

GAZPROM VS NAFTOGAZ: GAS WAR TO BE SETTLED IN STOCKHOLM?

NATURAL GAS SPECIAL REPORT

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What is the issue?

Russia's giant gas exporter Gazprom and Ukraine's state-owned gas production, import and transit company Naftogaz Ukrainy find themselves in two inter-related arbitration cases around gas supply, price and transit with a final ruling from the international arbitration court in Stockholm expected for both cases in the spring of 2017, the first expected by the end of April.

There are effectively three elements of the 2009 gas agreement between the two companies under dispute. Two elements are disputed in the first case around supply and pricing.

- Oil-indexed pricing terms – Naftogaz argues that it overpaid for gas from 2010-2014 because oil-linked contract prices were so much higher than the traded market prices in Europe, while Gazprom argues that Naftogaz is in its debt for certain periods as the contract prices were set according to the agreed oil-indexed formula in the contract, but Naftogaz paid what it considered to be the market price.
- Take-or-pay obligations – Gazprom argues that Naftogaz failed to lift contractually agreed minimum annual volumes of Russian gas and that it did not pay for the gas it did not lift, while Naftogaz argues that the take-or-pay obligations were unfair.

The second case is around the transit of Russian gas via Ukraine.

- Transit fees and obligations – Naftogaz argues that Gazprom underpaid for transit of Russian gas to Europe and also failed to transit sufficient volumes of gas via Ukraine in breach of ship-or-pay obligations, while Gazprom argues increased transit fees and ship-or-pay rules cannot be retroactively applied.

What are the implications?

Extreme case scenario: a big win for either party

- Gazprom's current market capitalization is \$55 billion so a total loss on its side of as much as \$28 billion could be extremely damaging to its business, and could have an immediate impact on its share price and general finances.
- Naftogaz is Ukraine's biggest company, but is not listed so it is difficult to estimate its value. Naftogaz has said it could be worth as much as \$40 billion, but analysts believe the number to be much lower than that. A \$44 billion arbitration ruling against it would obviously be impossible for the company to manage.
- Any serious impact on either company's ability to finance itself could result in gas supply issues for Europe – Gazprom could face short-term issues and longer-term difficulties financing new pipeline infrastructure, while Naftogaz may struggle to be able to run its pipeline infrastructure.

Neutral case scenario: no big financial award to either party

- Analysts and industry commentators believe the court will not rule entirely in favor of one party, dampening the financial implications for both parties.
- A small net win or net loss for either party would likely be paid and the matter resolved, even leading to an improvement in relations between Gazprom and Naftogaz and the possibility of a new agreement on gas supply and transit.
- In the event of a bigger win on either side, it is expected that the "loser" would both appeal the ruling and refuse to pay, effectively holding up the actual outcome for several years.
- The status quo could endure whereby Ukraine continues importing from Europe and rejects resuming Russian imports.

GAZPROM, NAFTOGAZ ARBITRATION CLAIMS AND COUNTERCLAIMS



* Includes bill of \$5.3 billion submitted in January 2017 for gas not taken by Naftogaz in 2016.

** Other claims of Naftogaz, i.a.: amending/replacing invalid or ineffective and unreasonable provisions in the supply contract (annual gas volumes, "take-or-pay" provisions, destination clause, unilateral suspension rights and a mandatory sales clause in favor of Gazprom).

*** Other claims of Naftogaz, i.a.: amending/replacing invalid or ineffective provisions of the transit contract based on European competition or related energy law (based on cost reflective tariffs and capacity booking principle), applying the 3rd Energy Package to Russian gas transmission across Ukraine (incl. the provision of shipper code pairs).

Source: Naftogaz, Platts

The long road to arbitration

The 2009-2019 contract was agreed by Russian President Vladimir Putin and then Ukrainian Prime Minister Yulia Tymoshenko on January 18, 2009, and was signed by Gazprom and Naftogaz the following day. Tymoshenko, however, was later sentenced to seven years in jail for “abuse of power” and for agreeing a “bad deal.”

The case is already having European gas market implications – Naftogaz has said it would not consider resuming imports of gas from Russia until the cases are settled having halted purchases in November 2015. Instead, it has been importing gas from Europe, which has lent support to the relevant European hubs such as the NCG, Gaspool and Austrian hubs.

The case dates back to June 2014 when Gazprom filed the first arbitration claim against Naftogaz for unpaid gas bills for gas supplies in November and December 2013, and April and May 2014. In retaliation, Naftogaz filed an arbitration claim against Gazprom for having overpaid for gas in 2010-2014.

In October 2014, Naftogaz filed a separate complaint about Russia not using all the booked transit capacity for gas supplies to Europe via Ukraine, claiming Gazprom should provide compensation for unpaid revenues under the transit agreement. Gazprom made a small counter-claim over Ukraine’s use of balancing gas for \$6 million.

According to the take-or-pay terms of the contract, Ukraine is obliged to buy 41.6 Bcm/year of Russian gas (80% take-or-pay level on contracted volume of 52 Bcm/year), but this amount can be lowered to 33.3 Bcm/year with Gazprom’s consent.

