

Naftogaz versus Gazprom: First news from Stockholm

Even though Ukraine has not imported gas from Russia since November 2015, their state-owned gas companies Naftogaz and Gazprom are since 2014 involved in a legal battle over their 2009 gas supply and transit contracts.

The overall sum of compensation claims from both sides amounts to a staggering USD 77 bn, which is a huge amount of money by any standards. Thus, it comes as no surprise that a first ruling of the arbitration tribunal at the end of May 2017 on the supply contract received significant interest around the world. Based on publicly available information, it seems very unlikely that Gazprom's substantial claims need to be fulfilled by Naftogaz, which removes significant uncertainty on the company and the Ukrainian government.

Background: The 2009 supply and transit contracts

Since the break-up of the Soviet Union, Ukraine has imported significant volumes of gas from Russia (79% of its consumption in 2008) and transported a large share of Russian gas exports to Europe (69% in 2008). Due to the mutual dependency, mixture with other policy areas, significant payment arrays and the involvement of rent-seeking intermediaries, these arrangements were highly political.

Throughout 2008, Ukraine and Russia tried to negotiate new gas contracts that were supposed to cut out intermediaries and make prices more market-oriented. The negotiations finally failed and gas supply to and transit through Ukraine was stopped in early 2009. This caused a gas supply crisis in Ukraine and in the EU. Under pressure to resolve this issue, Ukrainian Prime Minister Tymoshenko went to Moscow and negotiated a 10-year gas supply and transit deal with Russian Prime Minister Putin. The two contracts were not disclosed but later leaked.

The gas supply contract implied that Ukraine had to buy 42 billion cubic metres (bcm) per year at a price that was linked to European gasoil and mazut prices, with a six month delay. Given rising oil prices and falling gas demand in Ukraine, both provisions became a growing problem for the country.

While the gas transit contract led to an increase in transit tariffs for Ukraine, it also implied that Ukraine was not able to use its gas infrastructure to import gas from the EU or create an independent gas transmission company in line with EU rules.

In subsequent years, discretionary relieve was granted to Ukraine in return for political concessions. But, in April 2014 Russia (1) withdrew the politically-motivated gas price discount granted to Ukraine in 2013 (2) cancelled the reduction in gas-export duties granted for hosting the Russian Black Sea fleet in Crimea and (3) asked for the repayment of Ukraine's huge gas debts. Ukraine did not accept a return to the 2009 price formula – which implied a hike in the gas price from USD 268.50 to USD 485 per thousand cubic metres (tcm). The parties started to negotiate both the gas price and conditions of debt repayment and in parallel filed suits against each other at the Stockholm International Arbitration Court.

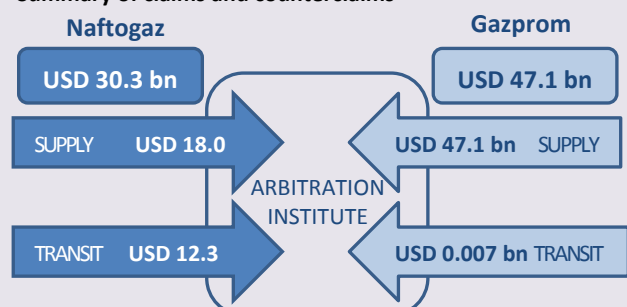
The position of Naftogaz

As the legal proceedings are confidential, we have to rely on public statements by the parties. With respect to the supply contract, Naftogaz essentially seeks compensation in the order of USD 18 bn (incl. penalties and interest) for excessive gas prices from May 2011 to October 2015. In addition, Naftogaz wants to void provisions in the supply contract relating to minimum off-take volumes, destination clauses and the price formula. With respect to the transit contract, Naftogaz seeks compensation in the order of USD 12 bn for under-utilisation of the transit 2009-2016 (the contract foresaw annual volumes of 110 bcm). In addition, Naftogaz wants to void provisions in the transit contract that are not in line with the third energy package that Ukraine has to implement as a member of the Energy Community.

The position of Gazprom

With respect to the supply contract Gazprom claims a compensation of USD 35 bn from the take-or-pay clause for 2012-2016 (except for winter 2015-16) as well as USD 2 bn for unsettled price disputes in two quarters. Together with penalties and interest these claims sum to USD 47 bn, equal to 50% of Ukraine's GDP (2016). With respect to the transit contract, Gazprom has no significant claims.

Summary of claims and counterclaims



Source: Naftogaz

The ruling in Stockholm: First impressions

Given the amount of claims and counterclaims in both cases, it is not a surprise that the ruling of the Arbitration Institute of the Stockholm Chamber of Commerce was expected with great interest in Ukraine and abroad. On 31 May 2017, the arbitration court issued an 800-page separate award in the supply case, which was given only to the two parties to the dispute, and not made public. Thus, any available information on the ruling and its content is based on information that either of the parties disclosed. Below, we summarise the main points of the ruling that Naftogaz made public:

- Price formula: The court revoked the oil-price linked formula underlying the contract, linking it to European gas hub prices.
- Take-or-pay clause: This clause, which required Ukraine for paying gas that it did not purchase, and which was the main point of Gazprom's claims, was revoked until the final award.
- Re-export: The court abolished the ban of re-exports of Russian gas that the contract included.

Next steps

The court ordered the parties to the dispute to sit together and find a solution to the points mentioned in the previous section, in particular to the pricing mechanism. In order to reach a consensus, the parties have up to 3 months of time for negotiations. In case there is no consensus reached between them, the court will take over again and determine in a final award the applicable mechanism and the resulting monetary awards which need to be satisfied. This will most probably be in the second half of the year.

An appeal to this final ruling is possible, but won't change the fundamental decisions laid down in the separate award. Such an appeal can only change specific calculations and monetary awards resulting from the application of the fundamental principles. However, it would further prolong the process.

A separate arbitration case is the transit case, where a ruling in the coming months is expected. Since this case is simpler than the supply case, it is expected that only one award will be issued by the arbitration court. The appeal procedure applies to this case as well.

Outlook

The first decision of the Stockholm court in this 3-year dispute removes significant uncertainties from state-owned Naftogaz, and implicitly also from the sovereign. While the amount of monetary claims is still to be decided, and the transit case still pending, it seems very unlikely that these sums are close to the originally claimed amounts. As of now, it is impossible

to say who of the two parties will eventually receive a net claim on the other party.

Once the claim is awarded and a possible appeal procedure exhausted, the question will then be to enforce the judgement. This will most probably involve further negotiations between the parties, or courts, in the future.

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