therefore, deviations of ships away from a pre-planned delivery schedule can sometimes cause a number of difficulties, both for the seller — in terms of re-arranging its production process — and for the buyer, who has to re-arrange its supply portfolio. In view of these technicalities, delivery schedules are arranged between the seller and the buyer. It is therefore natural that LNG contracts include provisions clearly outlining the conditions for such deviations, both between EC ports and on a larger inter-continental scale (1) in case the delivery schedule cannot be met any longer because of the deviation.

The issue is relevant for LNG because a tanker can be diverted during its journey (so long as terminal capacity is available in an alternative port). LNG supplies are therefore inherently more flexible to take advantages of price spikes in different national markets than gas supplies through pipelines. The type of arrangements discussed here would be difficult to justify in pipeline contracts, where deviations of the gas are unlikely to disrupt the upstream production process and where, anyhow, gas molecules are difficult to track in a meshed network.

Given these factors, some historic LNG contracts have included mechanisms to share profits arising from resale of an LNG cargo in a port/country other than its originally intended destination.

Such arrangements should however not lead to limiting the buyer's freedom to re-sell the gas within the European internal market wherever he deems commercially appropriate. The exact functioning of such profit sharing mechanisms is of considerable importance in assessing whether their object or effect is to restrict the resale of LNG between Member States (2). Several dimensions of an LNG contract are relevant for determining a PSM's impact on competition.

Sharing of costs or sharing of profits?

First, a consistent theme identified in the precedents cited above relating to profit sharing is that the pass-over of part of the total margin may be justified, where this compensates the recipient for costs that they demonstrably incur because of the re-sale. These might, for instance, be after-sales services, or charges to ensure that all distributors participate fairly in marketing costs.

However, in the case of LNG sales, no after-sales services appear to be provided by the seller. Nor does the seller appear to incur any marketing costs for such a non-branded commodity. It is hard to see, therefore, what costs arise that can legitimately be reclaimed through a systematic levy on resale.

The impact of the contractual regime

Second, PSMs risk, by their nature, interfering with the freedom of a buyer to dispose of his goods as he sees fit. It is this interference which creates the basis for anti-competitive object or effects (3). However, whether these practices lead to a restriction depends also on the stage in the value chain where the PSM is being applied.

LNG cargoes, like other international freight, can be shipped on the basis of internationally recognised commercial terms (INCOTERMS), established by the International Chamber of Commerce (ICC) (4). The most likely contractual regimes for LNG shipments are as following (emphasis added):

- **FOB (Free on Board)** means that the seller delivers when the goods pass the ship's rail at the named port of shipment. This means that the buyer has to bear all costs and risks of loss of or damage to the goods from that point.

- **DES (Delivered Ex Ship)** means that the seller delivers the contract goods when those goods are placed at the disposal of the buyer on board of the ship at the named port of destination. The

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(1) LNG trading is beginning to emerge as a global market. Naturally, since the jurisdiction of European anti-trust law is limited to matters affecting trade within the single market, this article is of no relevance for trades not affecting the EC market.

(2) The present considerations apply merely to transactions which could affect trade between Member States. Mechanisms which apply merely to transactions between the Community and third countries are therefore unlikely to fall within the scope of EC antitrust rules.

(3) See judgment of the Court of Justice of 14 December 1983, Kerpen & Kerpen, case 319/82, ECR, p. 4173.

(4) An overview of the Incoterms, 2000 edition, can be found on the following website: http://www.iccwbo.org/index_inco.htm
seller has to bear all costs and risks involved in bringing the goods to the named port of destination before discharging.

- CIF (Cost, Insurance and Freight) means that the seller delivers the contract goods when those 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 and procure marine insurance against the buyer's risk of loss of or damage to the goods during the carriage. However, the risk of loss of or 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 in the loading port.

In principle, both parties to a CIF or DES shipment have to agree about deviating a ship before it has arrived in the re-gasification terminal. Indeed, in the absence of both parties' agreement no deviation can be realised whilst still respecting the essential conditions of the contract (delivery of a gas volume at a certain delivery point within a certain period range). In other words, a change of delivery point encompasses a substantial change to the agreement, as in the absence of an agreed delivery point, there can be no contract. PSMs applying to a CIF or DES cargo which has not yet been delivered therefore constitute, in some sense, an agreement between the parties to change an essential element of the contract (the delivery point) in exchange for a price (determined, for instance, by means of the PSM). In this sense, a PSM included in these types of contracts does 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, therefore, it is unlikely that PSMs in CIF or DES contracts would constitute an infringement of antitrust law, so long as they apply to what happens with 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 could exceptionally be the case for a PSM in a CIF/DES contract (if for instance the use of the gas after its re-gasification is restricted (1)), but would normally more clearly result from a PSM in a FOB contract. PSMs in FOB contracts constitute, in principle, a limitation of the freedom of the buyer after transfer of property/risk. They can thus undermine incentives to sell gas in a different part of the European market than originally intended. Therefore they are, prima facie, to be considered as a violation of article 81(1) of the EC Treaty.