In 2012, Ukraine bought only 33 Bcm of Russian gas, but Gazprom did not seek to recover the missing volumes under the take-or-pay rules.

In addition, over the 2.5 years since the original filing, both sides add to their arbitration claims, including new penalties under take-or-pay rules, fines and interest. Naftogaz also claimed Gazprom underpaid for transit since January 1, 2016, when it passed legislation intended to increase the transit tariff, and Gazprom applied to the court in January 2017 to have a further \$5.319 billion added to its claim for gas not taken by Naftogaz in 2016.

Part of the arbitration process is also Ukraine’s attempt to bring its transit arrangements into line with European standards by separating gas transmission and supply functions – something it says is impossible given the 2009-2019 accord with Russia.

Ukraine is a contracting party of the Energy Community since February 2011, which commits it to implementing key EU energy law, including on gas sector unbundling. However, the Gazprom-Naftogaz agreement from 2009 is a “legacy deal” that should be honored until its expiry in 2019.

The original cases were heard in November and December 2016 and a ruling is expected in the coming months.

Given the financial claims in the case – Gazprom is claiming \$44 billion from Naftogaz, while Naftogaz is claiming at least \$28 billion from Gazprom – the final ruling of the court could have far-reaching consequences for the European gas market.

“An important prerequisite for successful reform implementation is bringing the gas transit contract between Naftogaz and Gazprom into line with current legislation. This is why the timeline for the gas market reform depends on the conclusion of arbitration proceedings in Stockholm.” – Naftogaz, October 2016.

Range of views on possible outcomes

The likely outcome of the arbitration depends crucially on the wording in the contracts and the court’s interpretation of what was agreed in the contract between Gazprom and Naftogaz. It will set aside all political arguments, and focus uniquely on the text or the intent.

According to commentators, the main point is that the value is now so large that if one or the other side “wins” – and particularly if Gazprom wins – then the result can become “existential” for the losing side.

David Cox of London Energy Consulting, who has experience as an expert witness in previous gas supply contract arbitration cases, believes Gazprom has a stronger case. “It’s 80/20 a win for Gazprom,” he said.

John King of Platts Analytics’ Eclipse Energy, another expert witness who has appeared in several LNG and European gas arbitrations, agrees that Gazprom will “generally prevail” in the arbitration, saying the only reason the contract price should not be paid is if there is a price review clause and that this issue is being arbitrated.

“But regardless of the price dispute, the volume commitment – take-or-pay – would have to be honored, payments made and adjustments made after the award,” King says. “The buyer should always pay the prevailing contract price unless otherwise agreed.”

Jonathan Stern, analyst at the Oxford Institute for Energy Studies, believes that Ukraine will not pay if it loses. “Ukraine has a track record of not honoring arbitration decisions,” he said.

The question then becomes how either side can force the other to pay up.

If Russia wins it could: file a lawsuit in an international court to seize Ukrainian assets in third countries in lieu of payment, but it would not be able to unilaterally seize Ukraine assets in Russia in lieu of payment as neither the Ukrainian government nor Naftogaz is thought to hold any assets in Russia.

If Ukraine wins it could: unilaterally seize Russian assets in Ukraine in lieu of payment; file a lawsuit in an international court to seize Russian assets in third countries in lieu of payment; seize Russian transit gas in lieu of payment.

According to Stern: “Neither side will pay. If it falls on one side or another in the amount of just a few billion, they may pay to settle it once and for all.”

But the result is really anyone’s guess.

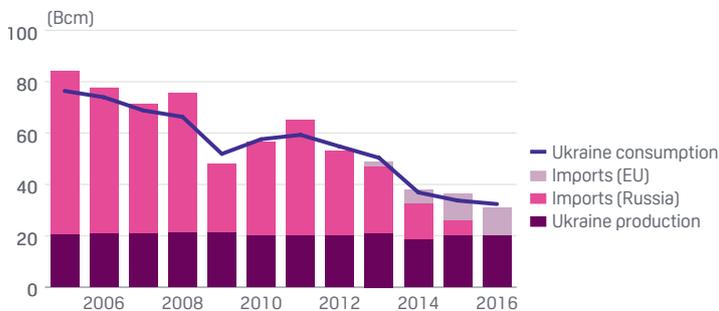
Legal view

The court will focus on the contract wording alone and not be swayed by external factors.

Contracts will often have a “price review clause” that says that in the event of changes in economic circumstances beyond the control of the parties and where the price no longer reflects the value of the gas, then either party can trigger a price review. While it is clear that oil-linked contract prices and traded prices may have diverged in the years since the agreement from 2009, the contract will dictate what can be done about the situation.

In recent times buyers have been able to pass on the cost of higher gas prices to the customers, thereby softening the blow of higher oil-indexed gas prices.

FALLING CONSUMPTION, RUSSIAN IMPORTS MATCHED BY RISING EU FLOWS



Note: Storage injections and withdrawals not included
Source: Ukrtransgas, Platts

RUSSIAN CONTRACT PRICE AT SIGNIFICANT PREMIUM TO HUBS IN 2014



Note: Transport cost from Gaspool to Ukraine border ranged 14-21 \$/000 cu m in 2016. Ukraine imports capacity tripled to 60 million cu m/day since September 2014 when Budince entry point was brought online.
Source: Platts

But buyers that have agreed to an oil-indexation in a contract that is onerous should be commercially responsible for this. The main issue is whether a contract includes a price review clause that allows for that indexation to be changed or any hardship provisions. According to Joseph Tirado of Winston & Strawn LLP, the concept of *pacta sunt servanda* (that contracts should be performed as agreed between the parties) is key, even if it produces an “unfair” result.

