GAR Global Arbitration Review NEWS

Gas payment issues in Europe: what are the next steps?

11 May 2022

*Squire Patton Boggs partners **Michelle Bock**, **Max Rockall**, **Stephen Anway** and **George von Mehren** consider the options available to European importers of Russian gas in the wake of President Putin's decree that supplies should be paid for in Russian roubles.*

In recent weeks, Russia has demanded that certain buyers of natural gas pay in roubles. On 27 April 2022, Russia announced that it had cut off gas flows to two EU member states, Poland and Bulgaria, which refused to comply with this demand. Where does that leave the remaining EU member states and what are the next steps if and when Russia cuts off gas supply?

This article explores the critically important currency payment issue and considers the possible next steps available for buyers.

The Russia-Ukraine conflict and the Decree

When the Russia-Ukraine conflict commenced in February 2022, concerns immediately increased regarding Russian gas supplies to European buyers. While various sanctions were imposed against Russia and Russian companies and individuals, gas sales were not embargoed. At the time of writing, Russian gas sales are still not embargoed.

On 23 March, Russian President Vladimir Putin announced that Russia would continue exporting gas under previously concluded contracts, but that such exports to "unfriendly countries" would change their payment currency to Russian roubles. The Russian government previously identified "unfriendly" countries to include all EU member states, the US, the UK, Japan, Switzerland and Norway.

Approximately 60% of Gazprom's gas sales exported to other countries are settled in euros, while approximately 40% are settled in US dollars. President Putin's announcement that exported Russian gas would have to be paid in roubles raised immediate questions about whether such a unilateral change to payment currency could be made, whether buyers in nations deemed "unfriendly" would comply with the requested currency change, and what the impact would be if they failed to comply.

In the wake of public outcry resulting from this announcement, Russia ultimately announced a more nuanced payment scheme, rather than a straightforward demand that payment be made directly in roubles. On 31 March, Russia issued Decree No. 172, entitled "On special procedure for the fulfilment of obligations by foreign buyers to Russian Natural Gas suppliers". While the vast majority of Gazprom Export's gas sales to European countries are priced, invoiced and paid in euros or US dollars, the Decree seeks to change that.

Under the Decree, gas supplied by Russian exporters after 1 April 2022 to "unfriendly" states must be paid by way of a multistep mechanism through specialised Gazprombank accounts:

- The buyer must open special "type K" banking accounts in euro and rubles at Gazprombank.
- The buyer must then transfer the foreign currency stipulated in its contract into its own "type K" account at Gazprombank.
- Gazprombank then changes the euro payment into rubles before depositing that sum in the Russian exporter's account.

The Decree stipulates that payment under these long-term supply contracts—regardless of the actual contractual terms—will be effected only once the rouble proceeds of foreign currency exchange are deposited in the Russian exporter's account.

The effects of the Decree are in their natal stages but evolving rapidly. Long-term contracts typically provide that gas delivered in April will be invoiced in the first half of May, and the invoice is then paid at the end of May. However, at least two importers have already had their post-Decree invoices come due: Polish importer PGNiG and Bulgarian importer Bulgargaz. In response, both companies refused to pay those invoices in accordance with the new payment scheme set out in the Decree. Those refusals prompted Gazprom to announce that it had taken immediate steps to shut off gas flows to both companies.

As gas is piped from Russia to continental Europe through an extensive pipeline infrastructure network, and because gas is a fungible commodity, it is not clear how supply could be cut off only to certain buyers along a pipeline route while still allowing other buyers to offtake from the same pipeline infrastructure. It appears likely that Russia contemplated this exact scenario when it stated that, if PGNiG and Bulgargaz nevertheless offtake gas from the pipelines, Russia will reduce deliveries to Europe in the amount of the offtake.

Now what?

The EU immediately responded that the demand for payment in roubles is “unjustified and unacceptable” and “shows once again the unreliability of Russia as a gas supplier.” However, the EU has also not yet put forward a clear, consolidated view on how the issue should be addressed, leaving importers to bear the risk of determining how to proceed at this critical time.

As a legal matter, whether the currency of payment provisions in a contract can be unilaterally changed depends on the language of the contract. Most long-term contracts, however, require that any changes to the contract need to be agreed, made in writing, and signed by an authorised representative of both parties. Further, most contracts specifically identify the currency in which gas is priced, invoiced and paid (usually euros or US dollars). They also typically specify how payment will be made – usually in a point-to-point transfer from the buyer to the seller, to an account often identified in the contract.

A change to the contract stipulating that payment is only effected once roubles are received by the seller would constitute a contractual amendment if the contract previously provided that invoices were to be paid in euros. Equally, a change to the contract stipulating that payment must be made in a multistep process involving a currency exchange between a first and second transfer of funds between buyer, intermediary and seller would represent an amendment if the contract previously provided for a point-to-point transfer between the buyer and a designated bank account of the seller. Where a contract provides that amendments must be made in writing and signed by both parties, an amendment to currency or payment mode, imposed unilaterally rather than mutually agreed, would not constitute an effective amendment of the contract.

