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WHITE PAPER

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The War in Ukraine and the Consequences for the European Gas Market: New Russian Sanctions a Tit for Tat? Not Quite

European energy companies face unprecedented uncertainty as a result of Russia's invasion of Ukraine. As noted in our last *White Paper*,[1] many countries have progressively imposed increasingly significant sanctions on Russia and Belarus. These have included targeted sanctions on Russian institutions, state-owned enterprises and political elites, restrictions on debt and equity instruments, as well as a broad range of other restrictions that impact the energy sector, including import and export controls (with, most recently, the European Union's introduction of a phased prohibition on the import of crude oil and certain petroleum products from Russia into the European Union on June 3, 2022).

Since the publication of our *White Paper* on the ripple effects on the downstream European gas market[2] in early May 2022, the Ukrainian government announced it would suspend the transportation of Russian gas through its eastern Luhansk region and shift volumes to run through the Sudzha interconnection point instead. Thereafter, the Russian government announced its own counter-sanctions program, initially targeting 31 energy companies worldwide, including former Gazprom-related companies now under German state trusteeship.

This *White Paper* explores recent developments involving the transportation of Russian gas through Ukraine, Russian counter-sanctions, the potential effects of these developments on the mid- and downstream gas markets in Continental Europe, as well as potential legal remedies that some market participants may need to consider.

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A RAPIDLY CHANGING STATUS QUO

At the beginning of May, we addressed the ripple effects that a reduction or cessation in Russian gas supplies would have on the European gas market and outlined relevant scenarios for market participants to consider. Since that publication, two significant events have occurred in rapid succession.

First, on May 10, 2022, Ukraine announced that it would suspend the transport of Russian gas through pipelines located in the eastern Luhansk region, which is now controlled by Russian forces.

Second, on May 11, 2022, Russian authorities announced an additional round of counter-sanctions on 31 global energy companies. These Russian counter-sanctions have potential implications for the mid- and downstream markets, and companies targeted include corporations in the European Union, the United States, and Singapore.

SUSPENSION OF GAS TRANSPORTS THROUGH PARTS OF UKRAINE

Gas deliveries through Ukraine, until recently, have continued unabated despite the conflict. One third of Russian gas delivered by Gazprom to Europe flows through Ukraine, amounting to approximately 40 billion cubic meters annually.[3] This gas is delivered to onward destinations such as Moldova, Hungary, Slovakia, the Czech Republic, Austria, Italy, and Germany. Daily, around 32.6 million cubic meters of gas flow through the transit system in the Luhansk region.[4]

However, on May 10, 2022, Ukraine stated that it would halt transport through the Sokhranivka route / Novoposkov compressor station effective 7:00 a.m. local time on May 11, 2022 (relying on a declaration of *force majeure*), and would temporarily shift quantities to flow through the Sudzha interconnection point instead.[5]

While the shift announced will not affect the domestic Ukrainian market, it is likely to impact the European market, particularly if it results in an overall reduction in gas supplies.[6] As an example, Naftogaz, the Ukrainian state-owned energy company, has predicted that gas flows to Europe could fall by one third if flows are not diverted to the alternative route through the Sudzha interconnection point.[7]

If gas supplies to Continental Europe drop as a result of this shift, contractual performance may be affected at all levels of the market, including delivery contracts between Gazprom and European importers and contracts between those importers and buyers further downstream.

There likely will be a range of arguments and claims raised by market participants, including impossibility, illegality, *force majeure*, and hardship. However, we caution that each individual situation will need to be assessed on the facts and circumstances of each case and in the specific context of the parties' contractual relationship.

A CLOSER LOOK AT RUSSIA'S COUNTER-SANCTIONS

Russia has imposed a range of counter-sanctions in response to sanctions imposed by the West. In this *White Paper*, we focus on one set of Russian counter-sanctions relating to the energy sector, which appear to be primarily aimed at ensuring Russia continues to receive payment for its gas (and oil) exports, notwithstanding the significant Western sanctions that would otherwise prohibit those payments. In particular, Russia has issued counter-sanctions requiring payment in Russian Roubles, which has the effect of consolidating its gas supply business by eliminating foreign-controlled middlemen. There is also a suggestion that Russia may seek to frustrate newly proposed EU gas storage requirements.