What do the experts say?

The outcome is without precedent. Looking at the past is not always a good measure of what might happen in another case. As Gazprom Export itself says:

“The decision of an arbitrator only refers to a particular proceeding and does not set precedents for other proceedings – even if the same parties are involved. This is due to the uniqueness of every long term contract, the nature of each complaint, and the changing conditions of the gas market over time and across countries. Every new arbitration request yields a new investigation and will produce a new ruling – unless the parties find an agreement before the conclusion of the arbitration procedure.”

The latter point is important – Gazprom has made multiple out-of-court settlements ahead of an arbitration hearing with European gas buyers. This time it is unlikely though as both sides have ruled out bilateral talks until the Stockholm court rules in 2017.

The OIES’ Stern believes any award would be contested in a court of appeal, dragging out the process further.

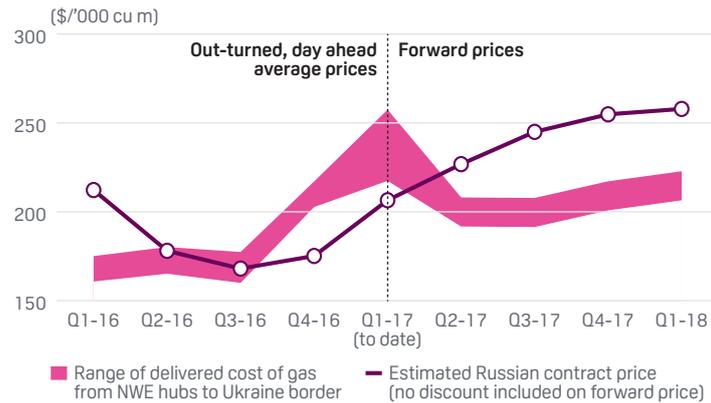
Stern adds: “The Arbitration Tribunal may make a decision in favor of one side on one issue and the other side on the other issue and the net award will be manageable. Even then I wouldn’t count on the Ukrainians paying if the net award goes against them. But the hope must be that we shall get legal clarification on the past situation of supply and transit and we can then start with a clean-ish slate.”

However, Gazprom has already stated that it hopes to be able to eliminate the need for Ukraine as a transit country for its gas to Europe and is building the 55 Bcm/year Nord Stream 2 and 31.5 Bcm/year TurkStream pipelines to achieve that aim.

“One possibility is that Ukraine will lose on pricing, but win on take-or-pay, and lose on transit, meaning an effective net win for Gazprom. The Tribunal could say to Gazprom – you didn’t enforce Take-or-Pay rules on a year on year basis. Take-or-pay should be honored, but the first years Gazprom did nothing to enforce it,” he says.

Stern concludes: “The Tribunal could say to Ukraine – you’ve only had reverse flow for a few years and now you’re asking for a big rise in transit fees – we’re not wearing that. Ukraine shouldn’t be allowed to put a price on transit retroactively based on the tariffs on reverse flow pipes. And asking for penalties on past transit fees not paid is not tenable.”

RUSSIAN CONTRACT SEEN OUT OF THE MONEY IN SUM-17



Based on Platts forward price assessments on March 17
 Source: Platts

LEC's Cox sees Ukraine as more likely to be in the wrong, especially as the contract is not a "legacy" 20 or 30-year contract. "Already in 2009 there was a shift towards including some hub indexation in gas supply contracts. So why would you not put in a clause around hub indexation?"

On take-or-pay, Cox believes Ukraine has very little argument. "Ukraine agreed to the take-or-pay obligation when it signed up, so it should pay up. It's rare to have 'hardship' clauses in supply contracts. You can't just walk away from a contract, or try to wriggle out of them. Contracts will often have a clause that says that in the event of changes in economic circumstances you can trigger a price review. These are experienced energy companies signed by experienced employees."

On transit, it is widely agreed that there were no ship-or-pay obligations in the contract. Cox asks: "Why did Ukraine sign it? Why didn't Ukraine agree ship-or-pay at the time?"

Other implications – market level and gas flows

Gazprom currently supplies no gas to Ukraine and hasn't since November 2015. Ukraine has repeatedly said it would resume gas imports from Russia if the 2009 contract were amended, something Gazprom has refused to do.

Since 2013, Ukraine has been importing gas from Europe, with volumes rising to an all-time record of 11.1 Bcm in 2016.

This trend has already impacted on the markets in central Europe, with gas being pulled into Ukraine from Germany and Austria, thereby boosting the hub prices in those countries.

Ukraine also still transits significant volumes of Russian gas to Europe, and will do at least until the end of 2019 when the contract expires.

If the arbitration ruling is broadly neutral, it is still unlikely that Ukraine will resume Russian gas imports unless it achieves an amendment to the contract as part of the settlement so it does not suffer future "take-or-pay" bills.