Nevertheless, for European importers, the critical question is whether the gas that they are entitled –and, indeed, obliged – to offtake under their long-term contracts will continue to flow. Russia’s curtailment of gas flows to Poland and Bulgaria may serve as a warning signal to other importers if they fail to comply with a proposed unilateral amendment to their contractual terms, whereupon their gas flows could be terminated.

What options does an importer have?

Given the current state of play, what are the options for a European importer?

- **Accept new terms** – An importer can accept the new payment terms of the Decree and amend its long-term contract accordingly. This approach, however, risks running afoul of the EU, which has issued a preliminary analysis stating that these new payment terms breach EU restrictive measures. It also opens the door to potential currency and exchange risk issues in the future, depending on how the situation develops.
- **Refuse new terms**—An importer could refuse a unilateral amendment to contractual payment terms and risk its gas supplies being cut off in the same way that Poland and Bulgaria have experienced, thereby jeopardising its supply security. Where a contract is toward the end of its expiration date and the importer does not intend to renew it, this option might provide greater flexibility.
- **Find a middle ground** – An importer could try to craft a middle-ground approach, which internal EU guidance appears to encourage. In essence, subject to different nuances and finessing, the buyer could effectively participate in the new payment scheme but declare payment to be effected upon receipt of euros into the Gazprombank account rather than upon conversion of the funds into roubles. This is likely to lead to an "agreement to disagree" between buyer and seller as to when the payment has actually been effected: on the date that the initial euros transfer is effected or later once the funds have been exchanged and roubles are received in the seller's account. Although an uneasy compromise, this approach may continue to respect a party's contractual rights while still receiving gas and preserving supply stability. How long such a compromise may last, however, depends on how the situation develops, both on the EU and Russian sides.

What if gas is turned off by the Russian counterparty?

Where an importer does not accept the new payment scheme and where no compromise can be reached, what happens if Russia nonetheless turns off the gas taps?

An importer's options will depend on the specific language and governing law of its contract. As a general matter, however, several options may be available.

- **Contract termination** – The analysis of whether contract termination is available depends on the wording of the contract and its governing law. Many long-term gas import contracts do not have express termination provisions. However, many long-term contracts in Europe importing Russian gas are subject to civil law and the UN Convention on Contracts for the International Sale of Goods (CISG). Under the CISG, at a high level, a contract may be terminated by the buyer where the seller fails to perform obligations that amount to a fundamental breach of contract. In general, sustained failure to deliver gas under a contract, the object of which is gas delivery and offtake, would rise to the relevant level.

- **Specific performance** – Article 46 of the CISG also allows a buyer to require a seller to specifically perform its obligations. In the current situation, however, there are serious questions about whether specific performance can actually be enforced, where a counterparty has already unilaterally cut off gas supply to other importers.
- **Damages** – An aggrieved buyer may seek damages under Article 74 of the CISG if the seller fails to perform any of its obligations arising under the contract. An order for damages would likely have better potential for enforcement given the likely existence of assets found in different jurisdictions. Some contracts, however, expressly limit the possibility or amount of damages.

At the same time, a buyer that seeks to make payment pursuant to the payment mechanism stipulated in their long-term contract—rather than the new mechanism set forth in the Decree—may be unsuccessful in making such a payment because of the actions of its counterparty. For example, the counterparty might close its account nominated in the contract, instruct the receiving bank to reject such a payment, or the receiving bank may refuse payment. Any buyer will want to avoid a counterclaim by the counterparty that it has breached the contract by failing to effect payment for gas already delivered and offtaken.

One procedure that a buyer could use to try to safeguard its rights and its position under the contract is to commence a procedure for an emergency arbitration under the institutional rules of the relevant arbitral institution identified in its contract. Both the ICC International Court of Arbitration and the Arbitration Institute of the Stockholm Chamber of Commerce – two arbitral institutions often selected by parties to long-term European import contracts – offer procedures for parties seeking urgent temporary relief. This procedure offers a short-term solution for parties that are unable to wait for the constitution of an arbitral tribunal, which often takes a number of months. Any emergency measure granted would be in the form of an order or an award. Enforcement of such an emergency order, however, could prove difficult.

In the end, however, whether Russian gas supplies will continue to flow to Europe is perhaps more a practical and political question than a legal or contractual one. Legal tools can be limited in the situation where a counterparty seeks to single-handedly change a contract and is willing to stop performing without such a change being agreed and effected. There is also the question of how armed conflict in and around key areas of gas transit infrastructure in Ukraine, through which Russia pipes much of its gas exports to Europe, will impact gas flows. Indeed, Ukraine announced yesterday that it would suspend a significant portion of gas flows passing along one of its transit routes. Nevertheless, there are still avenues for importers to pursue to secure their rights, position, and economics. The starting point is a firm grasp of one's contractual rights and the availability of other commercial and political mitigation options to manage the supply uncertainty.