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Oil & Gas: Naftogaz v Gazprom - Right to a natural gas price revision

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During the course of 2017 an arbitral tribunal in the case of *Naftogaz v Gazprom* (SCC Arbitration No. V2014/078/080) [1] rendered two awards in determination of the price review dispute between the parties. Following Naftogaz's subsequent and ongoing enforcement efforts, the ramifications of this decision are set to continue in the year to come.

Against this backdrop, in November 2018 Naftogaz made the unusual decision to publish redacted copies of the arbitral tribunal's awards,[2] which has offered the oil and gas industry a rare insight into a high-profile gas pricing mechanism and an opportunity to review an arbitral tribunal's determination as to its operation. It should be reassuring for users of contracts containing price review provisions that, despite the political background to and interest in this dispute, the arbitral tribunal based its decision only on the price review clause wording contractually agreed between the parties. It is also of note that the arbitral tribunal resolutely refused to allow the re-opening of pricing issues already determined in a previous arbitration.

Background

In the immediate aftermath of the gas crisis of January 2009, which ultimately saw Russia temporarily halt all deliveries of natural gas to Ukraine (both for Ukraine's own use and for onward transmission to other European countries), National Joint Stock Company Naftogaz of Ukraine ("**Naftogaz**") and Public Joint Stock Company Gazprom ("**Gazprom**") entered into a long term contract for the purchase and sale of natural gas for the period 2009-2019 dated 19 January 2009 (the "**Gas Sales Contract**"), and into a contract on volumes and terms of transit of natural gas through Ukraine for the same period (the "**Gas Transit Contract**").

Disputes arose under both the Gas Sales Contract and the Gas Transit Contract, and have been determined by way of three separate arbitrations presided over by the same arbitral tribunal. This article concerns the Gas Sales Contract and the two arbitrations conducted in determination of disputes thereunder. An article considering the Gas Transit Contract arbitration can be found here. The contracts are governed by Swedish law, with disputes to be resolved by arbitration in accordance with the rules of the Arbitration Institute of the Stockholm Chamber of Commerce.

The Issues

The issue at the centre of the pricing dispute was Naftogaz's claim to a contractual right to a price review and determination under the Gas Sales Contract. According to Naftogaz, it first requested a price revision by letter dated 20 May 2011. This request outlined developments in the fuel and energy market which meant that the price of gas payable under the Gas Sales Contract no longer corresponded to the then current price levels of natural gas. Further letters were exchanged between the parties in respect of the price revision, gas delivery volumes and the postponement of payment for the gas, and they met several times but no final agreement as to price revision was reached. The failure of this process led to the arbitration being commenced by both parties filing requests for arbitration on 16 June 2014.

The main issues in dispute between the parties for consideration and determination by the arbitral tribunal were as follows:

- Naftogaz claimed an adjustment of the price payable under of the Gas Sales Contract, and retroactive compensation for historic overpayments dating from 2011.
- Naftogaz claimed that certain provisions of the Gas Sales Contract should be declared invalid or ineffective - specifically the volume and take-or-pay provision, the destination clause, the unilateral suspension right clause and the mandatory sales clause of the Contract.
- Gazprom denied that Naftogaz was entitled to relief, and counterclaimed for payment of outstanding amounts due for gas delivered and for gas accessible but not off-taken under take-or-pay provisions, plus interest. Naftogaz rejected the counterclaim.

The Arbitral Awards

The arbitral tribunal chose to deal with the issues in dispute in bifurcated proceedings. On 8 May 2017 the arbitral tribunal rendered what it deemed a "Separate Award" disposing of the issues of fact and law to decide, amongst other issues: (1) Whether there was a right to price revision; (2) whether there was a right to price determination and what that price determination should be; (3) whether Gazprom has a right to take-or-pay payments; and (4) whether one or more contractual provisions should be declared void or ineffective (the "**Separate Award**"). In summary, the arbitral tribunal held as follows:

1. Naftogaz had a right to price revision.
2. Naftogaz had a right to price determination; the arbitral tribunal determined a new formula on the basis of the pricing mechanism seemingly linked to German Hub prices, taking effect from 27 April 2014.
3. Gazprom had no right to retrospective take-or-pay payments for the period 2009-2017.
4. Several clauses were declared invalid (notably the destination clause, which had prohibited the sale of gas purchased under the Gas Sales Contract outside of Ukraine), with the take-or-pay provision to be revised in a final award.