One possibility in this scenario is that the two parties could agree to discuss a new contract given weak domestic demand in Ukraine and Ukraine's improved access to the European hubs. Hub indexation could also be included, as could a lower level of take-or-pay, or more flexible take-or-pay conditions.

It is unlikely that the arbitration award will impact on gas transit to Europe in the short term as Russia needs the transit capacity until Nord Stream 2 and TurkStream are built, and Ukraine needs the transit fees. However, a heavy win by either side could see a potential for the issue to escalate with the possibility of disruption to transit.

- There could be a higher perceived risk of Ukrainian gas siphoning should Naftogaz have a big net win and Gazprom refuses to pay;
- Equally, there could be a higher perceived risk of retaliatory Ukrainian gas siphoning should Gazprom have a big net win and Gazprom seizes Ukrainian assets abroad.

Any increased risk of Ukrainian siphoning of gas could have a bullish impact on prices as has been the case over the past few years. The extent of a true supply disruption and any subsequent spike in prices would depend on what the risk is of volumes being taken and whether Gazprom would be able to divert flows through other routes at the time of the impact.

Russian gas flows through Ukraine to Europe have fallen from their peak in 2008 of 117 Bcm, hitting a low of 62.2 Bcm in 2014. Flows have recovered in the past two years on an overall uptick in Russian gas demand in Europe.

But Gazprom has been maxing out flows through its three other main trunklines – Nord Stream, Yamal-Europe and Blue Stream – this winter and avoiding using Ukraine where possible.

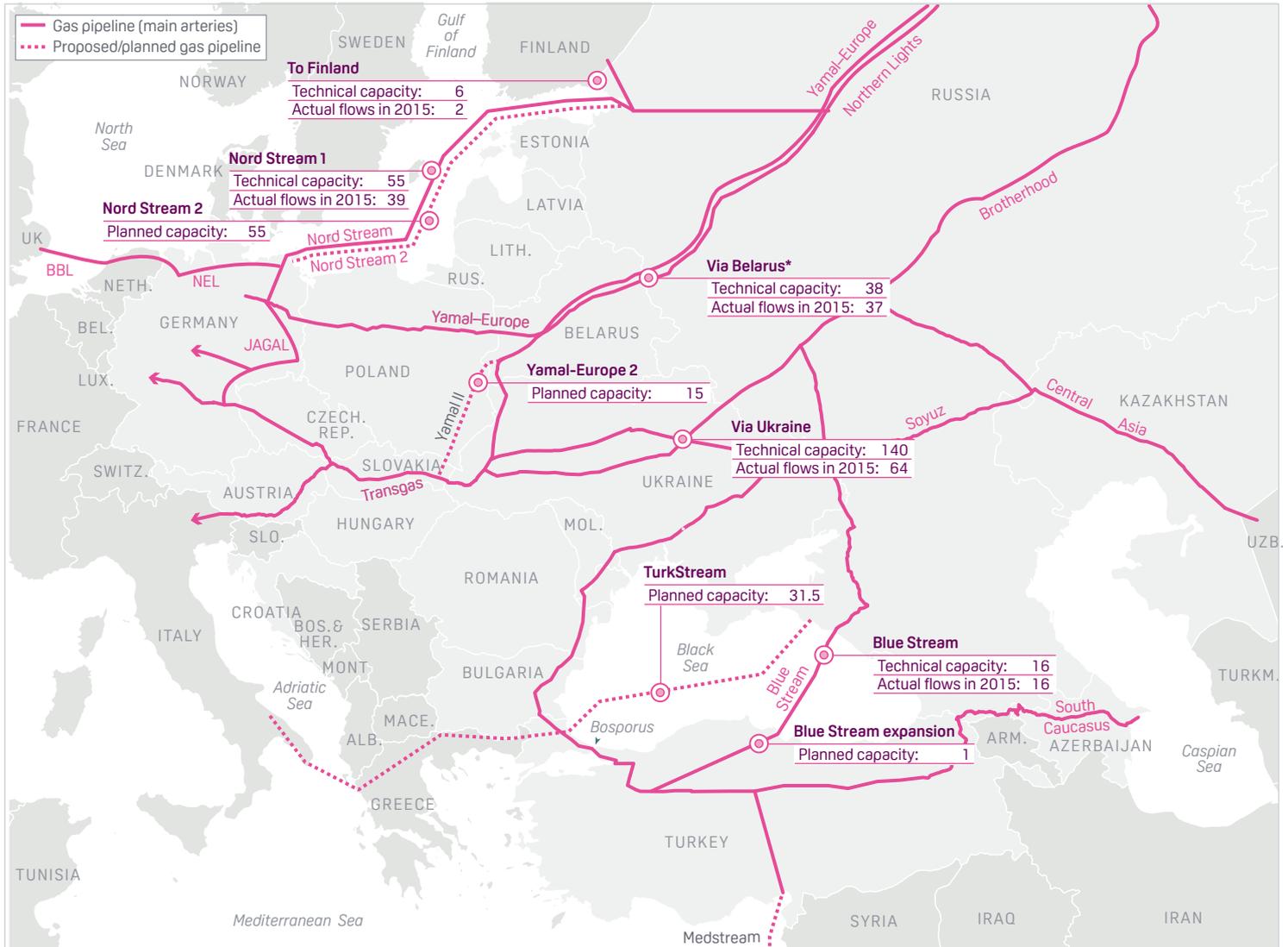
Flows through Nord Stream, however, are dependent on a legal case around the use of capacity in the interlinked OPAL pipeline in Germany.