‘Raw’ vs. ‘Net’ PSMs

Thirdly, the likelihood of a restriction being considered a violation of article 81(1) of the Treaty depends also on the methodology of the PSM. Although contractual practice is extremely varied, two broad categories of PSM clauses can be identified, which have quite different effects.

A first type of PSM splits the entire difference between, on the one hand, the upstream price between the seller and the European buyer and, on the other hand, the price obtained by the latter when re-selling in a territory alternative to the originally envisaged territory. Calling such mechanism a PSM could be considered a euphemism to the extent that what is being split is not really a profit, but rather the gross price differential between the upstream price and the downstream price in the new territory. Such mechanisms can be dubbed ‘raw PSMs’.

A second type of PSM can be dubbed ‘net PSM’. Such PSM applies where there is a positive ‘incremental’ profit differential between, on the one hand, the downstream profit expected to be made by the buyer in the originally envisaged territory and, on the other hand, the downstream profit effectively made when re-selling in the new territory. The term ‘net’ has been chosen in view of the fact that the split is to be applied to profits after deduction of the costs associated with the delivery of gas in the new territory.

The difference between raw PSM and net PSM clauses is significant as these clauses have quite different effects on the incentive for the operators concerned to change the destination of the cargoes and realise price arbitrage. This is illustrated by Figure 1.

In this illustrative schema, assuming that the PSM provides for a 50/50 share between operators concerned, the difference in the effects of raw and net PSM's can be described as follows:

- **raw PSM**: in the alternative destination, the difference between the final price (130) and the initial price (100) is 30, so 15 goes to the seller, leaving only 5 for the buyer (after costs of 10); whereas in the traditional destination, the realisable margin is 10 (downstream price (120) — upstream price (100) — costs (10)). The effect of the raw PSM is to reduce the margin of the buyer as compared to the margin originally expected in his traditional territory. The raw PSM operates, in reality, in a manner close to the ones condemned in the JCB and Volkswagen cases cited above.

- **net PSM**: the incremental profit as a result of the deviation is 10 (20 margin in the new territory as compared to only 10 margin in the original territory) Assuming again a 50/50 share of the additional profit, the application of the net PSM leaves the buyer with a profit of 15 (20-5 retroceded to the seller) as compared to the margin of 10 he would have made in the originally foreseen territory. In other words, the mere splitting of a real incremental profit will always lead to a higher margin, also for the buyer, in the new territory.

Because raw PSMs can be expected to (comparatively) reduce the margin of the buyer in case of deviations, they are likely to be considered as restrictions by object. Indeed, it can be presumed that a buyer will tend to sell its gas wherever it makes the biggest margin. Net PSMs, on the contrary, will tend always to leave an additional (even if reduced) margin in the new territory. It can therefore again be presumed that the buyer will again, go for the higher margin in the new territory. In view of this logic, it can be considered, from a policy point of view, that net PSMs, do not appreciably restrict competition to the extent they do not abolish the ‘incentive’ for the buyer to still obtain a higher margin in a new territory. In line with this, 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. This reasoning also implies that in case of deviations with a profit (as compared to the upstream price) but without an ‘incremental’ profit (as compared to the originally foreseen destination) no retrocession can take place.

### Sharing of confidential commercial information

In addition, the practical operation of PSMs can have significant indirect effects. In particular, any application of a PSM implies the risk of sharing of confidential information between (potential) competitors. More specifically, the price offered by the wholesaler to its final customers is likely to be used for computing the precise profit to be shared by the parties. To the extent that the producer is itself an actual or potential competitor selling directly to those final customers — or that it may subsequently share the information with other downstream competitors — this information-sharing may itself be anti-competitive. As a consequence, this direct passing-over of information about commercial prices or margins should be avoided, for instance, by means of the appointment of an independent trustee. This trustee will then be in charge of receiving from both parties the
different pricing, margin or cost information which is necessary to compute the part of the increment to be retroceded.

**Ability to determine likely effect**

Finally, it is also of great importance whether the contract terms are in fact clear enough to enable the buyer to determine in advance (and without the need for *ad hoc* renegotiation) what share of profit will be payable to the seller. In practice, PSM's appear by no means always so clearly drafted. Indeed, contracts not providing for clear wording as regards cost determination and the price comparators (raw prices or net incremental margins) will tend to be considered as having the purpose to oblige the buyer to ask for the prior approval of the seller before any transaction. Such vague clauses should therefore be considered to restrict competition in the same manner as the 'raw PSM's’ described above.

**Conclusion**

The authors' conclusion is that, to the extent that PSM's have the effect of creating a disincentive to resell gas outside the originally intended destination, thereby limiting the buyer's freedom to dispose of its gas as he sees commercially appropriate, they infringe anti-trust law. Such infringements are more likely in case of FOB contracts, in view of the fact that in CIF/DES contracts both parties' approval is anyhow necessary in order to amend the essence of the contract (delivery point and price). Where PSMs clearly maintain the incentives for the buyer to sell abroad — by leaving him systematically a positive incremental margin in a new destination where the LNG ship is deviated — they are considered, by the authors, as not being appreciably restrictive. This reasoning requires a detailed analysis of contractual mechanisms and their economic context. Unfortunately, the devil lies in the detail...