All resulting outstanding issues (including quantum) were to be determined by agreement of the parties or, failing such agreement decided by the arbitral tribunal in a final award after further proceedings. No such agreement was reached, and the arbitral tribunal rendered its final award on 22 December 2017 (the "**Final Award**"). In summary, the result was as follows:

1. The parties agreed that the arbitral tribunal should set off amounts owed between the parties in order that a single net amount should be ordered to be paid by one party to the other.
2. The net amount payable by Naftogaz to Gazprom, principal and interest included, as per 31 December 2017 was USD 2,018,920,854.91.
3. The arbitral tribunal finalised the text of the revised take-or–pay provision (the text of such revision was redacted).

Separate Award

In the text of the Separate Award the arbitral tribunal emphasised that its decisions were based on the interpretation of the parties' agreement on the basis of the Swedish law on interpretation of

contracts, meaning that provisions would be interpreted "*in accordance with the plain and ordinary meaning of the words used*". The arbitral tribunal found the contract to be "*imprecise and simplistic*" and its provisions "*not well formulated*". There was limited evidence as to the intentions of the parties, and it appeared to the arbitral tribunal that the parties had not given any real thought as to the meaning of the contract's terms. The arbitral tribunal therefore relied on the Swedish law of interpretation of contracts, thus interpreting the provisions in accordance with the plain and ordinary meaning of the words used.

Whilst acknowledging the special nature of the relationship between Gazprom and Naftogaz, and indeed Russia and Ukraine, the arbitral tribunal was careful to demonstrate that this special political nexus was not relevant to its decision-making in relation to the price review provisions. The arbitral tribunal considered that "*the relationship between Gazprom and Naftogaz is not merely a normal commercial relationship…..the relationship has also been political….where considerations other than merely commercial considerations have often been decisive*". However it clarified that *"[n]eedless to say, the case has, however, been examined by the Tribunal from a strictly legal point of view*".

Price revision - right?

The contract price payable under the Gas Sales Contract was based on a price formula made up of a base price, an escalation supplement and a coefficient. The escalation supplement was calculated by reference to the movements in the price of gas oil and fuel oil.

The price revision provision was as follows (there was no agreed translation of the clause; this is the version of the clause that the arbitral tribunal used, specifically Naftogaz' translation from Russian with text from Gazprom's translation inserted reflecting differences in translation):

"4.4 If either Party declares that the fuel and energy market conditions have changed significantly compared to what the Parties had reason to expect at the conclusion of this Contract, and if the contract price provided in Article 4.1 of this Contract does not reflect the level of market prices, then the Parties shall enter into negotiations regarding an adjustment of [Gazprom: proceed to negotiations to consider] the Contract Price in accordance with the provisions of this Contract.

4.4.1 A request for price revision [Gazprom: to reconsider the price] shall be submitted in writing and shall be properly substantiated [Gazprom: duly justified by the requesting Party]. Upon receipt of the above-mentioned request by the Party concerned, the Parties shall enter into negotiations within 20 days and, if an agreement is reached, sign the respective addendum to this Contract.

4.4.2 If a written agreement on the revision of the Contract Price [Gazprom: to reconsider the contract price] cannot be reached within 3 (three) months from the date of the beginning of negotiations, each of the Parties has a right to dispute the other Party's performance of the present Contract [Gazprom: has a right to challenge the actions of the other Party to perform this Contract] and to submit the matter to arbitration in accordance with Article 8 of the Contract for the passing of a final decision [Gazprom: for the adoption of a final resolution]."

In summary, contractually a price review required (i) a significant change in the fuel and energy market conditions, compared to what the parties had reasonably anticipated when they entered into the Gas Sales Contract; and (ii) that the contract price of the Gas Sales Contract no longer reflected the fuel and energy market conditions. If a party wished to declare a price review on this basis, it was mandated to commence a negotiation following a written notification to the other party. If such process did not result in written agreement, the parties were entitled to submit the matter to arbitration.