RUSSIAN GAS TRANSIT VIA UKRAINE WELL DOWN ON 2008 PEAK



Source: UkrTransGaz

NORD STREAM 1 AND UKRAINE TRANSIT UNDERUSED IN 2015 (Bcm)



Notes: * Includes Yamal-Europe and other pipelines
Source: Platts

Conclusion

Gazprom and Naftogaz both believe they will emerge victorious from the arbitration cases, both publicly stating they expect a favorable outcome. The Stockholm court should legally focus on the text in the 2009 contract and should rule accordingly, regardless of politics or what the impact could be on either party, financially or otherwise.

But the bigger question is how the two companies react to any ruling and how fiercely the “winner” will look to enforce the

award. An increased risk premium could be added to European gas prices as a result given the precedent of two previous gas cut-offs in 2006 and 2009. Whether it could potentially lead to any disruption to gas supplies via Ukraine to Europe remains to be seen.

And that is why the European gas industry will be watching closely when the result of the ruling is made public and in the weeks following the decision.

APPENDIX 1

Full timeline explaining evolution of the arbitration case between Gazprom and Naftogaz

January 2009: Russia and Ukraine sign the now infamous 10-year gas supply agreement that saw ex-Ukrainian Prime Minister Yulia Tymoshenko jailed in October 2011. (She would be exonerated in June 2014 having been freed in March that year.)

April 2014: Russia's gas price to Ukraine rises by 80% from \$268.50/1,000 cu m in Q1 to \$485/1,000 cu m in Q2. The price hike, which came just weeks after Russia annexed Crimea, prompted Naftogaz to cease payments for Russian gas. Naftogaz submits a pre-arbitration claim to Gazprom that gives both parties 30 days to try to negotiate a lower gas price.

May 2014: Ukraine said it would repay \$4 billion in gas debt to Russia by the end of May if Gazprom canceled the price hike. Naftogaz pays back some money to Gazprom, but no agreement on gas price is reached. Naftogaz and Gazprom agree not to submit a legal claim with the Stockholm arbitration court until more talks on gas prices are concluded.

June 2014: Gazprom agreed to cut the Ukrainian price to \$385/1,000 cu m by cutting its export duty by \$100/1,000 cu m, but Kiev rejects the proposal, saying the lower gas price had to be incorporated into a gas supply contract between Naftogaz and Gazprom and should not be regulated by a Russian government resolution, which could be rescinded at any time.

15 June 2014: Talks fail.

16 June 2014: Gazprom files a lawsuit in Stockholm against Naftogaz citing its "significant accumulated gas debt and non-payments for the ongoing supplies. Gazprom said Ukraine owed more than \$4.5 billion to Gazprom for gas supplies in November, December, April, May and June. At the same time, Gazprom switched Ukraine to gas prepayment and halted supplies.

The same day, Naftogaz also files a lawsuit in Stockholm to force Gazprom to set "fair market" prices for gas and also seeks to recover \$6 billion from Gazprom in "overpayments" for gas since 2011.

Naftogaz seeks "a retroactive revision of the price, compensation of all overpaid amounts starting from May 20, 2011, which according to the claim amounted to no less than \$6 billion, and cancellation of the contractual prohibition on re-export of natural gas," according to Gazprom.

July 2014: The two cases are consolidated.

October 2014: Naftogaz lodges a separate claim with the arbitration court in Stockholm seeking to change its contract with Gazprom on transit of gas to Europe. Naftogaz argued the 2009 gas transit contract is in breach of its commitment to the Energy Community that the country has joined in 2010 and must be completely compliant before the start of 2015.

Naftogaz said it would also seek compensation for shortfalls in gas transit volumes since 2009. From 2009-2014, Gazprom shipped an average of 94 Bcm of gas annually via Ukraine as opposed to 110-112 Bcm/year that was stipulated by the transit contract. Naftogaz said it repeatedly asked Gazprom to address these issues, but the Russian company refused to cooperate.

October 2014: Russia and Ukraine sign deals to secure gas supplies to Ukraine until the end of March 2015 at prices below \$385/1,000 cu m. The price for new supplies was to be calculated according to the oil-indexed formula in the two countries' current supply contract with a \$100/cu m discount applied until end-March. As part of the deal Ukraine commits to pay off \$3.1 billion of its gas debt to Russia by the end of the year. The repayments are based on a preliminary price of \$268.50/1,000 cu m, the price Ukraine was paying for first quarter 2014 deliveries before Russia canceled discounts and the price rose to around \$485/1,000 cu m from April 1.

Russia said that Ukraine's total gas debt under the terms of the current contract was \$5.3 billion. Ukraine disputed this along with the second quarter price rise, and both sides lodged counter-claims at Stockholm's arbitration court. The final price and debt payable is to be determined by the court.