Payment in Roubles

On March 31, 2022, Russia issued Decree 172 setting forth "the special procedure for the fulfillment by foreign buyers of obligations to Russian natural gas suppliers," which became effective on April 1, 2022. That decree requires payment for Russian natural gas supplies to be made in Roubles if:

- Deliveries were made under "foreign" (meaning non-Russian) trade contracts;
- With foreign (again, non-Russian) persons; and
- Supplied to "foreign states that commit unfriendly actions" against Russia, its legal entities, and individuals.[8]

Gas importers in what have been termed "unfriendly" countries—including all EU Member States, the United States, and the United Kingdom—are required to pay for Russian-supplied natural gas in Roubles for deliveries from April 1, 2022.[9] In the event that European-based buyers do not comply with this decree, Gazprom is then generally prohibited from delivering gas to such buyers.[10]

This decree thus placed any European-based buyer of Russian gas in a bind. In its initial guidance published on April 21, 2022,[11] the European Commission announced that any European-based buyers of Russian gas who might consider paying in Roubles would likely face an immediate issue under the sanctions regime of the European Union. The reason for this assessment was that initially, any such Roubles payment (made in accordance with the Russia counter-sanctions) appeared inevitably to involve the Russian Central Bank, through a number of transactions linked to the management of the Central Bank's assets and reserves, or could be regarded as the provision of new loans to the Russian Central Bank, which had been prohibited under the EU sanctions since February 23, 2022.

However, on May 4, 2022, a further Russian decree was issued that purports to exclude any transactional role for the Russian Central Bank or any other third party and is being promoted by the Russian government as a way for legal transfers of payment for gas supplied to Continental Europe.[12] The current proposed payment scheme instead involves GazpromBank, an entity that has been exempted from European sanctions for most of its activities, as well as a payment structure via an intermediary.

Specifically, the Russian decree provides for the payment of any existing gas supply contracts with affected buyers, by the buyer first depositing "foreign" funds (i.e., U.S. Dollars or Euros) in special "K" accounts at GazpromBank. The deposited amount will then be converted to Roubles via the Moscow

Stock Exchange and then transferred to the Russian seller. It is only at that point in time that payment by the buyer will be considered finally concluded.[13] In its FAQs on gas imports, the European Commission has stated that the sanctions “do not prohibit opening an account with GazpromBank.”[14]

Whether and to what extent European gas importers will comply with the new Rouble-payment decree, and how Gazprom will react if they do not, remains very unclear.[15]

As of May 19, 2022, news reports suggested that roughly half of Gazprom’s customers had opened “K” accounts with GazpromBank.[16] It has been reported that the European Commission communicated new written guidance to Member States that does not explicitly mention that opening an account in Roubles would be a violation of EU sanctions, but that buyers are advised against this course of action—raising the possibility of future sanctions and/or enforcement action for affected buyers.[17]

As of the writing of this *White Paper*, it has been suggested that Gasum, the Finnish-owned energy company, does not intend to comply with the Rouble payment decree. As a result, Gazprom reportedly stopped deliveries to Finland on May 21, 2022.[18] Gasum announced on May 17, 2022, that it has initiated arbitration against Gazprom.[19] Likewise, reports on May 31, 2022, indicated that Russia would suspend some exports to Germany after Shell Energy Europe notified that it would not make payments in Roubles.[20] By June 1, 2022, reports indicated that some supplies were cut to Denmark and the Netherlands.[21]

At the same time, Eni and Naftogaz have also indicated they are considering bringing claims in arbitration against Gazprom.[22]

These dual Russian decrees implicate a number of issues for market participants, including whether the Roubles-payment obligation constitutes a material change in contractual terms (because these gas supply contracts typically require payments in U.S. Dollars or Euros) and whether European importers can comply with the latest decrees without violating sanctions or breaching their back-to-back commitments with their buyers further downstream.

It is clear that the decisions that are being made in the upstream import market will also impact the markets further downstream [see above].