Naftogaz claimed that changes in the fuel and energy market afforded it a right to a price review under clause 4.4 of the Gas Sales Contract. Gazprom disagreed, arguing that clause 4.4 was actually a price renegotiation clause and as such, if negotiations failed, there was no right to have the price revised through arbitration and that therefore the arbitral tribunal did not have jurisdiction to revise, replace, adjust or amend the price.

The arbitral tribunal held that this provision **was** a price revision clause, and that where the parties failed to reach agreement in accordance with Article 4.4.1, a party had the right to submit the determination to arbitration in accordance with article 4.4.2. To reach this determination, the arbitral tribunal considered the plain and ordinary meaning of the wording used in the clause. Of note in the arbitral tribunal's reasoning was the fact that it noted that the Gas Transit Contract contained a similar price revision clause which the parties agreed was a price revision clause empowering the arbitral tribunal to revise the price. Although the clauses were

different, the arbitral tribunal was of the view that "*it is difficult to find any sensible reason for an intent that the [Gas] Transit Contract should be different in respect to price revision from the [Gas Sales] Contract*", and the parties were not able to provide any persuasive evidence on this point.

Following a detailed review of the correspondence and evidence, the arbitral tribunal decided that the circumstantial pre-requisites for a submission to arbitration had been met, namely that Naftogaz had declared a change in market circumstances, and had appropriately corresponded and negotiated with Gazprom in respect of a price review. Therefore, Naftogaz had a right to submit the price revision to the arbitral tribunal, and it was appropriate for the arbitral tribunal to determine the price.

Price revision determination

To determine the price itself, the arbitral tribunal considered what was meant by the "*fuel and energy market*", noting that no contractual guidance was offered. The arbitral tribunal reasoned, based on the wording of the Gas Sales Contract, that the Parties wanted to keep the contract price in line with market developments. As to what those market developments were, the arbitral tribunal decided that an exact meaning was not necessary, as the experts in the arbitration agreed that the market condition on which the Gas Sales Contract had been based was the oil price. The market had changed on the basis of European market-wide decoupling of oil-linked prices and hub prices, resulting in hub prices becoming a prominent and important price formation mechanism in European markets.

On this basis the arbitrators agreed with Naftogaz's argument that the gas price should be market-reflective, switching from 100% price referenced to petrochemical price to 100% referenced to gas market price. As to which specific gas market was the most appropriate to be used in the price formula, much of the arbitral tribunal's reasoning has been redacted. The parties agreed that the Ukrainian market as reference was irrelevant. Naftogaz claimed that Germany, Slovakia and the Czech Republic were the relevant markets, and whilst Gazprom agreed it also considered France, Italy, Poland and Hungary to be of relevance. The arbitral tribunal noted that the parties used three markets in common, namely Germany, Slovakia and the Czech Republic. Although much of the final price formula decision has been redacted from the Separate Award, it appears likely from the Final Award that German Hub prices were chosen as the reference market. The arbitral tribunal partially rejected the retrospective claim for overpayment. Naftogaz

had originally sought compensation for the price paid from 2011 to 2014, however the arbitral tribunal revised the price from 27 April 2014 (that date being the date on which Naftogaz sent Gazprom a notice of dispute indicating that it intended to refer the price revision to arbitration).

Take-or-pay

The arbitral tribunal's determinations on take-or-pay have mostly been redacted. It is understood that, whilst the arbitral tribunal maintained the take-or-pay principle for 2018-2019, its terms were modified, with the minimum take-or-pay level reduced to 4BCM. The arbitral tribunal rejected Gazprom's retrospective "take-or-pay" claim for gas not taken in 2012-2017.

Final Award

In the Final Award the arbitral tribunal firmly refused to allow the reopening of issues which had been dealt with in the Separate Award. It held that the decision to render a Separate Award was based on the concerns expressed by the parties that the arbitral tribunal may need assistance in making complex calculations and on the arbitral tribunal's desire to provide the parties with an opportunity to settle outstanding issues. If no settlement was reached, the arbitral tribunal would determine these issues, which were expressly and purposefully of a nature that did not involve the arbitral tribunal considering new legal arguments or new facts:

"The intent was not that the parties should re-argue issues that had been fully argued, even less issues that had been determined by the Separate Award, or that the parties should be allowed to make new claims. There is no basis in the Separate Award for allowing this. Nor is there any other decision by the Tribunal to that effect.