November 2014: Gazprom files its response to the Arbitration Court regarding the transit claim by Naftogaz on November 28.

December 2014: After trilateral talks also involving the European Commission, Gazprom resumed supplies to Ukraine on December 9 after Ukraine pre-paid for new volumes.

May 2015: Naftogaz submits formal "Statement of Claim" to Swedish arbitrators in its gas transit arbitration case with Gazprom. It follows a statement against Gazprom over supplies of gas that was submitted at the end of January. Naftogaz said it was seeking \$11-16 billion compensation in the transit case. Naftogaz said it wanted to recover losses relating to underpayment for transit going back to 2010. It is also claiming for under-deliveries of gas based on violations on volume commitments.

Ukraine also launches an anti-monopoly investigation against Gazprom, which dominated the Ukrainian market for years and may have manipulated it. If found guilty, Gazprom may be fined up to 10% of the volume of the company's annual operation in Ukraine.

May 2015: Gazprom imposes an \$8.2 billion fine on Naftogaz due to the Ukrainian company taking less gas from Russia than agreed in 2014 on the take-or-pay basis. Gazprom estimates Ukraine's total debt to Russia at more than \$29 billion. Ukraine's gas imports from Russia dropped by 44.2% year on year to 14.49 Bcm in 2014. Naftogaz rejects the fine, its CEO saying: "Arbitration is the most civilized way to resolve commercial disputes where the parties cannot find an agreement through negotiations."

October 2015: Gazprom files a minor \$6 million counter-claim to Naftogaz's May transit claims, saying Naftogaz had taken gas for balancing.

November 2015: Ukraine halts imports of Russian gas, saying it can source enough supplies from Europe.

January 2016: Ukraine implements new tariff regulations to bring it into line with EU rules, which means Gazprom would have to pay more to transit its gas through Ukraine. As of October 2016, Gazprom had not paid transit tariffs according to the new rules, and this was added to the Naftogaz arbitration case. Naftogaz said moving to ship-or-pay terms would increase Gazprom's costs, but refuted suggestions it was equivalent to tripling transit fees. "Gazprom has reserved the total capacity of 110 Bcm/year...but it is not willing to pay for the full reserved capacity," CEO Andriy Kobolev said.

January 2016: Ukraine's antimonopoly committee imposes a record fine of Hryvnia 86 billion (\$3.4 billion) against Gazprom for abusing its monopoly position while shipping gas via the country in 2009–2015. The committee obliged Gazprom to take action within two months to bring its gas transit practices via Ukraine in line with the ruling. Ukraine said it would sue Gazprom in a Ukrainian court if the Russian company refused to pay the fine. Gazprom said it would "defend its rights and legitimate interests by all legally available ways."

February 2016: Ukraine files another complaint against Gazprom in Stockholm for its refusal to provide information that would allow the country to use the practice of backhauling. The Stockholm court is expected to rule on the matter in early 2017. Backhauling, which is widely used in Europe, would allow Ukraine to massively increase imports of European gas without building more pipelines and even without moving physical amounts of gas across the border. But the practice has been opposed by Gazprom, which is unhappy because European companies simply re-sell its gas to Ukraine, capitalizing on lower prices in Europe compared with what Gazprom has been charging Ukraine.

February 2016: More amendments to the respective arbitration cases come to light. Then Ukrainian Prime Minister Arseniy Yatseniuk says Ukraine will seek to recover \$22.7 billion in losses as part of the suit it filed over its gas agreement with Russia in the Stockholm court. Ukraine alleges it overpaid Russia \$14.5 billion for gas purchases and undercharged it \$8.2 billion in transit fees for shipments to Europe since 2009. Gazprom is seeking to recover \$29.2 billion from Ukraine, alleging that Ukraine was supposed to buy even more gas from Russia under a take-or-pay clause.

March 2016: Ukraine increases its compensation claims against Gazprom by \$1 billion to \$23.7 billion for alleged underpayment for transit of Russian gas to Europe in the first quarter. The move came after Gazprom increased its own claim against Naftogaz by \$2.5 billion to \$31.7 billion as it seeks enforcement of "take-or-pay" clause in the gas supply contract.

April 2016: Ukraine says it will not seek negotiations with Russia over gas supplies and prices until after a ruling by the Stockholm arbitration court.

June 2016: Ukraine says it will only consider buying Russian gas if Gazprom agrees to amend its 10-year gas supply agreement that is due to expire in 2019. The amendments are needed to make sure Gazprom does not take future payments as part of its "take-or-pay" claims against Naftogaz.

August 2016: Naftogaz says it expects the Stockholm arbitration court to rule by the end of June 2017 on its dispute with Gazprom. The claim against Gazprom has now risen to \$26.6 billion.

Ukraine adds new complaints to its suit against Gazprom related to the Russian gas company's abrupt reduction in pipeline pressure in July. Naftogaz was forced to briefly switch to emergency operation mode after Gazprom cut gas supplies to markets in Europe via Ukrainian pipelines.