Prohibition of Foreign Transactions with Persons Under Sanctions

On May 3, 2022, Russia issued yet another decree that authorizes the Russian government to approve a list of “sanctioned persons” within 10 days, and prohibits Russian persons and entities from undertaking certain transactions with such sanctioned persons. Such prohibited transactions include:

- The conclusion of foreign trade contracts;
- The fulfillment of obligations (including under already concluded foreign trade contracts);
- Certain financial transactions; and
- The export from Russia of products and/or raw materials when the production and/or extraction was carried out in Russia and supply is to a sanctioned person or through a sanctioned person for the benefit of another person.[23]

Identification of “Sanctioned Persons” Under the Russian Counter-Sanctions

On May 11, 2022, through Decree 851, Russia identified various “sanctioned persons.” Among the 31 companies it listed are the owner of the Polish part of the Yamal pipeline as well as entities such as Gazprom Germania and WINGAS in Germany, WIEE in Hungary, Gazprom Switzerland in Switzerland, Vemex in the Czech Republic, and WINGAS Benelux in the Netherlands, Belgium, and Luxembourg.[24]

Many of the sanctioned intermediaries are members of an international group of companies related to Gazprom Marketing & Trading Ltd., which, in turn, is owned by Gazprom Germania GmbH. The latter company has been under the trusteeship of the German Federal Network Agency since its divestment from the St. Petersburg-based Gazprom Export Business Services on March 31, 2022.[25]

WHAT EFFECT WILL RUSSIA'S COUNTER-SANCTIONS HAVE AND HOW WILL THEY IMPACT GAS SUPPLIES?

Impacts on Gas Importers

Russia's latest counter-sanctions do not apply to many of the incumbent European gas importers that have contracts directly with Gazprom, including Uniper, Eni, Engie, OMV, etc. Importantly, the counter-sanctions do not in any way impact Gazprom's obligations under the long-term gas supply agreements concluded with these large-volume gas importers. These contracts remain in place and are currently being performed.[26] Contracting with Gazprom directly also remains possible as companies that are not on the sanctions list are not prevented from concluding new supply agreements with Gazprom. Some European energy companies, however, have voluntarily announced that they will not enter into new contracts for gas with Russian entities.[27]

Rather, the main targets of Russia's counter-sanctions are former European subsidiaries of Gazprom, especially those affiliated with Gazprom Germania. Many of these companies have been direct importers of Russian gas and themselves have downstream delivery obligations both to other members of the group and to independent customers. As Gazprom Germania is now under the trusteeship of the German Federal Network Agency, the affiliated companies are no longer directly controlled by Gazprom, which might be the reason why they were included on Russia's list.

Under the new counter-sanctions, Gazprom will no longer be allowed to perform existing contracts or enter into new agreements with the sanctioned companies. The affected companies thus most likely will not receive Russian gas and, to fulfill existing contracts with downstream buyers, will need to obtain replacement gas from other sources, if possible. If they are unable to obtain gas from alternative sources, they may be unable to secure enough to meet their contractual obligations.

In this situation, the former subsidiaries of Gazprom that now fall under the list of sanctioned companies may have legal remedies against their former parent company. In adhering to these recent sanctions, Gazprom may have to seize supplying the undertakings concerned and can be expected to rely on impossibility. As to whether or not the undertakings concerned have legal remedies in the case of a cessation of supplies will depend on the actual terms of the supply agreements as well as the applicable law.

Market participants should consider a range of options to the extent they are affected by this fast-moving situation. We emphasize that these high-level summaries will need to be tested against the specific legal and factual matrix for any particular contract or situation. Strategies to consider may include one or more of the following:

- **Acquiescence**. Companies may simply accept the current situation and seek to continue business as usual—this is likely to be challenging in the medium to long term.
- **Renegotiation**. Parties may seek to renegotiate their various contractual relationships.
- **Price Reviews.** If the events discussed above lead to an increase in the price for natural gas beyond that which was foreseen, and to the extent that the contractual balance is not maintained, parties may seek to engage in formal price reviews (either through negotiations and/or arbitration).
- **Suspension.** A suspension of the contract due to hardship or *force majeure*. These are common contractual components exempting parties from liability for a failure to perform their obligations during the duration of the event and in some circumstances permitting termination of the contract. In addition to these two provisions, parties may seek to reach a separate agreement on suspension.
- **Termination**. In exceptional circumstances, depending on their terms, contracts may be terminated by either party without reference to otherwise applicable termination dates and notice periods. Whether such circumstances exist will depend on the facts and circumstances of each individual case. Recovery of resulting losses (damages) may still be permitted.
- **Damages.** Affected companies may seek to recover any losses from the nonperforming party/party in breach. This includes, for example, the scenario under which the sanctioned importer would obtain gas from another source. Alternatively, if the downstream partner were forced to obtain gas directly from another supplier because of the sanctioned importer's inability to provide gas, it too could seek compensation for additional costs, and should do so vis-à-vis the sanctioned importer. Damages could be sought irrespective of whether contracts are performed, partially performed, suspended, or terminated.