Thus the arbitral tribunal rejected Naftogaz's attempts to further refine the pricing mechanism in the proceedings leading to the Final Award on the basis that these points were not open to re-arbitration. Further, the arbitral tribunal forcefully rejected any attempt by the parties to rewrite the contract:

"The fact that the Separate Award has been rendered, and that issues remained to be resolved, does not entail an opportunity for a party to improve its case or the Contract commercially for its benefit. Nor does it open the door for arguments that there are commercial or reasonable contractual solutions that are common or customary, or for solutions which are better or different from the ones that have been agreed by the parties in the Contract, or which may be desirable for avoiding ambiguities. In simple words, the arbitration is not about writing a new, better Contract.

Comment

It is notable that, despite the undeniable political interest in this dispute, the arbitral tribunal firmly applied a strictly legal interpretation of the contractual terms agreed between the parties, acknowledging yet side-stepping contentious political and strategical arguments. As there will frequently be a political backdrop to gas sales contracts, it is notable for negotiators and users of price review mechanisms that the precise wording used by the parties was of paramount importance in interpretation under Swedish law.

The case also serves as a useful reminder as to the need for contractual parties to closely comply (and document such compliance) with contractual mechanisms for pre-dispute communication and negotiation, as the arbitral tribunal was careful to ensure that the steps agreed between the parties had been fulfilled.

Although the price review mechanism in dispute was prescriptive as to the actions necessary to trigger a price review, the criteria on which the arbitral tribunal were to review and revise the price were arguably not clearly set out. Whilst the arbitral tribunal in this case disposed of the issue in simple terms by treating the trigger for price review (i.e. the change in market prices) as the basis on which the price formula should be reviewed and revised, this may not always be the case. Where parties wish to exert more precise control over the constituent elements of the price review they may wish to set out clear contractual wording as to the criteria to be applied by the decision-maker.

In this respect, the price review clause in the Naftogaz/Gazprom contract may be contrasted with those setting out greater guidance for the parties and any arbitral tribunal. For example, in an LNG sale and purchase agreement between Atlantic LNG and Gas Natural the price review clause expressly required:

"(b) In reviewing the Contract Price in accordance with a request pursuant to sub-Article 8.5(a) above the Parties shall take into account levels and trends in price of supplies of LNG and Natural Gas [redacted] such supplies being sold under commercial contracts currently in force on arm's length terms, and having due regard to all characteristics of such supplies (including, but not limited to quality, quantity, interruptability, flexibility of deliveries and term of supply).

(c) The Contract Price as revised in accordance with this Article, shall in any event, allow the Buyer to market the LNG supplied hereunder in competition with all competing sources or forms of energy…. And such Contract Price shall allow the Buyer to achieve a reasonable rate of return on the LNG delivered hereunder."

For further commentary see: Ashley and Holland, *Natural Gas Price Reviews: Past, Present and Future*(2012) 30(1) IBA Journal of Energy and Natural Resources Law 29.

Of further note was the arbitral tribunal's absolute refusal in the Final Award to allow the bifurcated proceedings to provide any party with the opportunity to reopen pricing issues that had already been decided, or which that party had already had the opportunity to raise, in the proceedings leading to the Separate Award. This serves as a useful reminder that in bifurcated proceedings it is not open to the parties to re-open issues already decided by an arbitral tribunal, nor to offer evidence which should have been offered in the first set of proceedings. Similarly parties should ensure to the greatest extent possible that they provide all appropriate and relevant evidence at the correct point in proceedings in order to avoid the risk of later being unable to do so.

Arbitral Tribunal:

Mr. Tore Wiwen-Nilsson (Chair), Mr. Jens Rostock-Jensen, and Mr. Johan Munck

Reference:

National Joint Stock Company Naftogaz of Ukraine v Public Joint Stock Company Gazprom (SCC Arbitration No. V2014/078/080) – the "Separate Award"

National Joint Stock Company Naftogaz of Ukraine v Public Joint Stock Company Gazprom (SCC Arbitration No. V2014/078/080) – the "Final Award"

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