September 2016: Naftogaz CEO says he is confident the company will prevail in tit-for-tat arbitration cases with Gazprom. He says the total claim from Gazprom's side is \$38 billion, while the total claim from Naftogaz is \$27 billion. "It is a very big case. But Gazprom has lost almost all similar cases in the past and we believe Gazprom will lose this time again."

November/December 2016: The cases are heard in the Stockholm arbitration court.

January 2017: Gazprom makes a claim for \$5.319 billion to Naftogaz for gas not paid for under take-or-pay rules from Q2, Q3 and Q4 2016. Naftogaz said it would ignore the bill until the court ruling is handed down. Gazprom said it would add the total to the rest of the claim before the Stockholm court.

APPENDIX 2:

Other ongoing international arbitration cases involving Gazprom

Counterparty	Date launched	Subject	Outcome	Hearing date
GasTerra	Mar 31, 2016	price revision	pending	pending
Botas	Oct 29, 2015	price revision	pending	Oct 2017
Shell	Sep 30, 2015	price revision	pending	Feb 2018
PGNiG	May 18, 2015	price revision	pending	July 2017
DONG	Dec 23, 2014	price revision	pending	Jun/Jul 2017

Source: Gazprom, Platts

One of the biggest cases that went to arbitration – but was ultimately settled out of court – was the 2013/14, Eur10 billion claim by Eni against Statoil.

Publicly announced financial gains to date:

Previous arbitration rulings over gas price in long-term contracts have seen wins for parties alleging unfair pricing practice. They include:

August 2010: Sonatrach vs Gas Natural – Eur2 billion

September 2012: Edison vs RasGas – Eur450 million

April 2013: Edison vs Sonatrach – Eur300 million

September 2014: Edison vs PromGas – Eur80 million

November 2015: Edison vs Eni (Libya contract) – Eur1 billion

February 2016: Botas vs NIGC – \$1.5 billion (estimated)

But others, such as that by Lithuania against Gazprom, were dismissed:

April 2013: Sonatrach vs Statoil – dismissed

July 2016: Eni vs GasTerra – Eur2 billion claim dismissed

APPENDIX 3:

Previously settled cases

To get a feel for what could happen next, it is worth looking at previous cases. Most Gazprom contract disputes were settled out of court – either without the need for arbitration at all or as a result of a case being filed but before a hearing.

The settlements with buyers have mostly been out-of-court and enabled buyers to “de-risk” their contracts, presumably by bringing in more hub pricing, or at least price corridors that put a cap and floor on prices.

In previous cases that went to arbitration, Gazprom lost against RWE Transgaz, twice, but won against Lithuania.

Other cases have tended to find in favor of the claimant requesting lower prices, although Eni had its Eur2 billion claim against GasTerra over Dutch gas prices dismissed in July 2016.

Cases that ended with an arbitration ruling

The two cases involving Gazprom that went all the way to an arbitration ruling were one regarding a pure pricing dispute (RWE Transgaz) and the other seemingly with a political agenda (with Lithuania and Lietuvos Dujos).

The current case with Naftogaz contains both elements. And importantly, there is no precedent on the element of what constitutes a “fair price” given that RWE Transgaz won its case, but Lietuvos Dujos lost its case. Details of rulings are not made public.

2011-2013: RWE Transgaz vs Gazprom

It’s worth looking back at the two cases in some detail, starting with RWE Transgaz, the German-owned Czech gas importer.

There were two cases that went to arbitration between Gazprom and RWE Transgaz in 2011, one initiated by Gazprom regarding the take-or-pay level in its long-term contract with RWE Transgaz and the other initiated by RWE Transgaz on the pricing formula in the contract. The arbitration courts found in favor of RWE Transgaz in both cases – in October 2012 in the take-or-pay case and in June 2013 on fair pricing.

Gazprom had attempted to impose a fine of an estimated \$500 million on RWE Transgaz for gas not imported in 2008-2011, in other words for failing to adhere to its take-or-pay obligations.

The Vienna arbitration court found in favor of RWE Transgaz in October 2012, RWE saying only that the ruling would have a “triple digit million euros per year” impact. The ruling meant RWE Transgaz could reduce its minimum offtake levels under

the take-or-pay clause by the gas volumes that Gazprom directly supplies to the Czech market.

At the same time, the center ruled that Gazprom could not increase RWE Transgaz’s minimal offtake levels by the amounts the Czech company exports to other markets where Gazprom Export operates, it said.

The option to fine-tune RWE Transgaz’s offtake levels under the take-or-pay clause, depending on Gazprom’s activities in the Czech market and RWE Transgaz’s exports outside the Czech Republic, was set forth in an appendix to the gas supply contract between the two companies.

Crucially – and this could be an important factor in the Naftogaz/Gazprom case – Gazprom appealed against the October 2012 ruling in January 2013 to the Vienna Commercial Court, arguing that the ruling contradicted EU antitrust regulations as it favored RWE Transgaz’s monopolistic position in the Czech market.

“The arbitration decision is clearly anti-Gazprom and forces Gazprom Export to act in breach of the European law. At the same time, the decision taken by the arbitration allows RWE Transgaz to retain its dominant position in the country throughout the duration of its contract, which results in restriction of competition. The arbitration decision contradicts public order [as] the arbitration wrongly applied the imperative norms of the European competition law. As a result, the decision of the arbitration contradicts the European Union law. The Vienna Commercial Court in this case is legally [able to] set aside arbitration decisions delivered on the territory of Austria.”