- **Arbitral Procedure.** Depending on the contractually applicable arbitration rules and the *lex arbitri*, parties may seek to resolve their dispute through fast-track proceedings and/or proceedings before an emergency arbitrator. While such arbitrations will most likely not secure gas flows, they could lead to the recovery of monetary damages (see above).

Potential Further Restrictions on Filling Storage

Although we are not aware of any formal legislation,[28] Russian agency Interfax has reported that Russian gas exporters will be prohibited from filling European gas storage facilities.

If put in place by Russia, it is possible such a restriction could jeopardize new mandatory EU storage obligations. The newly proposed EU Regulation on gas storage would require each Member State to meet minimum filling targets, i.e., binding targets for the filling level of storage facilities for non-liquefied natural gas.[29] Currently, the proposed regulation would require storage facilities in each Member State to be filled to 80% of capacity by November 1, 2022, and to 90% of capacity in all subsequent years.[30] However, as the addressees of these storage filling targets are Member States rather than individual companies, energy companies cannot be held responsible under the proposed regulation if they are unable to fill European gas storages due to the Russian sanctions.

OUTLOOK AND CONCLUDING REMARKS

In conclusion, the risk of disputes arising due to these recent developments remains high, although each matter must be assessed on a case-by-case basis.

The suspension of gas transports through parts of Ukraine has led to considerable uncertainty, as it is unclear whether Russia will accept the situation and what the legal consequences will be if it ceases deliveries.

As for the consequences of the Russian decree demanding payment in Roubles, the next period will be crucial. It remains to be seen which European companies will comply with the proposed new payment mechanism.

Finally, the Russian counter-sanctions against 31 energy companies may lead to a shortage of available natural gas, at least in the short term, which could make compliance with the new EU gas storage requirements difficult. Both importers and downstream companies should consider their legal rights and remedies if deliveries are stopped or reduced.

In short, the situation is evolving rapidly and highly politicized. Parties are advised to seek the assistance of experienced counsel when planning their mitigation strategy and managing any disputes that may arise as a result of Russian ripple effects due to their latest retaliatory sanctions.

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Jones Day is not qualified to advise on matters of Russian law; the summaries presented herein are for information only, may not be a complete summary, and do not constitute Russian law advice.

ENDNOTES

1 *See* Jones Day *White Paper*, "Impact of Global Sanctions Regimes Relating to Russia, Ukraine, and Belarus."

2 *See* Jones Day *White Paper*, "The War in Ukraine: Downstream Ripple Effects on the European Gas Market."

3 *See, e.g.,* Stephen Mufson, "Ukraine's pipelines are still carrying Russian gas to Europe," *The Washington Post*, March 28, 2022.

4 *See, e.g.,* Pavel Polityuk and Susanna Twidale, "Ukraine to halt key Russian gas transit to Europe, blames Moscow," Reuters, May 10, 2022.

5 *See, e.g.,* Pavel Polityuk and Susanna Twidale, "Ukraine to halt key Russian gas transit to Europe, blames Moscow," Reuters, May 10, 2022.

6 Whether GTSOU, the Ukrainian state-owned pipeline operator, can shift flows to another route has been questioned. *Id.*

7 *See, e.g.,* "Ukraine Suspends Some Russian Gas Flow, Blaming Interference of Occupying Forces," Radio Free Europe/Radio Liberty, May 10, 2022.

8 Decree of the President of the Russian Federation No. 172 "On the Special Procedure for the Fulfillment by Foreign Buyers of Obligations to Russian Natural Gas Suppliers" dated March 31, 2022, Article 1(a).

