LNG Contracts: Avoiding the traps of competition law

Operators in the LNG sector will often enter into collaboration or other contractual arrangements with each other in order to share the high cost and risk involved from production, to liquefaction, through to shipping, regasification, marketing and sales to end customers. Over the years, it has been clear that the European Commission will not hesitate to use EU competition law to ensure LNG markets are as open and competitive as possible (especially since liberalisation of the EU natural gas market).

So what should LNG operators watch out for? Here are five competition law traps to avoid:

1. Beware the long arm of EU competition law

EU competition law can apply where LNG is intended for the EU, or where there is a possibility that at least some of the LNG could end up in the EU. Consequently, EU competition law can apply even to arrangements between non-EU companies and where sales are concluded outside of the EU.

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2. Review of LNG arrangements under the EU merger control rules can offer certainty but it will impact the transaction timeline

If two or more parties formalise an LNG commercialisation/joint selling arrangement as a full-function joint venture (i.e. one that performs on a lasting basis all the functions of an autonomous economic entity) that meets the relevant thresholds for notification, then the EU Merger Regulation potentially may apply (or equivalent EU Member State merger control rules if the EU Merger Regulation does not apply). The merger control route provides legal certainty on the competition treatment of the LNG arrangement (either it is approved with or without conditions or not), but the merger filing requirement will be mandatory and will impact on the timing of completion as the parties must await a clearance decision before proceeding with their plans. Failure to notify a qualifying transaction or closing prior to clearance can result in significant fines for the companies involved (i.e. up to 10% of worldwide turnover and unwinding of the transaction).

3. Carefully self-assess LNG commercialisation / joint selling arrangements – they are typically viewed with particular scepticism

If the EU Merger Regulation does not apply, the LNG commercialisation/joint selling arrangement may be subject to scrutiny under Article 101(1) of the Treaty of the Functioning of the European Union (TFEU) which prohibits agreements between two or more parties which distort or restrict competition and which have an appreciable effect in the EEA (or the equivalent EU Member State prohibition). The European Commission has traditionally maintained a strict stance against commercialisation/joint selling arrangements in the gas sector. They are generally considered a guise for illegal price fixing, market sharing and information sharing. It is therefore important for parties to such an LNG arrangement to carefully self-assess early on and determine whether they can benefit from an exception under Article 101(3), TFEU by looking at whether any pro-competitive effects are likely to outweigh any restrictive effects on competition.

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Typically commercialisation / joint selling arrangements between competitors will only have a restrictive effect if the parties have some degree of market power, i.e. the market share of the parties does not exceed 15%. However, price fixing or coordination on price is rarely justified under EU competition law even where the parties have a combined market share of less than 15%.

Breach of Article 101, TFEU can lead to the possibility of a fine of up to 10% of the worldwide turnover of the group company in the preceding year, third party damages actions and arrangements being declared void/ unenforceable. In some EU Member States (e.g. UK), cartel activity can give rise to criminal sanctions on individuals (up to 5 years in prison) and/or disqualification of directors (up to 15 years).

4. Beware not to exchange illegally competitively sensitive information with (actual or potential) competitors

Competitors to an LNG arrangement need to ensure there is no exchange of commercially sensitive information, which can potentially infringe Article 101, TFEU. Information that is not historic or aggregated and which relates to parameters of competition such as current or future price, capacity or costs will be considered competitively sensitive. Each case needs to be analysed on its specific facts, but various forms of information exchange can be captured. For example, bilateral, unilateral and hub-and-spoke (e.g. information exchange between customers that is facilitated by a common supplier) exchanges and even a "one-off" unilateral exchange of sensitive information between competitors has been the subject of a successful cartel action. The competition risks may be mitigated, for instance, through the appointment of an independent third party (e.g. accountant, lawyer) charged with receiving and reviewing such competitively sensitive information. Alternatively, firewalls may be put in place between those involved in the commercial activities relevant to the agreement and other divisions of the company in order to ensure that commercial information relevant to the agreement and other functions is circulated on a strictly "need to know" basis.

In particular, in the case of joint venture (JV) structures, it is key to limit the exchange of information between parent companies and the JV company. For the purposes of EU competition law, a JV company is not part of the same corporate entity as its parent and therefore it is inappropriate for information to flow freely through the JV and between the parents. At a minimum, firewalls will typically need to be constructed so that sensitive commercial information about one parent (which may very legitimately, in appropriate circumstances be shared with the JV company) cannot be passed on to the other parent. Equally, where the JV company is competing with the parent companies, firewalls need to be constructed between the JV company and both parents, i.e. to limit the flow of information from the JV company to both of the parents and vice versa.

5. Avoid destination clauses and be careful when including profit sharing mechanisms in distribution arrangements

Another area of concern has been the inclusion of destination and profit sharing mechanisms (PSMs) in distribution arrangements between gas producers and wholesalers which can infringe Article 101, TFEU. Destination clauses undermine the creation of a single energy market by preventing the buyer from reselling the gas outside a defined geographic area, normally a Member State. This impedes arbitrage between low price areas and high price areas. Such clauses are treated as "hardcore" restrictions under EU competition laws. PSMs have been used as an alternative to destination/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. PSMs are not automatically considered "hardcore" and will typically only give rise to concerns where they have the effect of partitioning the market, i.e., if the mechanism disincentives the buyer from selling in particular territories.

Fine distinctions have been made between contracts supplied under FOB (Free on Board) and DES (Delivered ex Ship) whereby once the buyer takes title to and bears the risks for the LNG, he should be entitled to take the LNG to another destination, i.e. divert the ship. Where the LNG sale is made on a FOB basis, title and risk transfer to the buyer at the port of shipment and the buyer bears all costs and risk from the port of shipment which is likely to reduce or possibly eliminate the buyer's incentive to resell goods in another geographical area. On the other hand, DES is frequently applied in LNG contracts as title and risk passes to the buyer at the port of destination. Should the LNG be diverted from its initial destination while still in transit, it is difficult to speak of a resale restriction as the LNG still belongs to the seller.

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