But the appeal was dismissed in June 2013.

The second case was against Gazprom Export over its gas pricing policy. At the time, RWE Transgaz said: “The...arbitration has as its subject matter the adaptation of import price conditions towards the prevailing competitive levels in the wider Czech market.”

RWE Transgaz argued that the original oil-indexed long-term take-or-pay contract with Gazprom Export from 2010-2035 contained price resolution clauses that committed both sides to agree on adjustments to contracted gas prices if they became significantly out of line with those on the gas market. Gazprom refused to honor this part of the contract, it said.

Due to the long-term oil-indexed take-or-pay contract with Gazprom, RWE is buying gas expensively and selling it cheaply, with the average difference between the oil-linked contract gas from Gazprom Export and market prices around Eur12/MWh through 2012.

RWE Transgaz estimated accumulated losses since 2010 caused by Gazprom Export’s refusal to amend its long-term take-or-pay contracts at Koruna 29 billion. A best case scenario from the Vienna arbitration would be a decision forcing Gazprom to repay that amount..

In June 2013, RWE won the arbitration. It said: “The tribunal awarded RWE a reimbursement for payments made since May 2010 and adjusted the purchase price formula of the contract by also introducing a gas market indexation, which according to the arbitration tribunal reflects the relevant conditions on the gas market at the time of the price revision in May 2010.”

Gazprom Export confirmed it had received the international arbitration ruling forcing it to return cash to customer RWE and revising the long-term contract price of gas supplies to the Czech Republic. “This is the first case in Gazprom Export’s business history of an arbitration decision that revises pricing conditions of the long-term contract for gas supplies,” it said.

Gazprom Export said it has previously managed to reach mutually acceptable pricing solutions with other partners, and pursued a similar policy in negotiations with RWE. “However, despite all Gazprom Export’s attempts, RWE Supply & Trading CZ had not shown any readiness to find a compromise.” Gazprom Export also said the ruling did not grant all of RWE’s original demands.

“RWE Supply & Trading CZ had been putting forward many alternative demands on the free fall of price and radical pricing formula revision. However, most of these claims were rejected by the arbitration. As a result, the pricing formula has been adjusted in a certain way, but this adjustment is far away from the original demands made by RWE Supply & Trading CZ,” Gazprom said.

Although it was never made public, the amount RWE Transgas was awarded in its 2013 pricing ruling was thought to be around Eur350 million. Gazprom Export said RWE did not win all of its claims.

2011-2016: Lithuania vs Gazprom

The arbitration cases between Gazprom and Lithuania were complex and covered various elements of the relationship between the two – not dissimilar to the Naftogaz cases. Like Ukraine, Lithuania historically had paid some of the highest prices for Russian gas in Europe despite being border countries with Russia.

The first cases were launched by Gazprom against Lithuania’s energy ministry in August 2011 relating to the ministry suing gas importer Lietuvos Dujos (in which Gazprom also held a minority stake) in a Vilnius court for violating Lietuvos Dujos’ privatization agreement by not supplying gas at “fair prices” as specified in the agreement.

Gazprom also insisted that Lithuania was obliged to buy around 5 Bcm/year of gas after 2009 according to its oil-indexed take-or-pay contract, but had only used 60%-70% of the contracted volumes. The issue was complicated by a law to break up Lietuvos Dujos into two separate units – supply and transportation – to allow competition on the market as required by EU legislation.

In a second case in March 2012 Gazprom took the government of Lithuania to an international arbitration court over the planned split of Lietuvos Dujos.

The cases dragged on in all cases, with awards made to Gazprom and subsequently appealed. In the first case, proceedings were discontinued at the order of the Lithuanian supreme court and in the second, proceedings were terminated after Gazprom sold its stake in Lietuvos Dujos in June 2014.

A third arbitration case was brought in October 2012 by the Lithuanian government which filed a Eur1.45 billion (\$1.87 billion) claim against Gazprom with the International Chamber of Commerce Court of Arbitration in Stockholm, alleging that it has unfairly increased prices in the period 2006-2015.

In June 2016, Gazprom said it had won the arbitration case brought against it by Lithuania over Russian gas prices. Gazprom said the court rejected all claims made by Lithuania with respect to the terms of purchasing Russian gas, including the Eur1.45 billion claim against Gazprom. “In its ruling, the SCC rejected all of Lithuania’s allegations of unfair prices for gas supplied by Gazprom in the period 2006-2015 to Lietuvos Dujos, the Lithuanian-based company that used to have Gazprom and Lithuania as its shareholders,” Gazprom said. “The SCC ruling is final and not subject to appeal,” it said.

Nonetheless, Lithuania has appealed. The energy ministry submitted its appeal against the arbitration ruling to the Svea court of appeal in Stockholm on September 21. The Lithuanian government said it would take “all necessary steps” to cancel the ruling.

“After the arbitration decision, the only possibility to continue to defend our interests is to apply to a Swedish court that it cancel the award,” the Lithuanian ministry said.

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