9 "Unfriendly countries" include: all the EU Member States, the United States, the United Kingdom, Australia, Albania, Andorra, Canada, Iceland, Liechtenstein, Micronesia, Monaco, New Zealand, Norway, South Korea, San Marino, North Macedonia, Singapore, Taiwan, Ukraine, Montenegro, Switzerland, and Japan. *See* Order of the Government of the Russian Federation No. 430-p dated March 5, 2022.

10 The decree includes the possibility for an exemption granted by the Russian government, but does not include details on this derogation.

11 "Frequently Asked Questions on Gas Imports Concerning the Russian Presidential Decree No. 172 of 31 March," European Commission, April 21, 2022.

12 Decree of the President of the Russian Federation No. 254 "On temporary measures for servicing financial obligations with some foreign creditors in the corporate sphere," May 4, 2022.

13 Decree of the President of the Russian Federation No. 172 "On the Special Procedure for the Fulfillment by Foreign Buyers of Obligations to Russian Natural Gas Suppliers," dated March 31, 2022, Article 7. Involving an intermediary and requiring currency conversion adds risk for buyers that was not foreseen in their original contracts. These risks include those associated with a third-party intermediary and potential delays in making payments.

14 *See* "Frequently Asked Questions on Gas Imports Concerning the Russian Presidential Decree No. 172 of 31 March," European Commission, April 21, 2022.

15 The contracts provide for payment after the delivery month, with payments for April 2022 set to take place toward the end of May 2022. Exceptions to this common contractual payment provision were the Polish and Bulgarian import contracts, which required payment in advance. Deliveries under those two contracts were suspended by Russia in April 2022. *See* "Ukraine war: Russia halts gas exports to Poland and Bulgaria," BBC, April 27, 2022.

16 Nastassia Astrasheuskaya, "Half of Gazprom's gas buyers open accounts at Gazprombank," *Financial Times*, May 19, 2022.

17 Kate Abnett and Francesco Guarascio, "EU lets gas buyers decide on rouble accounts, but "advises" against it," Reuters, May 19, 2022.

18 Terje Solsvik, "Russia stops gas flows to Finland over payments dispute," Reuters, May 21, 2022.

19 "Finland's Gasum to take Gazprom Export to arbitration over payments," Reuters, May 17, 2022.

20 *See* Anna Cooban, "Russia is about to shut off some of Germany's gas," CNN, May 31, 2022. If suspended in their entirety, this quantity would total up to 1.2 bcm annually, a fraction of the 95 bcm Germany consumes annually. *Id.*

21 Anna Cooban, "Why Russia isn't hurting even as it cuts off Europe's gas," CNN, June 1, 2022.

22 Jack Ballantyne, "Gazprom faces first arbitration over roubles demand," *Global Arbitration Review*, May 18, 2022.

23 *See* Decree of the President of the Russian Federation No. 851 "On Measures to Implement Presidential Decree No. 252 dated 3 May 2022," May 11, 2022.

24 *See* Decree of the President of the Russian Federation No. 851 "On Measures to Implement Presidential Decree No. 252 dated 3 May 2022," May 11, 2022.

25 Specifically, in March 2022, Gazprom announced the sale of shares in Gazprom Germania to a company based abroad, without obtaining the prior notification and examination as required under German law. In response, the German Federal Ministry for Economic Affairs and Climate Action appointed the Federal Network Agency, the independent German regulatory authority, as trustee over Gazprom

Germania for a transitional period until September 30, 2022. The trusteeship became effective on April 4, 2022. *See* website of the German Federal Network Agency.

26 *See* discussion above regarding May payments for April deliveries. Whether and to what extent parties may choose to voluntarily exit their agreements is not yet known on the market.

27 *See*, for example, website of Uniper (referring to long-term contracts).

28 As of May 13, 2022.

29 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2017/1938 of the European Parliament and of the Council concerning measures to safeguard the security of gas supply and Regulation (EC) n°715/2009 of the European Parliament and of the Council on conditions for access to natural gas transmission networks, COM/2022/135 final. The European Parliament and the Council reached an agreement regarding the proposal on May 19, 2022.

30 Member States can use a variety of measures to implement these targets, including imposing an obligation to store minimum volumes of gas in storage facilities on gas suppliers.